

ENTIRE FAIRNESS AS A LIMIT ON CONTROL
Delaware Further Erodes the Business Judgment Rule in
Transactions with Controlling Stockholders

Two recent cases out of Delaware stress that dealings with controlling stockholders continue to trigger a heightened level of review. These cases, one involving a debt-for-equity conversion in a privately held distressed company and the other involving a freeze-out merger, highlight the Court of Chancery's continued insistence that boards prove the entire fairness of transactions with controlling stockholders—the board's sound business judgment will often not suffice to preclude liability.

The court underscored its view that such transactions must withstand the heightened scrutiny of entire fairness review, which forces the board to show both fair dealing and a fair price, even if a company faces significant distress, as was the case in *Gentile v. Rossette*.¹ Similarly, mere review of freeze-out transactions by a special committee no longer satisfies the court if the transactions involve a controlling stockholder. *In re CNX Gas Corporation Shareholders Litigation*² moves beyond recent precedent and establishes that even a two-step transaction triggers entire fairness review unless the transaction received an affirmative recommendation by an empowered disinterested committee of the board in addition to an affirmative vote by a majority of the minority of stockholders.

***Gentile*: Distress Will Not Lower the Standard of Review**

The controversy at the heart of *Gentile* arose from a debt-for-equity conversion that increased the holdings of the controlling stockholder of Single Point Financial, Inc., David Rossette, from 61% to 95%. His loan and investments in SinglePoint had been the troubled company's primary lifeline. SinglePoint's board, consisting of Rossette and one other director, relied on the conversion of Rossette's loans to equity to help strengthen SinglePoint's balance sheet and prepare the company for an eventual sale. The plan appeared to have succeeded, as SinglePoint was sold to a competitor in exchange for stock that same year.

Even though the sale valued SinglePoint's shares generously at \$2.46 per share, its former stockholders soon found themselves empty-handed when the acquirer filed for bankruptcy, which rendered its equity worthless. SinglePoint's minority stockholders filed suit, claiming that the debt-for-equity conversion at \$0.05 per share, and the resulting increase in Rossette's equity holdings, improperly diluted their economic and voting rights. In fact, Rossette himself had

¹ C.A. No. 20213-VCN (May 28, 2010).

² C.A. No. 5377-VCL (May 25, 2010).

participated in option grant valuations that had set the company's share price as high as \$0.75 just weeks before the conversion, and had several months previously negotiated a conversion of a portion of his debt at a share price of \$0.50.

While recognizing that the company's distress left the board with few alternatives in negotiating the terms of Rosette's transaction, the court nevertheless found fault with the fairness of the process, a critical component of any entire fairness review. Although the court acknowledged the lack of leverage held by SinglePoint in respect of negotiating the price per share and other aspects of the transaction, Vice Chancellor Noble nevertheless held that the second director, Douglas Bachelor, breached his duty of care to his minority stockholder constituents when he failed to even put up a fight or exercise any independent judgment. The court found additional fault with the transaction process due to the fact that Bachelor was inexperienced in matters of corporate governance, and "received no independent legal or financial guidance" in evaluating the debt conversion terms. Meanwhile, the influence of the controlling stockholder (as one of only two directors) and his financial interest in the conversion tainted the board's actions with self-dealing. Accordingly, the board's business judgment alone could not legitimize the transaction. Finding the defendants unable to satisfy the entire fairness standard by establishing the fairness of both dealing and price,³ the court held Rosette liable for damages in the amount of \$0.35 per share.⁴

CNX: The Special Committee Must Determine Outcomes

Another instance where the position of minority stockholders has been improved is the Chancery Court's decision in *CNX*, which raised the standard of review for freeze-out transactions that involve controlling stockholders. In the past, a board could avoid entire fairness review by structuring the transaction as a tender offer followed by a short-form merger and securing the approval of a majority of the minority of stockholders. While a special committee of the board needed to review the transaction, it was not required to make a recommendation to the minority stockholders in order to preserve the business judgment standard in the event of later judicial review.

³ The court recognized that certain imperfections in process, such as a single-member special committee, do not necessarily prevent a board from proving fairness in the case of a small and distressed company. However, if the special committee consists of only one director, this member's independence and the transaction review process must be unassailable to lift the taint of self-dealing and restore a board's ability to have its actions judged under the business judgment rule standard of review. The court in *Gentile* felt that SinglePoint's directors provided no evidence that the non-controlling director ever attempted to conduct a thorough or independent analysis.

⁴ Despite his breach of the duty of care, the non-controlling director was protected from personal liability by an exculpatory clause in SinglePoint's certificate of incorporation based on 8 Del. C. § 102(b)(7). Especially in light of the small size of Bachelor's holdings, the court determined that he was not improperly influenced by self-interest, but rather failed to fulfill his duty due to inexperience.

Since the court's decision in *CNX*, however, a company seeking to conduct a two-step freeze-out without triggering entire fairness review must not only allow its special committee to review the transaction, but must also endow it with all of the rights that the board could ordinarily employ in the context of reviewing and responding to an unrelated third-party offer, and the special committee must affirmatively support the tender offer price. The company's board in the case of *CNX* repeatedly rejected the special committee's requests for negotiating powers. Even when the committee's sole member expressed his discomfort with the price attained and refused to recommend the transaction, the controlling stockholder engaged in discussions only tentatively and did not yield on pricing.

Even though the defendants' actions generally could have led to business judgment review under prior precedent, Vice Chancellor Laster determined that the specific facts of the case called for entire fairness, already standard in single-step mergers with controlling stockholders. The board forfeited its leeway under the business judgment rule when it failed to empower the special committee to secure a better price for minority stockholders. It then failed the entire fairness test when it accepted an arguably unfair price despite the withheld recommendation of the special committee. While the court declined to enjoin the tender offer, the board and the two companies to the merger may thus be liable for future damages. *CNX* has generated a great deal of discussion regarding the different standards of judicial review of essentially the same resulting transaction, and it seems increasingly likely that the Delaware Supreme Court will address the issue of these conflicting standards.

The Delaware courts continue to refine the standard of review in transactions with controlling stockholders, but the trend is clear: A board that seeks to avoid the entire fairness standard in these transactions must go to great lengths to show its independence vis-à-vis the controlling stockholder. In a number of recent cases, the Court of Chancery has strongly emphasized the importance of the transaction review process (and put a microscope on deficiencies in specific examples): Special committees must be comprised of truly disinterested directors who are properly empowered and advised to fully review and negotiate the transaction, and who must in turn conduct a thorough and independent review of the proposed transaction. Controlling stockholders should therefore prepare for increasingly difficult transactions with their controlled corporations, as disinterested board members become more vigilant in fighting the stain of self-dealing in order to avoid entire fairness review. From a broader perspective, *Gentile* and *CNX* evidence the continuation of a worrisome trend in Delaware decisions from the perspective of controlling stockholders and preferred stockholders, as the last twelve months have seen not only these cases but also *Trados*,⁵ *LC Capital*⁶ and *Fletcher*,⁷ in which the rights of such stockholders have been narrowed, and their transactions placed under increased scrutiny.

⁵ *In re Trados, Inc. Shareholders Litigation*, C.A. No. 1512-CC (July 24, 2009).

⁶ *LC Capital Master Fund, Ltd. v. James*, C.A. No. 5214-VCS (March 8, 2010).

⁷ *Fletcher International, Ltd. vs. ION Geophysical Corporation*, C.A. No. 5109-VCP (May 28, 2010).

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September 2, 2010

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