

Client Alert

Corporate Practice Group

June 10, 2011

In re Smurfit-Stone Container Corporation Shareholder Litigation *Delaware Court Addresses Important Revlon Duties in Cash/Stock Mergers*

On May 20, 2011, Delaware Vice Chancellor Parsons issued an opinion in *In re Smurfit-Stone Container Corp. Shareholder Litigation*ⁱ addressing important questions under Delaware takeover law: namely, (i) whether an acquisition transaction where the merger consideration consists of roughly 50% cash and 50% acquiror common stock triggers the duties identified in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) and is subjected to heightened scrutiny under *Revlon* and (ii) under circumstances in which *Revlon* is applied, may the target company's board deal exclusively with the acquiror without undertaking an auction or other market check. King & Spalding represented the acquiring entity, Rock-Tenn Company, in connection with both the transaction and the litigation that led to the Chancery Court's ruling.

Background and Arguments

The background of this case centers on the proposed merger of the target company, Smurfit-Stone Container Corporation, with a wholly owned subsidiary of Rock-Tenn Company pursuant to a merger agreement dated January 23, 2011. At the time of signing, the equity value of the transaction was approximately \$3.5 billion, or \$5.3 billion when including net debt and certain pension liabilities to be assumed by RockTenn following the merger. As of the date of the merger agreement, the merger consideration to be delivered in connection with the transaction was split evenly between cash and stock, with each share of Smurfit-Stone common stock receiving in the merger (i) \$17.50 in cash and (ii) 0.30605 of a share of RockTenn common stock, for a value of \$35 per share at the time of execution of the merger agreement. By the date of the Chancery Court hearing, the 50/50 mix of cash and stock consideration had shifted to approximately 44% cash and 56% stock due to the increase in RockTenn's stock price since the announcement of the agreement. At the time of the hearing, it was expected that, if the transaction closed, existing RockTenn shareholders would own approximately 55% of RockTenn and that Smurfit-Stone stockholders would own approximately 45% of RockTenn on a fully diluted basis. Smurfit-Stone used a special committee of independent directors to negotiate the transaction on behalf of the Board.

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Smurfit-Stone and its subsidiaries emerged from bankruptcy proceedings in June 2010. Both shortly prior to and during the bankruptcy proceedings, Smurfit-Stone explored the possibility of an investment transaction or an acquisition or strategic transaction with various third parties, but these discussions did not involve negotiation of specific deal terms and did not yield any specific proposals. None of these third parties was willing to proceed with a transaction. Upon its emergence from bankruptcy, Smurfit-Stone did not adopt various takeover defense measures, and Wall Street analysts periodically speculated that Smurfit-Stone might be a possible takeover candidate. In addition to exploration of a transaction during bankruptcy, Smurfit-Stone explored a potential transaction with a third-party after it emerged from bankruptcy but before it began discussions with RockTenn. Discussions concerning this potential third-party transaction terminated when the third party advised Smurfit-Stone that it was not able to achieve a valuation that would justify a substantially increased price from its preliminary offer of \$29 per share. Shortly after discussions with the third-party terminated, RockTenn contacted Smurfit-Stone to raise the possibility of a transaction. From then forward, Smurfit-Stone did not engage in discussions with any other potential buyer. RockTenn initially proposed an all-stock, no premium transaction. After preliminary discussions with Smurfit-Stone's advisors, RockTenn revised its proposal to a 50/50 mix of cash and stock, with the final negotiated price resulting in a 27% premium to the most recent trading price of Smurfit-Stone stock prior to announcement. The merger agreement contained mutual no-shop provisions with fiduciary outs for superior offers, matching rights in respect of superior offers and a breakup fee of approximately 3.4% of the equity value of Smurfit-Stone (and 2.8% of its total enterprise value).

