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Delaware Court Applies Revlon To "Hybrid" Merger And Provides Guidance

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The Delaware Court of Chancery on May 20 rejected a challenge to the merger of Smurfit-Stone Container Corp. with Rock-Tenn Corporation.[1] The challengers sought to delay the stockholder vote by claiming that a 50% cash / 50% stock merger was subject to strict judicial scrutiny under the *Revlon* line of cases and that for several factors, including failure to hold an auction either pre- or post-announcement, the court should enjoin the transaction. With respect to the first contention, the court agreed with the challengers and applied enhanced scrutiny to the "hybrid" merger. Despite applying an "enhanced scrutiny" standard, however, the court was unwilling to set aside decisions it found were made by informed, active and independent directors.

Background

Delaware courts will generally defer to disinterested directors' decisions and not substantively review board decisions or substitute the court's own judgment, so long as the court can discern a rational business purpose for the decision. However, Delaware courts scrutinize, and will impose a duty of reasonableness on, the board's actions under the *Revlon*[2] line of cases in at least three scenarios: "(1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company; (2) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control".[3] Where *Revlon* applies, a board faces a duty to maximize the price available to stockholders.

In evaluating whether a board met its duty to maximize stockholder value, courts "(1) make a determination as to whether the information relied upon in the decision-making process was adequate and (2) examine the reasonableness of the directors' decision viewed from the point in time during which the directors acted."[4] As part of gathering adequate information to maximize the price available to stockholders, some have understood *Revlon* to require a board to conduct a more or less formal auction process before selling the corporation. However, recent Delaware precedent has indicated that the *Revlon* standard does not make an auction a necessary ingredient in an adequate decision-making process.[5]

The *Smurfit-Stone* Transaction

The *Smurfit-Stone* court was asked to apply these principles to a "hybrid" merger involving stockholder consideration paid 50% in cash and 50% in stock which was approved after approximately one month of negotiation. The board did not conduct a formal auction or marketing process, apparently relying on the directors' own business experience, including the experience gained through

the corporation's recent bankruptcy, strategic review and prior unsuccessful negotiations with an unsolicited bidder, and concluding that the risks of performing a "market check" outweighed the benefits. Smurfit-Stone had a board composed almost entirely of independent, experienced businessmen who had assumed their positions in June, 2010 when Smurfit-Stone exited Chapter 11. The new board had received and discussed a study of strategic alternatives which recommended partial divestitures and cost reductions. While these were being considered, the board was approached about a possible investment by a private equity firm and initially expressed no interest in a sale. After rejecting a proposed recapitalization, the board received an acquisition proposal at $29 per share which was considered with the help of newly engaged legal and financial advisors, but ultimately rejected.

The prospective acquirer declined to increase its $29 per share offer, but a few days later Rock-Tenn emerged as a potential acquirer, initially proposing a no-premium stock-for-stock merger. After being advised a proposal would be more attractive if it involved a premium and a cash component, Rock-Tenn proposed a $30.80 per share transaction, half stock and half cash, ultimately increased in stages to $35 per share after negotiations, which the *Smurfit-Stone* board accepted. The challengers argued that the stockholder consideration offered in the merger was inadequate and the process was flawed, because the merger was too hastily approved without a pre-signing auction or market check and provided the buyer unreasonably stringent deal protection measures.

Issues and Decision

The parties vigorously disagreed about whether *Revlon* applies to a 50% stock transaction and, if so, whether its requirements were met. The court decided that *Revlon* applied, but that the Smurfit-Stone board met its *Revlon* duties, even without a market check. The court acknowledged that its decision likely was not the last word on whether *Revlon* applies to a hybrid stock and cash deal, but the court's decision nonetheless provides important guidance and may shift analysis in a "hybrid" deal by augmenting "change of control" analysis with whether a "substantial part" of a holder's investment is cashed out.

How Does *Revlon* Apply To "Hybrid" Deals?

