Deal dynamics with controlling shareholders

BY DOUG RAYMOND

Ed. Note: For the Year in Review issues we give our *Directors & Boards* "Legal Brief" columnist Doug Raymond the "if you could pick just one" challenge. That is, we ask him to highlight a court ruling from the past year that he feels is of particular consequence to a board's decision-making considerations and fiduciary obligations. The case he selected is *In re CNX Gas Corporation Shareholders Litigation*, a decision rendered on May 25, 2010, in the Delaware Court of Chancery that highlights the position of minority stockholders in a freeze-out transaction.

Doug Raymond: The target's directors should have independent advisors and sufficient time and authority to explore other options.

Directors of a company with a controlling shareholder and directors of a company that is a controlling shareholder should know that they have essentially two different ways to freeze out minority shareholders of a Delaware company and take a target company private: (i) a negotiated merger between the controlling stockholder and target company in which the target merges with an entity wholly-owned by the controller, and (ii) a unilateral tender offer. The first approach requires a merger agreement negotiated by a special committee of the board with independent advisors and approved by a majority (or more, depending on the company's charter) of the target's stockholders. The second approach, the tender offer, can be initiated unilaterally by the acquirer and, so long as less than 10% of the shares remain minority-held following the tender offer, a "short-form" merger can be effected by the controlling stockholder without any input from the target company's board, or its other shareholders, to complete the transaction.

Recent Delaware case law adds a layer of complexity to the choice between these two approaches. If challenged in court, the negotiated merger transaction will be reviewed under the entire fairness doctrine. This is a factually intensive review of both the procedural and substantive fairness of the transaction. Importantly, because of its factually intensive nature, such lawsuits generally cannot be resolved on a motion to dismiss, instead requiring a full trial to adjudicate.

Being prepared to defend such a lawsuit requires precise attention to detail and a commitment to weather protracted litigation, and provides no guarantees of ultimate success. By contrast, if certain procedural elements are included in the tender offer transaction, the business judgment rule, a much more deferential standard, may apply, and any legal challenges may be resolved much earlier on a motion to dismiss.

Regardless of the approach, once a transaction is launched, all parties generally have an interest in getting a deal done. Accordingly, the important questions to consider when choosing a form of transaction are: how difficult will it be to obtain the necessary shares to effect a short-form merger; is it possible for a few shareholders to block a transaction; and if minority shareholders or the target's board of directors do object to the transaction, what would be the likely consequence — all weighed against the need of the controlling shareholder for detailed due diligence or other provisions typically available in negotiated transactions.

A majority holder who is very familiar with the company and holds a sizable block of the stock may be better off using a unilateral tender offer approach, particularly if it is willing to offer an attractive price to the other stockholders. Under these circumstances, chances of reaching 90% and being able to effect the short-form merger may be pretty good and, assuming the minority block is not concentrated, the minority holder's or the target board's ability to oppose the deal is minimal. A court's willingness to second-guess such a transaction under business judgment rule review should be limited.

On the other end of the spectrum, a controlling stockholder holding a smaller block, or offering a less attractive price, may find it difficult to achieve the threshold necessary for a short-form merger, even if the minority holdings are diffuse. Negotiated transactions can provide greater certainty that the transaction will be completed, and can also provide the opportunity for extensive due diligence and protection in the form of representations and warranties.

The latest Delaware case discussing these transactions, *In re CNX Gas Corporation Shareholders Litigation*, builds on earlier case law and offers a road map to business judgment rule review of a unilateral tender offer transaction. Because the Delaware Supreme Court has not commented on this fact pattern, *CNX* is just the latest case of several to provide such analyses, not the final word. But until the Delaware Supreme Court speaks to the issue, *CNX* makes clear that the following steps, if taken, will make a unilateral tender offer difficult to attack in a Delaware Court:

1. The controlling shareholder should act unilaterally.

2. The tender offer should be conditioned on (i) the target's board recommending the offer, and (ii) a majority of the minority tendering. There should also be a commitment to promptly execute the short-form merger if the tender offer is successful and there should not be any retributive threats in connection with the offer.

3. The independent directors of the target company should have independent advisors and sufficient time and authority to negotiate and explore other options, including the authority to take defensive action.

4. Sufficient disclosure should be made to allow the minority's review of the transaction to be informed.

Experienced counsel can flesh out the details involved in these requirements. While no transaction structure fits all cases, and the choice of structure will very much depend on the facts, *CNX* makes the unilateral tender offer and subsequent short-form merger a transaction structure worth considering for freeze-out transactions.

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