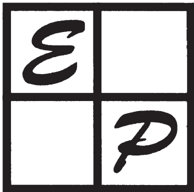

Try a 2012 No-Risk Trial and Get This Issue for Free!

DEAL LAWYERS

*Vol. 5, No. 5* September-October 2011

# The Down Economy: Special Negotiating and Diligence Items to Consider

***By Bryan Davis and Adam Schaeffer of Jones Day[1]***

A down economy presents unique challenges to buyers and sellers in an M&A deal, from identifying the right target and price to getting the transaction to close. This article presents some issues for both sides to consider when investigating and negotiating an M&A transaction in lean economic times. This article was drafted with private-target transactions in mind, but many of the issues presented below are equally applicable in a public-target transaction. While the tips outlined below are applicable regardless of the state of the economy, they are particularly relevant in a downturn or when a downturn is expected.

## Issues for the Buyer

1. Valuation

Valuation is central to any transaction and potential fluctuations in target value due to macroeconomic conditions should be considered during the diligence phase. A buyer should specifically consider whether an economic downturn will affect the multiple at which the target is valued. For example, in the wake of the 2008 economic crisis, buyers saw value erode simply through application of lower valuation multiples across industries.

The buyer also must pay attention to the valuation of individual assets or classes of assets that may be prone to value fluctuation in a volatile market. In a transaction involving a particularly valuable asset (even where the focus of the transaction is not that asset), the buyer should watch for warning signs of a bursting bubble with respect to that asset's market. The most obvious example is real estate. When the real estate bubble burst in 2008, many buyers were left owning acquisition targets with market values far below purchase price because real estate prices plummeted, even where the target's focus was not real estate. Other particular types of assets that may be particularly prone to valuation fluctuation include commercial paper and marketable securities, equipment and tooling, intellectual property, inventory and accounts receivable.

When a significant component of purchase price rests on the valuation of a particular asset, such as with respect to an inventory or equipment valuation, the buyer should negotiate for valuation subject to GAAP or other clear principles, and specify that valuation is at the lower of cost of fair market value. That way, the seller bears the risk of fluctuation in the value of the particular asset.

[1] The views expressed in this article are those of the authors and not necessarily those of Jones Day or any of its clients.

TABLE OF CONTENTS

– The Down Economy: Special Negotiating and Diligence Items to Consider . . . . . . . . . . . . 1
– Changing Due Diligence Practices for Uncertain Times: An In-House Perspective . . . . . . . 5
– Due Diligence: Implications of Dodd-Frank's Whistleblower Provisions for Acquirors. . . . . 8
– $17.50 from Column A and $17.50 from Column B: "50/50 Split" Implicates Revlon . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 12

© 2011 Executive Press, Inc.

DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com
ISSN 1944-7590

Failure to take outside economic conditions into consideration prior to signing a deal may have consequences post-closing. Lower valuation multiples of an acquired target could breach leverage covenants and trigger defaults under the buyer's credit facilities and could, in certain circumstances, result in shareholder dissatisfaction and assertions that the buyer's board overpaid for a target.

2. <u>Business Issues: Supply Chain and Customers</u>

When the economy turns south, vendors and customers may disappear. In addition, if a particular contract has become disadvantageous to a counterparty because of the prevailing economic climate, the counterparty may more aggressively pursue termination or other rights in the event of a prohibited change of control or assignment. Thus, from a business perspective, the buyer should conduct due diligence on whether the business can survive the loss of particular customers or suppliers and whether any material contracts are below market from the counterparty's perspective. In addition, the buyer's counsel should determine whether any default provisions will be triggered as a result of the transaction.

On the business side, the buyer also should pay particular attention to the expected needs of the target's customers in the pre-closing period. The buyer should ask itself whether the target's pricing models will hold up if the target's products have to be sold into a soft market.

A buyer also should confirm whether any of the target's contracts with suppliers contain take-or-pay obligations that would cause the target to pay for supplies or services that are not needed if the business slows. A buyer could find itself in a situation where the target has lost its customers, but it is obligated to pay for services and supplies it cannot use.

3. <u>Third Party Issues</u>

Buyers need to make sure that assets (including assets of the target in a stock deal) are owned by the seller (or target) and free and clear of liens at closing. When the economy starts to sour, collection activities will increase and third parties, including the seller's lenders and tax authorities, will be more likely to enforce claims against the seller's assets. Therefore, the buyer should make sure that the target's assets are free of liens by performing a lien search immediately prior to closing. Buyers should generally obtain lien searches in the states in which the target has significant property, the state of the target's incorporation and the county in which real estate is located.

In addition, the buyer should make sure it has clear evidence of the chain of title where appropriate. For example, where the target recently acquired a valuable asset, such as a significant piece of manufacturing equipment, the buyer should make sure that the seller has obtained a clear bill of sale from the original seller to avoid any title disputes relating to, for example, the target's failure to pay the applicable purchase price. The seller should also seek releases at closing for any liens known to encumber the applicable assets. In tough economic times, it is possible that a creditor's successor (and not the creditor) pursues recovery, either because the creditor sold the right to pursue the obligation or through foreclosure or similar proceeding. The assignee will not be familiar with the historical relationship and may have different motives and interests than the assignor. Thus, clear documentation of any lien releases, transfer of title or release of other claims should be obtained prior to closing.