Revlon can apply even if the board has not actively put a company on the market or decided to abandon a long-standing strategy and seek a sale in response to an unsolicited bid. The *QVC*[6] case had established that even in all-stock mergers, if a "change of control" left holders as minority holders in a company with a dominant holder, the duty to maximize the price arose, but later cases had not identified the standards applicable to a "hybrid" cash-stock transaction. Some cases interpreting *QVC* had focused on the post-merger market for the stock part of the consideration in determining whether a change of control had occurred. *In re Santa Fe Pac Corp. Shareholder Litigation*[7] was a Delaware Supreme Court case in which stockholders had the option to tender up to 33% of the shares for cash, but no holder was forced to tender and at least 67% of the consideration was stock. The *Santa Fe* court declined to apply *Revlon*, discussing mainly that control of the combined company would remain in a "large, fluid, changeable and changing market." *Smurfit-Stone* looked for guidance to *In re Lukens*[8], in which up to 62% of the consideration could have been cash, and an unreported case involving 56% stock and 44% cash.[9] In those cases the courts had relied on exculpatory provisions in the corporate charters to dismiss damages claims, and did not rule on the *Revlon* issue. In *Lukens*, the court suggested in a footnote that *Revlon* probably applied to a 62% cash transaction even though the stock component comprised shares in a widely held company but held that even if *Revlon* applied, the case would be dismissed.

The *Smurfit-Stone* court was influenced by the percentages of cash in *Sante Fe* (33%) and *Lukens* (62%), and it did not distinguish those cases based on the voluntary nature of the cash component in those cases. Instead, as in *Lukens*, the court noted that "hybrid" merger transactions at least partially deprive stockholders of the chance for continued growth because part of their investment is cashed out. The *Smurfit-Stone* court carefully noted that prior cases gave no definitive guidance, but felt that plaintiffs would likely establish that a 50% cash deal called for additional scrutiny, because for 50% of each stockholder's investment there was no "tomorrow."

Stating that the merger constitutes an "end-game" for a substantial part of a stockholder's investment, the court focused more on the need to protect the "portion of the stockholder's investment that will be converted to cash and thereby be deprived of its long-run potential" than on what a "change of control" meant with respect to the stock component. This concern prevailed over defense assertions that, because both pre- and post-merger, the *Smurfit-Stone* stockholders held an interest in a public company with a large, fluid and changeable market, there was no "change of control." In the court's view, the portion of each investment that had no long-term potential was a more relevant inquiry.

How Can A Board Fulfill Its *Revlon* Duties? Is A Market Check Necessary?

In a development more encouraging for boards of directors, the Chancery Court followed a line of Delaware cases rejecting a rigid requirement for an auction or "market check" when a company is sold.[10] Pointing out that the so-called *Revlon* duties are not a fixed set of requirements, the court set out to determine (1) whether the information the board relied upon was adequate, and (2) whether the board's decision was reasonable.

The court's analysis of the adequacy of the information the board considered is intermixed with discussion of the board's independence and its control of the process, but in the end the court held that even without a formal "market check," the board had relied on adequate information in its decision-making process. Specifically, the court cited the prior "strategic" study, the board's review of potential transactions studied before the company exited bankruptcy, the board's familiarity with the market for the company, the use of outside advisors, the experience gained in the rejected proposal for a sale at $29 per share, and the board's consideration of the risks involved in conducting an auction (i.e., information leaks and delay) as supporting the reasonableness of approving the merger and deciding that a "market check" was not needed.

The court also examined the conduct of the board of directors and, focusing on the largely independent nature of the board, its entirely independent special committee and their vigorous control of the decision-making process, concluded the decision had sufficient "indicia of reasonableness" to be accepted. The court's willingness to accept the directors' response to the Rock-Tenn proposal, despite the short timeframe, was enhanced by the fact that there were previous negotiations about the earlier proposed private equity transaction. The court cited with approval the board's previous demonstration of concern for stockholder interests in rejecting an offer at $29 per share by the unnamed private equity bidder and earlier offers from Rock-Tenn at $30.80 and $32 per share, and concluded the board acted reasonably. While this acceptance did not amount to applying the business judgment rule because the court examined the board's processes, it was certainly not a *de novo* or "strict scrutiny" review.

