HUNTON & WILLIAMS

# Client Alert

June 2011

**Contacts**

**Richmond**

Gary E. Thompson
gthompson@hunton.com

Steven M. Haas
shaas@hunton.com

**Atlanta**

G. Roth Kehoe II
rkehoe@hunton.com

## Delaware Court Addresses Revlon Duties in Mixed Consideration Mergers

In *In re Smurfit-Stone Container Shareholder Litigation*, decided in late May 2011, the Delaware Court of Chancery held that Revlon duties apply to a merger where the consideration is split evenly between cash and stock in the acquiring company. The court reasoned that, because half of the stockholders' investment was being liquidated, the court would apply intermediate scrutiny to determine if the directors obtained the best price reasonably available. The court refused to grant the plaintiff's motion for a preliminary injunction against the merger, however, finding that the plaintiff was unlikely to prove that the directors breached their fiduciary duties. The decision adds additional jurisprudence for mixed consideration transactions and also illustrates helpful practice points for conducting a sale process.

*Background*

Smurfit-Stone ("Smurfit") was a publicly-traded Delaware corporation that emerged from bankruptcy in June 2010. Facing an uncertain future, Smurfit explored various options going forward, including a number of potential divestitures. It was also seeking a permanent CEO. In September 2010, Smurfit was approached by a private-equity firm interested in a potential recapitalization or acquisition. Although Smurfit's CEO initially responded that the company was "not for sale," the board of directors authorized preliminary discussions and directed management to lead the due diligence efforts.

Ultimately, the board of directors formed a special committee, composed of all the company's directors except for its two insiders, to oversee the sale process. The special committee, in turn, formed a "subcommittee" to "oversee the deal process on a day-to-day basis." The special committee also retained its own outside legal counsel and financial advisors. The special committee determined that the private-equity firm's offer of $29.00 per share was inadequate and, although the special committee indicated its openness to a higher offer, the private-equity firm withdrew its interest.

In late 2010, Rock-Tenn expressed interest in a potential stock-for-stock merger-of-equals. Rock-Tenn's initial proposal provided for an all-stock, no-premium transaction. After several rounds of negotiation overseen by the special committee, however, Smurfit entered into a merger agreement with Rock-Tenn providing for a 27% premium over Smurfit's then-current trading price. In addition, the merger consideration would be split equally between cash and Rock-Tenn stock. Smurfit stockholders would own approximately 45% of the combined company after closing. The merger agreement contained several reciprocal deal-protection provisions, including a customary no-shop clause with a fiduciary out, a three-day matching right period, and a termination fee equal to 3.4% of Smurfit's equity value.

*The Court's Decision*

The central question in *Smurfit-Stone* was whether the transaction should be judged under the deferential business judgment rule or *Revlon*. Under *Revlon*, courts will apply intermediate scrutiny to determine whether directors acted reasonably to maximize stockholder value. These so-called "*Revlon* duties" are triggered where, among other things, the transaction constitutes a "change in control."

Prior Delaware courts have reasoned that *Revlon* does not apply to a stock-for-stock merger where ownership of the post-merger company lies in a fluid, unaffiliated group of public stockholders since there is no change in control.[1] Where merger consideration consists of a mix of cash and stock, however, the threshold for triggering *Revlon* has been unclear. In *In re Santa Fe Pacific Corp. S'holder Litig.*, 669 A.2d 59 (Del. 1995), for example, the Delaware Supreme Court did not apply *Revlon* to a transaction in which 33% of

[1] In contrast, where the combined company would have a controlling stockholder, *Revlon* applies to the transaction because it may be the last opportunity for the target stockholders to realize a premium for the sale of their shares.

the consideration was cash. In contrast, the Delaware Court of Chancery in *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720 (Del. Ch. 1999), assumed *Revlon* duties would apply where stockholders could elect to receive up to 62% of the merger consideration in cash.

Faced with this precedent, the *Smurfit-Stone* court held that Revlon duties apply where, as in the Smurfit-Stone/Rock-Tenn merger, at least 50% of the merger consideration consists of cash. While admitting its holding was "not free from doubt," the court reasoned that "there is no 'tomorrow'" for half of each stockholder's investment in Smurfit, thus justifying intermediate scrutiny of transactions that constitute "an end-game for all or a substantial part of a stockholder's investment in a Delaware corporation." The court was not persuaded that, with respect to the other half of the Smurfit stockholders' investment, such stockholders would be entitled to a control premium in any future sale of the combined company: "Even if Rock-Tenn has no controlling stockholder and Smurfit-Stone's stockholders will not be relegated to a minority status in the postmerger entity, half of their investment will be liquidated."

Having decided that the business judgment rule was inapplicable, the court then held on the preliminary record that the plaintiffs were unlikely to prove that Smurfit's directors had breached their *Revlon* duties. First, the court noted that all but two of Smurfit's directors were independent and disinterested. Second, the court observed that those independent directors formed a special committee that hired outside financial and legal advisors. Third, the court found that, on the preliminary record, the directors appeared to have acted reasonably in negotiating with Rock-Tenn and not conducting a broader canvass of the market. In that regard, the court confirmed long-established Delaware precedent that directors are not required to engage in a pre-signing market check so long as they have reliable information on which to judge the transaction. Here, the court noted, among other things, that Smurfit dealt with Rock-Tenn and the private-equity firm and had held various discussions during its bankruptcy with potential acquirors. In addition, Smurfit believed the market viewed it as a potential takeover candidate, yet no other interested parties had emerged.

Next, the court held that the plaintiffs were unlikely to prevail in their challenge to the deal protection provisions—namely, the no-shop provision, the three-day matching right and the 3.4% termination fee. The court recognized that not only were these provisions reciprocal, but that they also were standard among public company merger agreements. Moreover, the court observed that, "in an effort to entice an acquirer to make a strong offer, it is reasonable for a seller to provide a buyer some level of assurance that he will be given an adequate opportunity to buy the seller, even if a higher bid later emerges."