The Buyer should also pay careful attention to the target's compliance with laws and permits because governmental agencies may be more likely to actively pursue fines for violations of law when tax revenue from business activity decreases. Accordingly, buyers should pay attention to seemingly dormant, but unresolved, tax and environmental issues that may again present themselves.

4. <u>Working Capital: Accounts Receivable History and Collectability</u>

While always relevant, collectability of accounts receivable is particularly pertinent in lean economic times. Prior to signing a deal, the buyer should assess the credit risk presented by the target's debtors and whether the target has a sufficient bad debt allowance. Occasionally, parties agree to a post-closing bad debt adjustment that may provide for a credit to the buyer for pre-closing accounts receivable remaining unpaid as of a certain date. Such adjustment is typically dollar-for-dollar and not subject to baskets or caps that would be applicable to a representation with respect to accounts receivable.

Where a bad debt adjustment is employed, the buyer should resist burdensome covenants regarding collection of outstanding receivables and application of payment from the account debtors. For example,

the buyer should try to avoid agreeing that oldest invoices will be deemed to be paid first, regardless of how the debtor designates payment. The target's customer may pay a post-closing invoice, but leave an old invoice open due to a claim of defective merchandise. Because the old receivable is deemed to have been satisfied for purposes of the bad debt adjustment when the customer actually intended to pay the more recent invoice, the buyer is no longer able to utilize the bad debt adjustment to recoup the amount under the old invoice from the seller. While the buyer may have an indemnity claim for a breach of a representation, such a claim may be subject to limitations like baskets and de minimis claim thresholds that would be inapplicable to a bad debt adjustment.

The buyer should also be careful that prior collections from the target's debtors were done in the ordinary course of business because as the economy sours, it is more likely that, due to an adverse economic event, some of the target's customers will become subject to bankruptcy or other insolvency proceedings and the target may face statutory avoidance actions (preference actions and fraudulent conveyance actions) from the insolvent customers' estates. Establishing that prior payments were in the ordinary course of business or for adequate consideration may be an effective affirmative defense to such an action.

5. Working Capital Needs

The buyer should pay particular attention to working capital needs in the post-closing period because tighter credit terms and slow paying customers in an economic downturn may strain the target's working capital flow. If cash flow will be slow, the buyer may need to invest capital at or after closing. In addition, if the transaction involves a working capital adjustment targeted off a pegged value, the buyer may try to negotiate a target value that takes into consideration expected working capital needs of the business, not just historical values. While the working capital level of the business may have been consistent for a period pre-close, anticipated changes to the economy may be considered when the parties are negotiating the working capital target.

6. Sales History—Propping Up the Business

As the economy faces a downward turn, some sellers may be incented to demonstrate recently improved performance in order to soften the results of a sliding business. For example, the seller may push customers into buying more product right before the deal is signed to increase sales volume at the expense of future sales. Thus, the buyer needs to be especially tuned in to recent performance to be sure that reported results are accurate and to confirm the quality of sales reported. The buyer should be careful to consider whether sales are the result of unusual discounts or promotions or other unusual activity, such as selling new stock before older stock. The buyer should consider including inventory quality and age (either specifically or through a reference to GAAP accounting) in the working capital adjustment in order to mitigate the latter risk.

7. Indemnity

One of the most apparent risks in an M&A transaction when the general economy is suffering is the ability of the seller to satisfy a post-closing indemnity claim. Therefore, the buyer should be careful to evaluate the financial strength of the seller and, if necessary, seek an indemnity escrow, purchase price hold back or guarantee from an affiliate or parent of the seller.

8. Workforce Needs and Statutory Requirements

The buyer should carefully review the target's termination history and expected employee needs post-closing to ensure that the WARN Act or other similar state statutes will not be triggered by a post-closing layoff. Generally speaking, and subject to certain exclusions and other requirements, the WARN Act requires employers to give 60 days' prior notice before laying off 50 or more employees over a 30-day period. Failure to comply effectively triggers a severance obligation to the terminated employees. Typically, the seller will bear the cost of statutory implications of layoffs resulting from the transaction itself, but post-closing terminations will typically be the buyer's responsibility. While a seller may represent that it has not caused enough layoffs to trigger statutory liability, the buyer should confirm the exact number of layoffs prior to closing to avoid crossing the threshold post-closing.

9. Transaction Pace

Both parties should consider the pace of the transaction as the economy turns. Buyers want to sign and close rapidly where the downturn shows signs of letting up (before the seller is in a position to extract a

higher purchase price) or where upcoming macroeconomic difficulties will create problems for the target with its current ownership structure. For example, the buyer may want to close a transaction quickly if credit markets are expected to tighten such that the target will be unable to obtain short term financing for capital needs without the buyer's support and the inability to obtain credit would impair the target's purchasing power and ability to fulfill significant orders or otherwise strain customer relationships. Of course, sellers may try to speed up a transaction where a downturn is expected to result in a depressed purchase price or where the business is expected to perform poorly.

