Two Noteworthy Delaware Court Rulings on Controlling Stockholder Transactions

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The Delaware Court of Chancery recently issued two important decisions regarding controlling stockholder transactions. In re CNX Gas Corporation Shareholders Litigation[1] *concluded that a proposed two-step freeze-out transaction is subject to the entire fairness standard (as opposed to the deferential business judgment rule) unless the tender offer is both recommended by a special committee of independent directors with the authority to negotiate with the controlling stockholder and has a majority-of-the-minority tender condition. In* Gentile v. Rossette,[2] *a controlling stockholder/director was found personally liable for participating in a debt conversion that was found to be unfair in price and process. Directors involved in controlling stockholder transactions should be mindful of the "unified" standard announced in* CNX *and the lessons of* Gentile.

In re CNX Gas Corporation Shareholders Litigation

In *CNX*, CONSOL Energy, Inc. pursued a two-step merger transaction to acquire its subsidiary, CNX Gas Corporation, by commencing a tender offer to be followed by a short-form merger. In the transaction, CNX Gas stockholders were entitled to receive the same price for their shares under either step. Consummation of the tender offer was subject to a non-waivable condition that a majority of the outstanding minority shares be tendered.

Before commencing the tender offer, CONSOL executed a tender agreement with T. Rowe Price Associates, Inc., the largest minority stockholder of CNX Gas, that obligated T. Rowe Price to tender its shares. CNX Gas then formed a special committee to evaluate the tender offer. The special committee did not

[1] *In re CNX Gas Corp. S'holders Litig.,* 2010 WL 2291842, C.A. No. 5377-VCL (Del. Ch. May 25, 2010).
[2] *Gentile v. Rossette,* 2010 WL 2171613, C.A. No. 20213-VCN (Del. Ch. May 28, 2010).

have authority to negotiate the terms of the offer or to consider alternatives, and it later determined to remain neutral on the tender offer.

Noting that the applicable standard of review is a "much debated issue," Vice Chancellor Laster adopted additional requirements for the business judgment rule to apply to a controlling stockholder's acquisition of a controlled subsidiary through a tender offer followed by a short-form merger. Under the *CNX* "unified" standard, the business judgment rule would apply only if the tender offer were: (1) affirmatively recommended by a special committee of independent directors possessing the same authority as a board facing a third-party transaction *and* (2) subject to approval by a majority-of-the-minority stockholders. If either protective device is lacking, the transaction would be reviewed for entire fairness (fair dealing and fair price)—a more difficult standard to satisfy. The *CNX* ruling is significant because unless both special committee approval (with the committee empowered to negotiate alternatives) and a majority-of-the-minority condition are present, the entire fairness standard will apply.

In *CNX*, the tender offer failed to satisfy the unified standard because the special committee did not recommend in favor of the transaction. Even though this alone was sufficient to end the analysis and trigger entire fairness review, the fact that the special committee did not have the same authority as a board in a third-party transaction provided a separate and independent basis to trigger entire fairness review. Vice Chancellor Laster also questioned the effectiveness of the majority-of-the-minority condition, as T. Rowe Price's position on the transaction was hedged by virtue of its interests in CONSOL.

Notwithstanding the adoption of the "unified" approach to the CNX transaction, the court nonetheless declined to enjoin the tender offer because no irreparable harm was threatened. CONSOL committed to the same price per share on the short-form merger as on the tender offer, and no doubt had been cast on CONSOL's ability to satisfy a damages award.

CNX conflicts with a line of Delaware Chancery decisions, including *In re Cox Radio, Inc. Shareholders Litigation*,[3] issued mere weeks before *CNX*. These cases hold entire fairness review inapplicable where: (a) the tender offer is "non-coercive," defined to include a non-waivable majority-of-the-minority condition; and (b) independent directors are permitted to make an informed recommendation and provide fair disclosure. *CNX* goes further in requiring that the special committee affirmatively recommend the transaction, in addition to possessing the authority both to negotiate with the controlling stockholder and to pursue alternatives.

CNX also highlights a tension between the rules governing one-step and two-step controlling stockholder transactions. Under *Kahn v. Lynch Communication Systems, Inc.*,[4] courts review one-step mergers for entire fairness; the burden of proving unfairness shifts to the plaintiff if the merger was approved by either a special committee of disinterested and independent directors *or* by a majority of minority stockholders. In contrast, two-step transactions are subject to a less onerous but evolving standard of review, with *CNX* providing the latest link in the evolutionary chain. *CNX*'s "unified" standard attempts to reconcile this tension, but final resolution (if any) will require a decision from the Delaware Supreme Court.