Finally, the court found that the plaintiff was unlikely to prevail in its challenge to management's involvement in the sale process, notwithstanding certain change-in-control benefits that Smurfit's two senior executives would receive if the transaction was consummated. The court found that the special committee was aware of the potential conflict of interest and took an active role in the process. It also found that senior management participated primarily in exchanging due diligence information.

*Implications*

*Smurfit-Stone* provides that, in mixed consideration transactions, a 50/50 mix of cash and stock will trigger *Revlon* duties. This leaves open the question of whether *Revlon* applies to a mixed consideration transaction that provides for a smaller cash component, although the Delaware Supreme Court's decision in *Santa Fe* suggests that 33% cash would be insufficient to warrant intermediate scrutiny. Notably, a different member of the Court of Chancery reached a result similar to *Smurfit-Stone* in a January 2011 transcript ruling in *Steinhardt v. Howard-Anderson*, which garnered surprisingly little attention. There, however, the court reasoned that *Revlon* applies in a 50/50 cash/stock merger because, with respect to the stock consideration, the target's directors had a duty to "maximize the [target stockholders'] relative share of the future entity's control premium." This analysis stands in contrast to prior Delaware decisions and might suggest growing scrutiny of stock-for-stock deals, but this analysis was not adopted by the *Smurfit-Stone* court.

The decision also reveals further doctrinal complexities applicable to mixed consideration transactions. For example, in Smurfit-Stone, there was no collar on the exchange ratio and, due to an increase in Rock-Tenn's stock price, the cash component of the consideration had fallen to 44%—a fact noted by the defendants in arguing for business judgment rule protection. The court held, however, that it would judge whether Revlon applies by focusing on the merger consideration as of the signing of the merger agreement. This raises an interesting question as to how a court would respond to a transaction with a relatively low cash component at signing that, due to price movements in the company's stock, increased to 50% or more of the total consideration at closing.

Aside from its doctrinal implications, *Smurfit-Stone* offers some specific takeaways regarding the target company's sale process. With respect to its special committee, the court approvingly noted the following:

- the special committee formed a more nimble subcommittee to oversee the transaction "on a day-to-day basis because of [the non-executive chairman's] belief that the process should be driven by the Company's outside directors;"
- the special committee "made clear that potential acquirers needed to direct their communications and inquiries to the outside directors, through [the special committee's] financial advisor;"
- the special committee held "regular and robust discussions" to independently vet management's financial projections to guard against overly conservative projections that might tilt the board's decision toward a sale[2]; and
- the special committee, which "was assertive and apparently devoid of undue influence by management," created a record of negotiation and push-back against potential acquirors in seeking better terms for the company.

As noted above, the special committee consisted of all the board members except for its inside members. Alternatively,

[2] Notably, in the recent decision of *In re Orchid Cellmark Inc. S'holder Litig.*, 2011 WL 1938253 (Del. Ch. May 12, 2011), the Court of Chancery rejected a challenge to a decision made by independent directors to disregard management's projections that may have been overly optimistic where there was concern management might have been resisting a sale.

the independent directors could have operated at the board level and requested the insiders to recuse themselves and also have formed a special committee in lieu of the subcommittee.

The special committee also imposed limitations on senior management's involvement in the sale process, as certain managers stood to receive significant change-in-control payments that were set to expire if the merger was not consummated. Those limitations included:

- Smurfit's management participated in the special committee's meetings only to provide updates on negotiations and other business matters and were not present for the special committee's deliberations;
- management was involved "primarily in the due diligence aspect of the sale process and only took actions in this capacity that were expressly authorized by the Committee;"
- the special committee's financial and legal advisors were the "primary negotiator for many of the substantive terms of the Merger Agreement;" and
- the preliminary record showed that the special committee was aware of management's conflict but believed those managers had "an intimate knowledge of the Company" and were "better equipped to effectively and efficiently negotiate due diligence matters with Rock-Tenn than the nonemployee directors."

Finally, *Smurfit-Stone* affirms the long-standing Delaware principle that "there is no single blueprint" for fulfilling a board's *Revlon* duties. In this case, the board's decision not to conduct a pre-signing market check appears to have been made after reviewing the following factors:

- the burden of dealing with multiple bidders;
- the risk of information leaks by involving more parties in the sale process; and
- potential negative effects on customers, suppliers, employees and overall company morale if the sale process was made public.

The board's decision was also influenced by several unique factors. First, the company's stand-alone strategy arguably remained viable, such that a leak could have harmed the company's prospects. It also might have harmed the company's efforts to hire a permanent CEO. Second, the directors believed the market already viewed Smurfit as a takeover target such that potential acquirors should already have been on notice. Third, the directors viewed the company's recent bankruptcy process as the "functional equivalent" of a market check due to discussions held with potential acquirors during that process. While this third factor was not dispositive to the court, these facts should be contrasted with *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007), where the court held that plaintiffs had a reasonable probability of success in proving the directors breached their *Revlon* duties. Of particular note, *Netsmart* held that "sporadic chats" over a period of years between possible buyers and the target's CEO and investment banker were "hardly the stuff of a reliable market check." Thus, *Smurfit-Stone* is a helpful reminder that these factors are contextual, and illustrates the numerous considerations that come into play when determining how to conduct a sale process.

If you have any questions about this case or other matters of corporate law, please contact Gary Thompson at (804) 788-8787 or gthompson@hunton.com, Roth Kehoe at (404) 888-4056 or rkehoe@hunton.com, Steven Haas at (804) 788-7217 or shaas@hunton.com, or your Hunton & Williams LLP contact.