## Issues for the Seller

1. Certainty of Close

Sellers should seek to lock up the purchaser's obligation to close by minimizing closing conditions. Specifically, sellers should seek to avoid financing conditions, especially when the credit market may tighten. The seller is in a stronger negotiating position if the buyer is contractually obligated to close and the seller can seek specific performance to force the buyer to close the deal than if the buyer can simply refuse to close if it fails to obtain financing.

Another condition to consider is the traditional standalone MAC condition. As most deal lawyers would readily acknowledge, it is difficult to convince a court that a material adverse change has occurred. Nevertheless, with specific, objective and quantifiable triggers, a MAC condition can be an effective out. For example, a specific MAC condition might be defined to include any facility shut down longer than a specified period. If a supplier shuts down because of the overall economic condition, the target facility may be forced to temporarily close while an alternative supplier is sought. Then, indirectly, the economic climate caused a MAC shut down and the buyer may be able to walk. Sellers should be aware of these types of conditions as stand alone conditions as well.

Regardless of the state of the economy, sellers should carefully weigh the economic benefit of a higher bid price with multiple contingencies against bids with lower bid prices, but fewer conditions to close.

2. Buyer's Ability to Finance

Notwithstanding the buyer's contractual obligation to close, the seller should be mindful of the buyer's ability to close. Even without a financing out, many buyers do not have cash on hand to close a big deal without outside financing. Because credit markets can become volatile when the economy starts to turn, the seller should diligence the buyer's ability to close without financing. Although commitments from lenders can and should be reasonably relied upon, in extreme circumstances (as during the most recent financial crisis), credit sources may be unable to fulfill a financing commitment or may be willing to assert that conditions to closing have not been satisfied. The seller should consider what to do if such a scenario occurs. A common way to address this circumstance and mitigate some of the damage caused to a seller from a financing failure is to include a reverse break-up fee as part of the transaction architecture.

3. Seller Releases / Indemnity

Sellers should insist on broad releases of liability from the buyer, including with respect to directors, officers, employees and affiliates of the seller and disclaim representations and warranties, other than those set forth in the transaction agreement. In economically troubled times, the buyer may be more likely to assert more tenuous claims against a broader range of defendants to try to recoup an investment that has turned negative. Among the things for the seller to consider are specific releases of affiliates of the seller, specific disclaimers of representations or warranties with respect to forecasts or projections, and clear provisions limiting indemnity claims to those specifically provided for in the transaction document.

## The Bottom Line

Keeping these issues in mind when investigating and negotiating a potential transaction may play a part in helping buyers and sellers close successful transactions, even in down or down-turning markets. As in every transaction, both parties need to be aware of the broader market and be willing to adjust deal terms and expectations to match the current environment.

# Changing Due Diligence Practices for Uncertain Times: An In-House Perspective

***By Henry C. Eickelberg***[1]

"A rising tide lifts all the boats…" John F. Kennedy, October 3, 1963

For the past decade (and arguably much longer), the Federal Reserve engaged in what could easily be called "Project Easy Money." Its purpose was to support and spur economic activity in the face of the post-Internet boom crash and September 11th. But Project Easy Money fueled not only increased economic activity, it also drove a flurry of M&A activity led by financial and strategic buyers. It is not a stretch to say that prior to the late 2008 financial meltdown, flipping businesses was in many ways as common (and profitable) as flipping houses. In essence, Project Easy Money promoted a "rising tide" where buyers could concern themselves less with precisely determining a target's intrinsic value, and rely simply on timing and speed. And it was this laser focus on timing and speed that largely characterized a challenging due diligence process in a "rising tide" environment.

Well, the Fed's credit-induced tide has certainly exited the harbor and done so with a vengeance leaving in its wake numerous businesses struggling to stay afloat and many others rudderless as they lay stranded on their proverbial sides. And while the current cost of credit (at least in nominal terms) looks cheap, the business world seems far more content with accumulating piles of cash as security against future financial storms than lunging that cash over the side in the hopes of catching an acquisition.

Driving this reluctance is the fact that strategic buyers face greater uncertainty (risk) in pricing a target's underlying business value. Briefly continuing our maritime metaphor, it could well be said that in our current economic environment, the headwinds are strong, the waters are shallow and rocky (making it particularly dangerous for ships looking to take on more weight), and fishing for acquisitions is perilous, unless one can confidently gage intrinsic value. No buyer wants to find itself in the uncomfortable position of having borrowed a large, fixed sum of money to purchase a target that later is incapable of servicing that debt.

Financial buyers, who generally enter a deal with an exit strategy twinkling in their eye, have also been impacted (assuming, of course, they can even get their hands on a sufficient amount of credit). In an economic environment where asset values can easily fall—and fall quickly—financial buyers face the prospect that their previous strategy of "buy fast, close fast, fix it up and flip it even faster" could well turn into a long-term hold of properties they (and their investors) are not set-up to manage.

