DELAWARE COURT OF CHANCERY ARTICULATES NEW STANDARD FOR GOING PRIVATE TENDER OFFERS: *IN RE CNX GAS CORP.*

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To Our Clients and Friends:

The Delaware Court of Chancery has articulated a new standard applicable to going private tender offers by controlling stockholders. In *In re CNX Gas Corp. Shareholder Litigation*, C.A. No. 5377 (May 25, 2010), Vice Chancellor Laster held that the business judgment rule applies to a controlling shareholder going private tender offer only if the deal is conditioned on *both* (a) the affirmative recommendation of a special committee empowered to negotiate the transaction *and* (b) the approval by holders of a majority of the shares held by unaffiliated stockholders. If either prong is not satisfied, the transaction is subject to entire fairness review. The standard adopted by Vice Chancellor Laster is not entirely novel: it was proposed by Vice Chancellor Strine in *Cox Communications* as a way to unify the divergent strands of Delaware case law on going private transactions – those applying entire fairness in the case of mergers (such as *Kahn v. Lynch)* and those applying the much less stringent business judgment review in the case of unilateral tender offers (such as *Siliconix*).

In reaching his holding, Vice Chancellor Laster declined to follow the standard originally enunciated by Vice Chancellor Strine in *Pure Resources* (see Going Private the *Pure* Way), and recently followed by Vice Chancellor Parsons in *Cox Radio*, under which a unilateral tender offer by a controlling shareholder is subject to the business judgment rule if it (i) is subject to a non-waivable majority of the minority tender condition, (ii) includes a promise by the controlling shareholder to complete a prompt short-form merger if it obtained 90% of the shares and (iii) involves no retributive threats by the controlling shareholder if the offer fails. According to Vice Chancellor Laster, one of the cornerstones on which the *Pure Resources* decision was based – the holding in *Solomon v. Pathe Communications* that the maker of a tender offer has no duty to offer a fair price – is shaky because *Solomon* did not involve a freeze-out transaction by a controlling shareholder.

The *CNX* decision arose from the decision of CONSOL Energy, Inc., a publicly traded company and the owner of over 80% of the common stock of CNX Gas, to take the company private by means of a tender offer to be followed by a short-form merger. The largest minority holders of CNX Gas were funds managed by T. Rowe Price, which collectively owned approximately 6.5% of the company's stock. CONSOL negotiated an agreement with T. Rowe Price under which the T. Rowe Price funds would commit to tender into an offer commenced by CONSOL at a price no less than $38.25 per share (a 46% premium over the closing price on the day before CONSOL announced its intention to take CNX Gas private).

Thereafter, the CNX Gas board formed a one-person special committee consisting of its only independent director. The special committee was authorized to evaluate the tender offer, prepare a Schedule 14D-9 and hire advisors, but not to negotiate the terms of the offer or consider alternatives. The special committee specifically requested the addition of an additional director, and sought authority to consider alternatives and to exercise the full powers of the board in responding to the offer, but these requests were declined. The committee's financial advisor believed that the $38.25 was fair, but probably not the highest price CONSOL was prepared to pay. The committee tried to negotiate a higher price, was rebuffed and, in the end, determined to remain neutral with respect to the offer rather than recommend acceptance or rejection.

Applying the "unified standard" suggested in *Cox Communications*, Vice Chancellor Laster held that the plaintiffs were likely to prevail on the merits. In articulating this standard, Vice Chancellor Laster tightened the test described in *Cox Communications* in a small but important manner, requiring that the special committee affirmatively approve the transaction rather than merely, as in the earlier decision by Vice Chancellor Strine, not recommend against it. Since the special committee in this case remained neutral, and did not recommend that the CNX Gas shareholders accept the CONSOL tender offer, the court concluded that CONSOL was obligated to pay a fair price.

Although the court held that the failure of the special committee to approve the CONSOL tender offer was sufficient to subject the transaction to entire fairness review, the court went on to raise questions as to both the authority granted to the special committee and the effectiveness of the majority of the minority tender offer condition. Vice Chancellor Laster stated that a special committee should be granted "authority comparable to what a board would possess in a third-party transaction," and that the failure to do so may be sufficient to subject a transaction to the entire fairness test. This authority would include, in the court's view, the ability to adopt a poison pill, as well as the power to sue the controlling shareholder. Vice Chancellor Laster was untroubled by the fact that *Pure Resources* had rejected a claim that a subsidiary board breached its duties by not giving a special committee power to block an offer by adopting a poison pill, noting that subsequent cases had upheld the use of a poison pill against a controlling shareholder.

Finally, because funds managed by T. Rowe Price held a substantial position not only in CNX Gas but also in CONSOL, the court stated that the funds were indifferent to the allocation of value between CNX Gas and Consol. This, in the court's view, called into question the effectiveness of the majority of the minority test unless these shareholders were excluded from the equation. Although Vice Chancellor Laster determined that he did not have to rule definitively on this question, he asserted that such a ruling would not open the door in future cases to a general inquiry into other investments held by institutional shareholders and their motivations for tendering into or voting for a transaction. He pointed out that not only did

the T. Rowe Price funds constitute the largest minority shareholder of CNX Gas, controlling 37% of its public float, but also CONSOL had specifically "put the focus on T. Rowe Price and its cross-ownership" by pre-negotiating the terms of the tender offer with it rather than with the special committee. Nonetheless, it seems inevitable that parties seeking to challenge going private transactions will latch onto the court's discussion to argue for the exclusion of significant shareholders from majority of the minority tests where they can discover facts – whether cross-shareholdings, hedging arrangements or other circumstances – that arguably affect those shareholders' voting and tendering decisions.

Despite holding that the CONSOL tender offer was subject to review under the entire fairness standard, Vice Chancellor Laster ultimately declined to issue an injunction, finding that the offer was not structurally or substantively coercive and that there was no showing that money damages would be an insufficient remedy.

Vice Chancellor Laster acknowledged that the decision not to follow *Pure Resources* is at odds with the recent decision of the Chancery Court in *In re Cox Radio Litigation* (Del. Ch. May 6, 2010). However, he said that the choice among the applicable strands of cases "implicates fundamental issues of Delaware law and public policy that only the Delaware Supreme Court can resolve." Until that happens, however, controlling shareholders cannot be confident in relying on *Pure Resources* to avoid a fully empowered special committee while still escaping entire fairness review of a going private tender offer.

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