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Delaware Chancery Court Provides New Data Point for Application of *Revlon* Standard to Mixed Stock and Cash Mergers

By Spencer D. Klein and Enrico Granata

In its recent decision in *In re Smurfit-Stone Container Corp. Shareholder Litigation*,¹ the Delaware Chancery Court held that so-called *Revlon* duties were triggered by a merger in which the target shareholders would receive their consideration half in cash and half in stock, with the stock component resulting in ownership of approximately 45 percent of the combined company.²

Under *Revlon*,³ a board's actions are reviewed not under the deferential business judgment rule standard, but rather under a heightened standard of reasonableness. When *Revlon* applies, the board of directors must engage in a process reasonably designed to obtain the best short-term value reasonably available for its shareholders. The Delaware Supreme Court has held that a board might find itself faced with *Revlon* duties in at least three scenarios:

- when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a break-up of the company;
- 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
- when approval of a transaction would result in a sale or change of control.⁴

Delaware courts have long held that transactions where shareholders receive only cash for their shares result in a change of control for *Revlon* purposes. In contrast, the courts have determined that the *Revlon* standard does not apply to a stock-for-stock merger between two publicly traded companies where control shifts from one large unaffiliated group of public shareholders to another.⁵ But in transactions where there is mixed stock and cash consideration, the guidance has been less than clear. The target company in *Smurfit-Stone* had argued that because 50 percent of the consideration

¹ C.A. No. 6164-VCP (May 20, 2011).

² While it was held that *Revlon* duties applied to the case, the Chancery Court found that even though the sale process followed by the board of directors and the special committee was not perfect, it included sufficient indicia of reasonableness under the circumstances to satisfy the *Revlon* requirements.

³ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

⁴ *Smurfit-Stone*, C.A. 6164-VCP at 31 (citing *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 71 (Del. 1995), and *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1289-90 (Del. 1994)).

⁵ *Id.* at 32 (citing *Santa Fe Pac. Corp.*, 669 A.2d at 71 (noting that a corporation does not undergo a change in control where control of the post-merger entity remains in a "large, fluid, changeable and changing market"), *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989), and *Krim v. ProNet, Inc.*, 744 A.2d 523, 527 (Del. Ch. 1999) (noting that *Revlon* "does not apply to stock-for-stock strategic mergers of publicly traded companies, a majority of the stock of which is dispersed in the market.")). A stock-for-stock transaction may still be in *Revlon* territory if the resulting entity has a controlling shareholder or shareholder group such that the target's shareholders are relegated to minority status in the combined entity, since the target's shareholders would be foreclosed from an opportunity to obtain a control premium in a future change-of-control transaction involving the surviving entity.

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consisted of common stock of the acquirer and ownership of the post-merger entity would remain widely dispersed in the public market, the transaction was not a change of control for *Revlon* purposes. Rejecting this argument, Vice Chancellor Parsons noted that the issue was not free from doubt, and that the Delaware Supreme Court has not yet addressed the issue of whether a mixed stock and cash merger constitutes a change-of-control transaction for *Revlon* purposes. However, valuable guidance and data points can be derived from the Chancery Court's decision in *Smurfit-Stone* and other existing case law:

- Transactions where the cash component is equal to or below 33 percent of total consideration should continue to be reviewed under the business judgment rule standard (absent other factors that might otherwise alter the standard, such as a buyout by a controlling shareholder) so long as control would remain in a large, fluid, changeable and changing market after giving effect to the transaction.⁶
- After *Smurfit-Stone*, a transaction where the cash component is equal to or above 50 percent of total consideration may be scrutinized under the *Revlon* standard, even though the acquirer does not appear to have a controlling shareholder or group of shareholders, since it would constitute an end game for a "substantial part" of a shareholder's investment in the target company.⁷
- In determining whether to review a transaction under the heightened standard of reasonableness, courts may also consider the relative voting power of the target shareholders in the resulting entity, and may apply the *Revlon* standard if the transaction could be viewed as the last time the target shareholders have leverage to bargain for a control premium.⁸
- The relative portion of cash and stock will likely be assessed by the courts at the time the parties entered into the merger agreement. In *Smurfit-Stone*, the court refused to take into account the fact that post signing, the fixed exchange ratio of the stock component of the merger consideration had caused the value of the stock portion of the target shareholders' consideration to become considerably greater than the value of the cash portion.⁹
- It remains unclear how Delaware courts will review cases involving cash consideration between 33 and 50 percent of total consideration, as the decision in *Smurfit-Stone* does not articulate a standard of determination for cases below 50 percent.

We caution that most of the above guidance is gleaned from Delaware Chancery Court opinions and is therefore subject to the views of other members of the Chancery Court, as well as the possibility of the Delaware Supreme Court taking a different view if a case involving mixed consideration reaches that court on appeal.

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⁶ *Santa Fe Pac. Corp.*, 669 A.2d 59 at 71.

⁷ *Smurfit-Stone*, C.A. No. 6164-VCP at 36.

⁸ *Steinhardt v. Occam Networks, Inc.*, C.A. No. 5878-VCL (Jan. 24, 2011) (Transcript). In *Occam Networks*, a bench ruling passed earlier this year, Vice Chancellor Laster applied *Revlon* to a transaction with consideration approximately equally split between cash and stock where the target shareholders were to receive 19 percent of equity of the surviving corporation. In doing so, Chancellor Laster reasoned that, given the minority position of the target's shareholders in the surviving entity, the merger transaction was the only time when the target's shareholders would be bargaining for how much of any future control premium they would obtain in connection with a possible sale of the surviving entity.

⁹ It remains to be seen whether Delaware courts will adopt a similar approach when reviewing transactions where the relative portion of cash has increased significantly post signing.

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