## Should Due Diligence Practices Change in a 'Falling Tide' Market?

Given that backdrop, it seems prudent to question if a due diligence process largely shaped in a 'rising tide' market will work equally as well when the tide is falling. The answer would seem to be a fairly obvious "no," but that begs the question as to how should the due diligence process change?

It would seem that the due diligence process will need to be re-focused. In a falling market, the primary purpose of the due diligence process must be to assist the buyer in validating the target's on-going operational value (verses focusing on the identification and quantification of liabilities (assumed and/or contingent) that will need to be factored into price – finding the proverbial "deal-breaker"). To accomplish this refocus, counsel will need to have a greater understanding of the client's fundamental business drivers and how the target is intended to add intrinsic value. And, more importantly, clients will need to be ready to work with their deal counsel in ways and areas that they have previously not done.

Evaluating the Target's Business Base: The most important part of the due diligence process is scrubbing the target's business base. While the process of buying a business may end at the closing table, it is only

---

[1] Mr. Eickelberg is a corporate officer with a Fortune 100 company. The opinions expressed herein are his own and not necessarily those of his employer. Mr. Eickelberg is a former partner of Jenner & Block, where he specialized in employee benefits and executive compensation. He is an adjunct professor of law in the LL. M. program at Georgetown University Law Center, where he teaches courses in Employee Benefits in Corporate Transactions, Avoiding and Managing ERISA Litigation and Employee Benefits in Bankruptcy. He is also the lead instructor for the ABA Joint Committee on Employee Benefits workshop entitled "M&A Due Diligence for ERISA Attorneys: A Case Study" and is a member of the Board of Advisory for DealLawyers.com. Mr. Eickelberg is a Certified Public Accountant and is a licensed attorney in the State of Illinois and District of Columbia and is awaiting admission to the State of Florida. He earned his J.D. (with distinction) and LL.M. in taxation from the John Marshall Law School in Chicago, Illinois.

the beginning for the client's management team. Companies buy companies to make money and not as some type of grand financial science experiment or academic exercise. For those whose livelihood solely revolves around the acquisition process, this is an important perspective to keep in mind.

While a client's strategic finance team is generally charged with evaluating a target's business base, deal counsel should work (and work hard) to really understand their client's economic model and that of the target. With a solid understanding of these factors, deal counsel can execute the due diligence process with a greater appreciation for the client's goals and objectives. And, clients should consider ways to actively educate deal counsel as to the client's important economic drivers and the business value the client sees in the target.

One way to keep this focus is by constantly asking the following question during the due diligence process: what business factors (if they are present or absent after closing) would keep the client from fully leveraging the target's business model?

One quickly realizes, however, that in order to fully address that question, deal counsel will need to understanding how the client makes money; what factors (directly and indirectly) impact the client's business results; how the target business makes money and how different it is from that of the client's; and how the client intends to integrate the target into its business. Getting one's hands on the deal book or offering memorandum is a good first step in gaining important insight into the target's business. At the start of the due diligence process, clients may want to consider holding a purely business-based briefing for deal counsel to educate them about the various financial considerations that are driving the buyer to even consider buying the target, as well as to clearly articulate those factors that the buyer believes are critical to the target's success post-closing.

A Time for 'True Lawyering': It doesn't take long as a deal lawyer before one hears the term "deal heat." Deal heat is that point in the acquisition process when all other considerations pale in comparison to buttoning down the contract, typing up the schedules and closing the deal. Many times, the client's own internal political environment makes closing the deal so important — "we've spent all that time and money looking the target up and down, we can't go back to the Board of Directors now and tell them that we've walked away!" It is at these times that a [illegible] capital can be inappropriately risked.

In a falling market, deal lawyers need to help their clients stay focused on the true mission of due diligence: evaluating whether the target can actually financially perform as projected, and if it can't, helping the client (both legally and politically) move on. Doing this takes "true lawyering," which requires deep personal relationships on a number of levels combined with a solid understanding of the client's business and financial objectives.

"Changed Circumstance" Provisions: In unsettled economic times, buyers and deal counsel should pay particularly attention to triggers that allow the buyer to exit the deal. Business conditions can deteriorate quickly, even between signing and closing, and the buyer has to be prepared both legally and, more importantly, mentally, to use these provisions. To be effective, the provisions must be based on objective, measureable factors and allow the buyer to adjust their plans (including backing out of the deal) if underlying economic conditions deteriorate. A provision like this can only be effectively drafted if deal counsel understands what underlying business elements are important to the buyer.

Assessing the Risk Allocation Embedded in Business Contracts: The target company will typically have numerous contracts in place that are critical to its success. These contracts are normally reviewed during the due diligence process. When times are tough, parties to any contract have a strong incentive to try and reshape their contractual obligations to better fit their current economic circumstances.

As such, it is not enough to simply outline the essential business terms of the target's existing contracts and review them for assignability. Buyer's counsel needs to carefully review those provisions of the contract that delineate the risks and responsibilities the parties bear in the event of a dispute or default. The buyer may find that the target company's approach to allocating these risks leaves a lot to be desired, especially if the contracts were signed during the recent economic heyday. The question for the buyer is: if push comes to shove, will the buyer be comfortable trying to enforce the contract against a third-party using only those rights and remedies the target company accepted?