The end result of the court's decision seems to be that Delaware courts will probably scrutinize board actions which result in a merger or sale that cashes out a "substantial part" of the holders' investment (with at least 50%, but maybe less being "substantial"), even if the surviving corporation is widely held. But the enhanced scrutiny applied will accept actions by an independent board that can

demonstrate "sufficient indicia of reasonableness" in gathering and considering information. The court is also unlikely to require a market check as long as it concludes there is a meaningful opportunity for a higher offer to be received and considered by the board in the exercise of its fiduciary duties. Rejecting the plaintiffs' claim that these duties could only be satisfied by a pre-signing auction or by an explicit attempt to seek other offers, the court approved transaction terms which prevented the board from actively seeking a competing transaction while allowing it to accept a superior proposal, even with what the court characterized as "relatively standard" deal protection measures in place.[11]

Conclusion

Although the *Smurfit-Stone* court acknowledged that the issue would likely be resolved or clarified in the future by the Delaware Supreme Court, the court's decision indicates that when stockholder consideration in a merger transaction includes a significant proportion of cash, a court will most likely apply *Revlon*'s enhanced scrutiny standard to the board's decision-making process. Although the court invoked *Revlon* at a 50% cash level, it did not try to state authoritatively what percentage of the consideration must be paid in cash to invoke *Revlon.* Based on its deference to the Delaware Supreme Court's decision in *Santa Fe*, the court probably felt a 30% cash transaction would not be scrutinized.

Even though the decision may broaden the transactions to which *Revlon* applies, the court indicated that complying with *Revlon* may not be as narrow a road as some previously thought. Even under *Revlon*'s enhanced scrutiny, the *Smurfit-Stone* court's willingness to accept decisions of what it regarded as informed, active and independent directors should encourage directors in future situations to be less concerned about the particular steps they take to conclude a transaction is appropriate, as long as they can demonstrate a reasonable and informed basis for believing they understand the market and have allowed for the possibility of a competing transaction. In particular, a market check or auction does not seem to be a necessary step in a board's evaluation if a court is convinced that the board thoroughly considered stockholders' best interests.

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[1] *In re Smurfit-Stone Container Corp. S-holder Litig.*, C.A. 6164-VCP (May 20, 2011). The transaction closed on May 27, 2011.

[2] *Revlon v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173, 180 (Del. 1986); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989).

[3] *Smurfit-Stone*, C.A. 6164-VCP (May 20, 2011) quoting *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42-43, 47-48 (Del. 1994).

[4] *Id.* at page 40 and 41.

[5] See, e.g., *Lyondell Chm. Co. v. Ryan*, 970 A.2d 235, 243 n.28 (Del. 2009).

[6] *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d at 42-43, 47-48.

[7] 669 A.2d 89 (Del 1995).

[8] *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 732 n.25 (Del. Ch. 1999), *aff'd sub nom., Walker v. Lukens, Inc.*, 757 A.2d 1278 (Del. 2000).

[9] See *In re NYMEX S'holder Litig.*, 2009 WL 3206051 (Del. Ch. Sept. 30, 2009).

[10] See, e.g., *Lyondell*, 970 A.2d at 243 n.28. The court also quotes in a footnote *Herd v. Major Realty Corp.*, 1990 WL 212307, at *9 (Del. Ch. Dec. 21, 1990) which says "Revlon certainly does not … require that every change of control of a Delaware corporation be preceded by a heated bidding contest, some type of market check or any other prescribed format."

[11] These measures included a "no-shop" clause, a Rock-Tenn right to match competing proposals and a 3.4% "breakup" fee.