Soon after announcement of the transaction, a series of putative class action lawsuits were filed by Smurfit-Stone stockholders, alleging, against the directors of Smurfit-Stone, breaches of fiduciary duty and, against RockTenn and its transaction-vehicle subsidiary, aiding and abetting the directors' alleged breach. In addition to requesting monetary relief, the plaintiffs sought a preliminary injunction to delay the closing of the transaction. The cases were largely consolidated in Delaware, where the Chancery Court certified a shareholder class, ordered expedited discovery, and heard argument regarding the plaintiffs' motion for preliminary injunction.

In connection with their preliminary injunction motion, the plaintiffs argued that the transaction represented a change of control of Smurfit-Stone, thereby invoking so-called *Revlon* duties and the associated heightened standard of review contemplated by *Revlon*. The plaintiffs further argued that the Smurfit-Stone board's process for negotiating with RockTenn and considering this transaction fell short of the board's duties under *Revlon*. Specifically, the plaintiffs argued that the board's alleged failure to conduct a market check, combined with the deal protection devices agreed to in the transaction, effectively precluded the emergence of an alternative bidder and limited the board's ability to extract from RockTenn a sufficient price for Smurfit-Stone stockholders.

The defendants argued that *Revlon* did not apply because, among other things, (1) even after the transaction, there would be no controlling shareholder and control of the combined entity would remain in the market; (2) Smurfit-Stone stockholders were to obtain a 45% interest in the combined entity; and (3) half the merger consideration consisted of acquiror common stock. Thus, the defendants contended that the Smurfit-Stone board's actions should be reviewed under the deferential business judgment rule, not *Revlon*. The defendants also argued that even if *Revlon* applied, the board's conduct was appropriate.

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Revlon May Apply to a Merger with 50/50 Cash and Stock Consideration

On May 19, the Chancery Court denied the plaintiffs' motion for preliminary injunction and allowed the transaction to proceed to stockholder vote. The court held that *Revlon* applied to this transaction but ultimately agreed with the defendants that the board's conduct withstood the scrutiny *Revlon* required.

The Chancery Court considered the potential application of *Revlon* to be a novel issue "not squarely addressed" in prior opinions. In resolving the question, the court recognized the longstanding Delaware Supreme Court precedent according to which a stock-for-stock merger between two public companies without a controlling stockholder does not constitute a change of control implicating *Revlon*. As the court noted, in such a transaction, control remains widely held in a public marketⁱⁱ and the target stockholders would not be foreclosed from an opportunity to receive a control premium upon the sale or change of control of the combined company.ⁱⁱⁱ The court also recognized the well-accepted conclusion that an all cash sale unquestionably triggers *Revlon* because it represents the final opportunity for the target stockholders to receive a control premium in connection with a sale of the business. In an all cash sale, the target company stockholders will not participate in the profits of the combined entity following the transaction.

Delaware courts have previously addressed whether *Revlon* applies to transactions where the merger consideration is neither all stock nor all cash in only a few cases. For example, the Delaware Supreme Court has held that *Revlon* does not apply to a transaction where the merger consideration consists of a 67%/33% stock and cash mix. More recently, Vice Chancellor Lamb determined that a transaction with a 38%/62% stock and cash mix, which resulted in public stockholders of the target owning approximately 12% of the acquiror, also triggers the application of *Revlon* duties.^{iv}

In *Smurfit-Stone*, Vice Chancellor Parsons followed Vice Chancellor Lamb's prior ruling and held that the plaintiffs are likely to prevail on their argument that *Revlon* applies to the Smurfit-Stone transaction. Even though the target's stockholders would retain a 45% interest in the combined entity and there was no controlling stockholder, the court held that *Revlon* applied because half of each of the target's investment was liquidated. As such, the court held that the transaction represented an "end-game for all or a substantial part of a stockholder's investment," requiring the application of *Revlon*.