Assessing Issues That Can Impact Value: Deal value can be viewed from a number of different perspectives. In a rising market, the focus is generally on the 'here and now' with the implicit assumption that the target's on-going value-generating capacity will remain unchanged or can be increased appropriately over time. But, in a falling market, the focus flips 180 degrees to one that examines the target's sustainability as an on-going enterprise informed by what the buyer knows about the overall marketplace.

As such, the due diligence process must be changed to match. In reviewing a target's financials, buyers will be very sensitive to conditions and costs that are not reflected in the target's financial statements. Below are a few basic examples that may help clarify the change in emphasis:

- *Access to credit*: Businesses run on credit. In a down market, the credit markets can be very fickle and it is dangerous to assume that somehow existing credit lines can be rolled over. To the extent that the target's business model depends on a steady replenishment of credit, the buyer must carefully study these implications.

- *Pension Plan Funding*: If the target sponsors a defined benefit plan, a number of factors can affect the target's costs. First is the division of plan assets if the plan is split post-closing. When pension plans are split, it is rare that the division would be proportional with assets following liabilities assumed. After the split, the buyer could find itself with a far lower percentage of pension assets supporting the target's pension costs than were available prior to the split.

  This will cause the target's pension costs (on a standalone basis) to be significantly higher and it is highly unlikely that these higher costs were baked into the target's financial projections. Even a sudden market and/or interest rate drop between the time of estimating the on-going costs and the closing can dramatically impact the target's pension costs in the buyer's hands. Finally, the current pension funding rules—adopted in 2006—add a tremendous amount of volatility in the level of required pension contributions. This too would not have been factored into the target's financials.

- *Multiemployer Plan Participation*: If the target has union employees, it may participate in a multiemployer pension plan. Based on the multiemployer pension plan's funded status, the plan may be required to charge participating employers with a special contribution that may not have been included in the target's financials.

- *Severance Costs*: If future market conditions dictate reducing the target's workforce, the buyer may find itself needing to readjust the target's workforce. The buyer will need to understand the implications of such an action, none of which will have been baked into the target's financials. This is particularly true if the employees are located in Europe. European severance costs can be extremely expensive (and time-consuming to execute) to the point that these factors could literally destroy the value of an acquired business (which is the purpose of these laws—to make workforce adjustments in these jurisdictions so costly and painful that the jobs will be among the last to go).

- *Healthcare Reforms*: Based on the target's employee population and the benefits it offers them, it may face significant financial penalties for failing to provide sufficient healthcare coverage starting in 2014. It is highly unlikely that these costs would have been factored into the target's financial projections.

## The Bottom Line

Conducting due diligence in a down market requires focusing on the target's financials as an on-going enterprise and assessing how those financials may change in the buyer's hands. This is not to say that the due diligence process can neglect reviewing assumed liabilities. Assessing any balance sheet liabilities that the buyer will assume is still a very critical part of the due diligence process because an underestimation of assumed liabilities will negatively impact the target's future earnings power in the buyer's hands.

The need to refocus the due diligence process is in recognition that in a down market, errors in estimating future earnings power will become very transparent, very quickly and will be a lot harder to overcome with economic 'wins' from elsewhere. When economic activity was strong and asset values rose rapidly, the sins of a bad acquisition could be easily masked. Not so anymore. There's an old M&A adage that says *a good deal lost is never as costly as a bad deal gained*. It was true then—and it's far truer now.

# Due Diligence: Implications of Dodd-Frank's Whistleblower Provisions for Acquirors

***by Philip Stamatakos, a Partner of Jones Day*[1]**

Potential acquirors should redouble their efforts to determine whether acquisition targets have violated securities laws and instituted compliance programs that deter and detect such violations. The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] and the related SEC rules (the "Rules")[3] is likely to result in a dramatic increase in investigations by the SEC into possible securities law violations by U.S. companies. This could make acquisitions more costly for acquirers which do not detect targets' securities law violations or which, having detected such violations, fail to make appropriate adjustments to representations, indemnities or the purchase price.[4]

Dodd-Frank contains whistleblower provisions that provide for the payment of substantial financial awards to whistleblowers who voluntarily provide the SEC with information about violations of federal securities laws where resulting judicial or administrative actions result in monetary awards or settlements of $1 million or more. Under Dodd-Frank, whistleblowers are eligible to receive awards or bounties equal to 10% to 30% of such awards or settlements. Whistleblowers can be employees, customers, suppliers, consultants or others, including, in certain circumstances, in-house counsel and others responsible for legal compliance.[5]

Dodd-Frank's bounty provisions provide whistleblowers with considerable financial incentive to report possible securities law violations to the SEC, particularly violations of the Foreign Corrupt Practices Act, a securities law the violation of which has resulted in very large penalties and settlements in recent years. The FCPA prohibits corrupt payments to foreign officials and employees anywhere in the world and requires SEC reporting companies to maintain accounting records and internal controls pursuant to standards set forth in that statute. Recently, the SEC and the Department of Justice (the "DOJ"), the agencies that enforce the FCPA, have increased their FCPA enforcement actions, and in 2010 those agencies recovered $1.8 billion of penalties under that statute. A number of these actions involved settlements in the hundreds of millions of dollars.