[3] *In re Cox Radio, Inc. S'holders Litig.*, 2010 WL 1806616, C.A. No. 4461-VCP (Del. Ch. May 6, 2010).

[4] *Kahn v. Lynch Commc'n Sys., Inc*., 638 A.2d 1110 (Del. 1994).

Gentile v. Rosette

Unlike *CNX*, the court's decision in *Gentile* breaks no new legal ground. However, it does serve as an important reminder to controlling stockholders and boards of directors of the possible ramifications that may arise from an improperly structured controlling stockholder transaction.

In *Gentile*, the founder and former executive and director of an unprofitable software company brought suit against two directors, one of whom was also a controlling stockholder, alleging that the directors violated their fiduciary duties by approving a debt conversion involving the controlling stockholder. In the four years leading up to the conversion, the controlling stockholder made substantial investments in the company, which resulted in his owning 61% of the company's equity. Pursuant to the debt conversion, the company and the controlling stockholder agreed that the stockholder would convert $2.2 million of debt into shares of the company at a price of $0.05 per share, resulting in the controlling stockholder's owning 95% of the company's equity. Six months later, the company merged with a privately held competitor that unfortunately filed for bankruptcy within several months of the acquisition.

The *Gentile* court quickly determined that the debt conversion should be reviewed under the entire fairness standard because the controlling stockholder implemented a process without any real negotiation as to price and the board acted without benefit of a special committee or any independent legal or financial guidance.

The court made a number of useful observations in reviewing the fair dealing and fair price components of the entire fairness standard. First, the court noted that the board could not be deemed to have been independent and disinterested when it approved the agreement because, at best, the two-person board had been evenly divided between conflicted and non-conflicted members. While the board could have attempted to remedy this conflict by establishing a special committee consisting of the one potentially disinterested board member, the court noted that no such attempt had been made. In addition, the court noted that the one potentially non-conflicted member of the board did not receive any independent legal or financial guidance in considering the transaction.

Second, in ruling that the price component of the debt conversion had also been unfair, the court found particular relevance in the fact that the controlling stockholder had, less than one year earlier and simultaneously with entering into the debt conversion agreement, agreed in separate transactions to a price ten times higher than the price agreed to in the debt conversion. In addition, while not dispositive as to the question of fair value at the time the debt conversion was entered into, the fact that the controlling stockholder was also willing to purchase shares at $0.50 per share provided compelling evidence that the agreed-upon $0.05 per share price was not fair.

Having determined that both process and price were unfair, the *Gentile* court next addressed whether the directors were entitled to exculpatory protection from personal liability for money damages caused by their breach of fiduciary duty. The court held that the non-controlling stockholder director was entitled to the protection of Section 102(b)(7) of the Delaware General Corporation Law, noting that he had received no personal benefit from the debt conversion and was, at most, guilty of breaching his fiduciary duty of care. More significantly, the controlling stockholder was not afforded the same benefit, as the court determined that he breached his fiduciary duty of loyalty by using his position as controlling stockholder to direct the debt conversion, with its unfair price and process, for his own personal benefit.

CNX Considerations and *Gentile* Lessons

The "Unified" Standard for Freeze-out Transactions by Controlling Stockholders is Likely to Remain Uncertain Until the Delaware Supreme Court Addresses the Issue Definitively. As *CNX* and other cases note, the standard of review in two-step controlling stockholder transactions is evolving and debated. Until the Delaware Supreme Court clarifies this area, the transactional costs of satisfying the *CNX* standard should be weighed against the litigation costs of satisfying entire fairness review if the forum court applies the "unified" standard of *CNX*. Entire fairness review sharply decreases, if not eliminates, the likelihood of obtaining a dismissal on the pleadings, even if the burden under that standard is shifted to the plaintiffs. The attendant costs and risks of litigation should therefore be considered when structuring a transaction of this nature.

A Board Reviewing a Controlling Stockholder Transaction Such as Debt Conversion Should Consider Using a Special Committee and Independent Legal and/or Financial Advisors. A board of directors should consider delegating to a special committee consisting of independent directors the authority to approve a controlling stockholder transaction such as a debt conversion where there is a potential for self-dealing. The special committee's mandate should be clear and sufficiently expansive and distance should be maintained between the special committee and the controlling stockholder. In addition, the special committee should undertake a comprehensive analysis and have the ability, absent special circumstances, to control timing and process and negotiate the terms of the transaction. Further, the special committee should be authorized to select its own financial and/or legal advisors who are free from relationships that could compromise their independence. A fairness opinion can assist a special committee in its evaluation of a proposed controlling stockholder transaction.

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