Even After Application of *Revlon*, the Board's Actions Were Likely Reasonable

The court then considered whether the Smurfit-Stone board's conduct was appropriate even under *Revlon*. The Chancery Court emphasized that "reasonableness, and not perfection, is what *Revlon* requires." In addition, the court noted that there is "no single path that a board must follow in order to maximize stockholder value." Applying these principles, the Chancery Court held that the plaintiffs had not shown a reasonable probability of success on their claim that the Smurfit-Stone board breached its fiduciary duties by dealing exclusively with RockTenn and not otherwise conducting an auction process or other market check. According to the court, while the directors have a duty to maximize stockholder value, they have "no duty to employ a specific device such as the auction or market check mechanism." In *Smurfit-Stone*, the directors reviewed and considered a "sufficient amount of reliable evidence" by the time they received RockTenn's best and final offer so that they could reasonably determine that a topping bid was unlikely. Moreover, the directors had sufficient information to determine that the RockTenn bid was superior to remaining a stand-alone company, and, therefore, "the Board reasonably could have sought to sign an exclusive deal with RockTenn to prevent the latter from considering other acquisitions, subject to its fiduciary duties."

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Similarly, the Chancery Court rejected the plaintiffs' claim that the deal protection provisions in the merger agreement were impermissible under Delaware law. The Chancery Court found that the mutual no-shop and matching-rights provisions, along with the termination fee, were "relatively standard" and "have not been shown to be preclusive or coercive, whether they are considered separately or collectively." Even under *Revlon*, the court concluded that agreeing to these provisions was not likely to constitute a breach of fiduciary duty.

Conclusions and Practical Applications

The Chancery Court's determination that *Revlon* duties applied in *Smurfit-Stone* provides an additional data point to practitioners in determining the appropriate legal analysis for transactions involving cash and stock consideration. While the case clearly resolves the question of whether *Revlon* applies to a transaction involving merger consideration consisting of 50% cash and 50% stock, there is still significant uncertainty regarding the application of *Revlon* to transactions with mixed stock and cash consideration. It is not clear that *Revlon* would apply under circumstances in which the cash component of the consideration represents more than 33% of the merger consideration, but less than the 50% at issue in *Smurfit-Stone*. It is also not clear whether the Delaware Supreme Court would endorse the analysis employed by the Chancery Court. Thus, while *Smurfit-Stone* is instructive on *Revlon*'s reach, it does not end the debate.

Beyond the application of *Revlon*, the Chancery Court's decision also reaffirms that *Revlon* does not require a specific course of action. Rather, as the Chancery Court stated in its decision, a board can satisfy *Revlon* only by "follow[ing] a path of reasonableness which leads toward" the end of maximizing shareholder value. Thus, Delaware law does not specifically require boards to employ an auction or other market check in a *Revlon* transaction. So long as the Board makes a reasonable, informed determination that its obligations have otherwise been satisfied in the sale process, the board's actions will withstand scrutiny. Under circumstances in which a target company board has less information regarding market interest or pricing than that of the *Smurfit-Stone* board, an auction or market check device may be appropriate.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.

ⁱ *In re Smurfit-Stone Container Corp. Shareholder Litigation*, C.A. No. 6164-VCP (Del. Ch. May 20, 2011).

ⁱⁱ See, e.g., *In re Santa Fe Pac. Corp. Shareholders Litigation*, 669 A.2d 59, 71 (Del. 1995) (noting that a corporation does not undergo a change in control where control of the postmerger entity remains in a "large, fluid, changeable and changing market"); *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1289-90 (Del. 1994) (same); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989); *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.").

ⁱⁱⁱ See *Arnold*, 650 A.2d at 1290 ("[P]laintiff argues that there was a 'sale or change in control' of Bancorp because its former stockholders are now relegated to minority status in BoB, losing their opportunity to enjoy a control premium. As a continuing BoB stockholder, plaintiff's opportunity to receive a control premium is not foreclosed. Thus, plaintiff's claim that enhanced scrutiny is required under the circumstances of this case lacks merit . . .").

^{iv} See *In re Lukens Inc. Shareholders Litigation*, 757 A.2d 720 (Del. Ch. 1999).