This is the time for acquirers to adjust their acquisition due diligence strategies to increase the likelihood of identifying any securities law violations by targets, better understand targets' compliance culture and, where possible, quantify related risks. This article outlines how acquirers can assess the risk that acquisition targets are violating securities laws, and structure and conduct due diligence to increase the likelihood of exposing such violations. It also identifies some practical considerations that may inhibit effective due diligence concerning potential securities law violations.

## The Goal of Due Diligence Concerning Possible Securities Law Violations

The objective of due diligence on a target's compliance with securities laws should be to:

- determine whether the target has violated any securities laws;
- identify specific and systemic legal, compliance and financial risks relating to possible securities law violations by the target;
- determine the extent to which the target has an effective compliance culture and procedures;

[1] The opinions expressed in this article are those of the author and not necessarily those of Jones Day or any of its clients.

[2] 15 U.S.C. § 78u-6.

[3] Securities and Exchange Commission, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Rel. No. 34-64545 (May 25, 2011). The Rules became effective on August 12, 2011, and apply to all submissions of information by whistleblowers to the SEC since Dodd-Frank was enacted on July 21, 2010.

[4] For a detailed discussion and analysis of Dodd-Frank and Rules, see Philip Stamatakos and Ted Chung, "*Dodd-Frank's Whistleblower Provisions and the SEC's Rules: Compliance and Ethical Considerations,*" Corporate Governance Advisor, September/October, 2011.

[5] Dodd-Frank provides significant protections for whistleblowers by prohibiting employers from retaliating against whistleblower employees and subjecting employers to significant penalties for retaliatory conduct. Dodd-Frank also vests employees with a private right of action against retaliating employers in federal court.

- assess whether the acquisition is desirable given the risks associated with the target's actual or potential securities law violations;
- provide the basis for negotiating appropriate provisions in the purchase agreement, including compliance with laws representations, escrow and indemnity provisions and, if appropriate, pre- and post-closing covenants;
- provide the basis for negotiating purchase price reductions or other concessions from the sellers or target;
- evaluate whether to adjust personnel, contracts, markets and relationships post-closing to minimize the risk of securities law violations;
- determine the feasibility and cost of implementing compliance procedures and remedial measures post-closing;
- begin communicating the importance of securities law compliance to the target's management; and
- document the acquirer's good faith inquiry as a factor for reducing possible penalties or sanctions by the SEC, DOJ or other government agencies that may investigate securities law violations by the target after the closing.

## How to Assess the Risk

Before initiating a due diligence review, an acquirer should assess the legal, compliance and financial risks associated with possible securities law violations by a target and tailor its due diligence investigation accordingly. To do so, an acquirer should consider the following questions, some of which pertain to possible FCPA violations:

- Who owns and controls the target? Is it an entity or person with a history of compliance violations?
- How actively do the target's board and officers manage compliance and risk?
- In what countries does the target do business and what level of risk do those countries present with respect to potentially corrupt business-related conduct?
- Are any of the entities with which the target does business state-owned enterprises or foreign governments?
- Does the target do business in industries known for presenting heightened risks of corruption?
- How does the target conduct its sales? Does it employ sales agents and distributors?
- What financial relationships does the target have with other companies or individuals?
- How much authority do the target's non-U.S. representatives have?
- What regulatory permissions and approvals are required for the target to do business?
- Who at the target interacts with government agencies and officials? What checks and balances are in place with respect to their authority?
- Is the target in an industry where there is a risk of securities law liability for failure to make disclosures about particular risks?
- Has the target disclosed significant deficiencies or material weaknesses in its financial controls or internal reporting mechanisms?
- Has the target ever been the subject of a government investigation or criminal or civil suit related to securities law violations or accounting irregularities or inadequacies?

## Determining the Scope of Due Diligence

The answers to these questions will help an acquirer assess the appropriate scope and depth of its legal, accounting and financial diligence on the target. Of course, the nature and extent of the acquirer's diligence will be affected by several additional factors, including, for example:

- whether the target is being sold pursuant to an auction, the time available to conduct diligence and how diligence will affect the timing of closing;
- whether the proposed purchase price is sufficiently low to induce the acquirer to assume certain risks that it might not otherwise assume;
- the comfort the acquirer can derive from the extent of the seller's or target's representations and indemnities;
- the speed with which diligence must be conducted as a result of the parties' business imperatives or the availability of financing;
- the acquirer's own compliance history and whether its reputation, ability to do business or relations with its regulators or constituents (including shareholders, suppliers, customers, employees and the public) might be adversely affected if it were to acquire a target that has violated the securities laws;
- the potential financial effect on the acquirer or value of adverse consequences for securities law violations, particularly relative to the value of the transaction and its benefits to the acquirer; and
- the possibility of successor or acquirer liability for the target's pre-closing securities law violations.

