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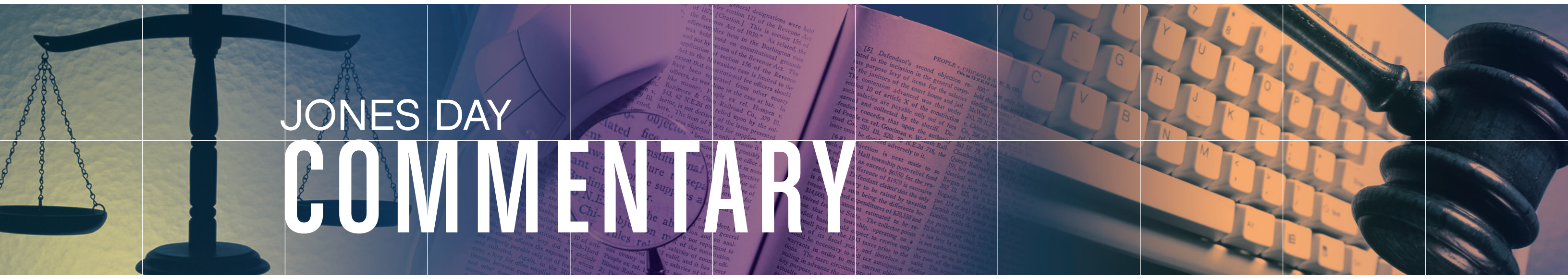

DELAWARE COURT OF CHANCERY CLARIFIES *REVLON* APPLICABILITY IN MIXED-CONSIDERATION TRANSACTIONS

In a shareholder action claiming a target company's board breached its *Revlon* duties, Vice Chancellor Donald F. Parsons, Jr. of the Delaware Court of Chancery recently held the heightened standard of review under *Revlon* applied to a merger where shareholders were to receive 50 percent cash and 50 percent stock for their shares. *In re Smurfit-Stone Container Corp. Shareholder Litigation*, No. 6164-VCP (May 20, 2011). Although the Chancery Court went on to deny injunctive relief, the decision suggests that the *Revlon* standard may now apply to any merger of widely held companies involving a 50 percent or more cash payment to shareholders. This leaves open the question of whether a less substantial cash component would also be subject to the *Revlon* standard.

BACKGROUND

The 50/50 cash/stock offer in *Smurfit-Stone* represented a 27 percent premium to the target's prevailing trading price. Under the proposal, Smurfit-Stone's stockholders would own 45 percent of the merged entity's outstanding common stock. The merger agreement's deal protection provisions included standard "no-shop" and "matching rights" clauses, and a $120 million termination fee that amounted to 3.4 percent of the transaction's equity value.

Plaintiffs claimed the *Revlon* standard applied because (a) the stockholders would relinquish ownership of Smurfit-Stone in favor of a minority stake in the merged entity and (b) the offer's cash portion deprived stockholders of the potential to share in all of the merged entity's future profits. Under the *Revlon* standard, a board's actions are reviewed under the heightened standard of reasonableness and not under the deferential business judgment rule. In addition, when *Revlon* applies, the fiduciary duty of a target board shifts from acting in the best interests of the company to obtaining the best value reasonably available for its shareholders.

The shareholders also asserted that the Smurfit-Stone directors breached their *Revlon* duties by failing to inform themselves adequately about the market, agreeing to restrictive deal protection provisions, permitting members of the Smurfit-Stone management with conflicting interests to participate in the negotiations, relying on an inexperienced financial advisor, and accepting an inadequate price.

THE DECISION

As Vice Chancellor Parsons noted, a pure stock-for-stock merger does not trigger the *Revlon* standard when the ownership shifts from one large unaffiliated group of public shareholders to another because there is no change of control. In an all-stock transaction of this type where there is no resulting majority shareholder, the target's stockholders are not relegated to minority status and are able to participate fully in any future success of the company and any future control premium should the company be acquired later. *Revlon* does apply, however, when stockholders receive only cash because they are foreclosed from deriving any benefit from the merged entity's future profits and will never obtain a control premium in a subsequent transaction. Under settled Delaware law, however, *Revlon* is not triggered simply because the transaction includes some cash. In 1995, the Delaware Supreme Court ruled that *Revlon* did not apply to a 33 percent cash transaction. *In re Santa Fe Pacific Corp. Shareholder Litigation*, 669 A.2d 59, 64-65, 71 (Del. 1995).

Acknowledging that it is unclear precisely when a mixed stock-and-cash merger triggers *Revlon*, Vice Chancellor Parsons held that *Revlon* did apply to a 50 percent cash transaction. Noting that in *In re Lukens Inc. Shareholders Litigation*, 757 A.2d 720, 732 (Del. Ch. 1999), then-Vice Chancellor Stephen P. Lamb held that *Revlon* applied where 62 percent of the transaction was in cash, Vice Chancellor Parsons stated that in a 50 percent cash transaction, there is similarly "no tomorrow" for the cash received by a target's shareholders. The *Smurfit-Stone* court went on to hold that *Revlon* standards did apply, even in the absence of a controlling shareholder in the new entity, because (a) the 50 percent portion of the stockholders' investment that was to be cashed out was substantial, and (b) the transaction in question was marginally closer to the *Lukens* 62 percent cash deal, which was subject to *Revlon*, than to the *Santa Fe* 33 percent transaction, which was not. Still, the court acknowledged that its "conclusion that *Revlon* applies is not free from doubt."

Applying the *Revlon* standard to the facts before it, the court concluded that the Smurfit-Stone board had not breached its duties because it had been adequately informed about the market, the deal protection clauses did not have a preclusive effect, the board acted appropriately throughout the merger process, and the plaintiffs had not shown that the price was inadequate. After finding as well that the plaintiffs did not face irreparable harm and that there was a danger that the stockholders could lose out on the deal altogether, the court denied the request for a preliminary injunction.

As a result of *Smurfit-Stone*, and notwithstanding the criticism of some commentators that the analysis ignores prior Delaware decisions finding that *Revlon* should be inapplicable when control of the combined entity remains in the hands of a fluid public market, it appears that a 50 percent or more cash transaction may now trigger the *Revlon* standard of review. Although there have been no Delaware cases addressing the issue of whether *Revlon* applies to transactions with a 34 percent to 49 percent cash component, the absence of any logical rationale for triggering *Revlon* at levels between 33 percent and 50 percent suggests that, if *Smurfit-Stone* remains good law, a 50 percent cash proportion may ultimately be the minimum at which *Revlon* is triggered. Given the uncertainty in this area, however, we expect that practitioners will continue to advise that a transaction could be subject to *Revlon* unless the cash portion is 33 percent or less and no other *Revlon* factors apply.

OTHER MATTERS

The decision also provides useful perspectives on a target company's shareholder duties in face of a merger offer. In rejecting the injunction, the court addressed a variety of the plaintiffs' claims for fiduciary breach and, among other things:

- The court reiterated that a target company has no specific duty to employ an auction or market check in a

transaction subject to *Revlon*, nor any legal obligation to run a post-signing "go-shop" process in situations in which there is not a pre-signing market check.
- Although the court did not address the decision to form a special committee in response to potential management conflicts resulting from contractual officer payouts triggered by the transaction, this likely was a significant factor in the court's rejection of plaintiffs' argument that management was too heavily compromised to participate in the sales process.

These are important reminders that the analysis will, and should, be driven by the facts and circumstances of the situation, with a board's transaction process being the key.

You can download a copy of the full *Smurfit-Stone* opinion by clicking here.

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