## Conducting Due Diligence

A prudent acquirer will assess its exposure to securities law violations and tailor its due diligence efforts based on the specific facts related to each transaction. A good starting point for reducing acquisition risk related to securities law violations is to make appropriate and comprehensive legal, financial and accounting document requests that address matters such as the existence and details of:

- the target's whistleblower hotlines and compliance policies and handbooks;
- policies concerning violations of law, including securities laws;
- compliance training for directors, officers, managers and employees;
- hotline reports and the manner in which the target has responded to and resolved them;
- historical and ongoing internal and government investigations for violations of securities laws;
- securities litigation affecting the target and its directors, officers and employees;
- employee handbook provisions and other policies prohibiting retaliation against target employees who report securities law violations internally, to the SEC or to another government agency; and
- policies and rules designed to prevent violations of the FCPA, including prevention of corrupt payments and adherence to accounting norms.

Such document requests and reviews can be supplemented by an analysis of publicly-available information, and, as appropriate (and if allowed by the target) with interviews of the officers and managers who play a significant role in the target's securities law compliance, reviews of the target's books and records by forensic accountants, in-depth exploration of various communications, and meetings with the target's sales agents, distributors, other intermediaries and customers.

## Some Practical Considerations

An acquirer's ability to conduct effective diligence may be affected by certain practical considerations related to Dodd-Frank. First, an acquirer should balance the benefits of sharing information on a target's securities law violations with members of its internal deal team against the possibility that such individuals could, themselves, become whistleblowers either before or after the acquisition is closed.

Likewise, a cautious seller or target may be concerned that (a) an acquirer's employees or representatives will attempt to obtain a whistleblower award under Dodd-Frank by submitting to the SEC information they have learned about the target's possible securities law violations, or (b) an acquirer's due diligence investigation may induce the target's employees to become whistleblowers. Consequently, a seller or target may try to limit a prospective acquirer's access to relevant information. This tendency may be exacerbated by Rules that prohibit impeding any person from communicating with the SEC about possible securities law violations, including (generally) by enforcing or threatening to enforce confidentiality agreements.

Potential acquirers and targets routinely enter into confidentiality agreements when they initiate acquisition discussions to protect targets' (and often acquirers') confidential information. Under the Rules, if an acquirer's employee or representative discovers evidence that a target may have violated the securities laws, neither the acquirer nor the target may enforce the parties' confidentiality agreement to prohibit the employee or representative from becoming a whistleblower. Consequently, targets may withhold information from acquirers or delay the disclosure to acquirers of information that could reveal possible securities law violations. Thus, ironically, Dodd-Frank, which was promulgated to encourage the reporting of securities law violations, may have the unintended consequence of inducing targets to conceal such violations or impede their discovery.

Second, during the course of due diligence into securities law violations, the parties should consider whether they will be able to preserve their attorney-client privilege and work product protections, and, if so, take appropriate steps to preserve such protections. Sometimes, this can be achieved by involving attorneys instead of accountants or others to review certain documents and communications, or by having the parties sign common interest or similar agreements. Whether privilege can be protected in this context usually requires a review of applicable law (which often varies considerably jurisdiction to jurisdiction) and a fact-specific analysis.

Acquirers should be aware, however, that the Rules permit lawyers to become whistleblowers when permitted by the SEC's or applicable states' attorney conduct rules. In particular, under the Rules, a lawyer may disclose privileged information to prevent an issuer from committing a material violation of the securities laws that is likely to cause substantial injury to the financial interests or property of the issuer or investors, or, under certain circumstances, to rectify the consequences of a material violation of securities laws.

## The Bottom Line

In many instances, properly structured acquisition due diligence can reduce an acquirer's acquisition risk by identifying potentially significant penalties related to a target's securities law violations. No amount of due diligence can provide an acquirer with complete assurance that a target has not violated the securities laws, however. This is especially true because securities law violations, particularly those related to corrupt payments to foreign officials, often involve behavior that has been intentionally and carefully concealed and consequently is difficult to detect.

It remains to be seen whether, in practice, acquirers will insist on conducting considerably greater and more exacting due diligence to identify securities law violation risks than they have in the past, and whether sellers and targets will routinely attempt to limit access to their books, records, customers, distributors and personnel out of concern that such inquiries could induce whistleblower submissions to the SEC or cause prospective acquirers to reduce the consideration they otherwise would have paid. What is certain, however, is that acquisition risk has increased with the passage of Dodd-Frank.

# $17.50 from Column A and $17.50 from Column B: "50/50 Split" Implicates Revlon

***By Michael Maimone and Clifford Neimeth of Greenberg Traurig, LLP***

In *In re Smurfit-Stone Container Corp. Shareholder Litigation.,*[1] a case of first impression, the Delaware Court of Chancery addressed whether directors' so-called "*Revlon* obligations" apply to a merger where the value of the deal consideration—measured at the time the merger agreement is entered into—consists of 50% cash and 50% acquiror stock. At issue was Plaintiffs' challenge of Rock-Tenn Company's ("Rock-Tenn" or the "Company") proposed $3.5 billion acquisition of Smurfit-Stone pursuant to the merger of Rock-Tenn's acquisition subsidiary with and into Smurfit-Stone (the "Merger"), with Smurfit-Stone surviving the Merger as a wholly owned subsidiary of Rock-Tenn.

## The Terms of the Merger Agreement

The merger agreement provided that, at the effective time of the Merger (the "effective time"), each outstanding share of Smurfit-Stone common stock would be converted into the right to receive, in the aggregate, $35 worth of cash and Rock-Tenn stock—which represented a 27% premium to the unaffected price of Smurfit-Stone's common stock (the "merger consideration"). Specifically, the merger consideration consisted of $17.50 in cash and .30605 shares of Rock-Tenn common stock (*i.e.,* the .30605 fixed exchange ratio was valued at $17.50 at the time the merger agreement was entered into). Based on the respective capital structures of Smurfit-Stone and Rock-Tenn, immediately after the effective time the Company's former stockholders would own approximately 45% of Rock-Tenn's outstanding common stock. Notably, Rock-Tenn's common stock is listed on the New York Stock Exchange, Inc., Rock-Tenn has no controlling stockholder or control group, and the market for Rock-Tenn's common stock is relatively liquid and disaggregated.

The merger agreement contained several "deal-protection" provisions, including (i) Smurfit-Stone's "no-shop" covenant (with "window shop" exceptions), (ii) unlimited "matching rights" exercisable by Rock-Tenn prior to any fiduciary termination of the merger agreement by Smurfit-Stone in the case of an unsolicited superior offer received from a third party prior to adoption of the merger agreement by Smurfit-Stone's stockholders, and (iii) a 3.4% termination (or "break-up") fee payable to Rock-Tenn upon Smurfit-Stone's fiduciary termination of the merger agreement and signing of a third-party acquisition agreement providing for a superior offer, or upon the Smurfit-Stone board's failure to make, adverse amendment of, or withdrawal of, its recommendation that Smurfit-Stone's stockholders vote to adopt the merger agreement.[2]

## Plaintiffs' Revlon Claims

In their complaint, Plaintiffs alleged that the Company's directors breached their enhanced fiduciary duties of care and loyalty articulated by the Supreme Court of Delaware (the "Delaware Supreme Court") in its seminal *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,*[3] decision, which requires directors to obtain the best value (and overall deal terms) reasonably available when, among other things, they approve a definitive agreement to sell control of a Delaware company. Specifically, the Plaintiffs alleged that the Company's directors failed to conduct an adequate (pre-sign) sales process designed to obtain maximum

---

[1] 2011 WL 2028076 (Del. Ch. May 20, 2011, revised May 24, 2011) (Parsons, V.C.).

[2] The "no-shop" clause prevented Smurfit-Stone from "initiat[ing], solicit[ing], induc[ing], or knowingly encourag[ing] or facilitat[ing]" a potentially superior acquisition bid from a prospective acquiror. The "fiduciary-out" clause provided that the board retained the ability to consider and to approve, and the Company retained the ability to accept, an unsolicited "Company Superior Proposal" consistent with the board's fiduciary duties. The "matching-rights" provision provided Rock-Tenn with the right to receive details of an unsolicited "Company Superior Proposal" submitted to the Company, as well as the bidder's identity, and, within three calendar days, negotiate an amendment to the merger agreement to match or top the price and other terms of the competing offer. The termination fee provision required Smurfit-Stone to pay Rock-Tenn $120 million, which represented 3.4% of the total equity value of the Transaction, if the board failed to recommend that Smurfit-Stone's stockholders adopt the merger agreement, or if the board caused Smurfit-Stone to terminate the merger agreement in favor of a "Company Superior Proposal."

[3] 506 A.2d 173 (Del. 1986). Notwithstanding the oft-cited phrase "*Revlon* duties", *Revlon* does not impose any new duties per se, but instead, it simply mandates a temporal objective for directors—an obligation to seek to obtain maximum current value and the best overall deal terms. This contextual obligation is reviewed under an enhanced judicial lens to determine whether the directors satisfied their fundamental duties of care and loyalty.

current value for Smurfit-Stone's stockholders and failed to obtain an adequate price from Rock-Tenn.[4] Plaintiffs also alleged that Rock-Tenn aided and abetted the board in violating its fiduciary duties. Plaintiffs sought a preliminary injunction to delay Smurfit-Stone's stockholder vote on the adoption of the merger agreement and to temporarily stay (for 45 to 60 days) the effectiveness of Rock-Tenn's deal protection devices to enable the Company to actively seek superior third party acquisition proposals.

Vice Chancellor Parsons determined that, although not entirely free from doubt, the 50% cash—50% Rock-Tenn stock components of the merger consideration animated the *Revlon* obligations of the Company's directors, but, he denied the Plaintiffs' injunction motion.

## Enhanced Scrutiny: The Revlon Standard of Judicial Review

Under well-established Delaware common law, directors are required to satisfy enhanced fiduciary obligations of care and loyalty under *Revlon* in primarily three contexts; namely: "(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."[5]

In determining whether the *Revlon* standard was applicable to the Merger, the Court of Chancery noted that the Plaintiffs failed to allege that the Company initiated an active bidding process or that the Company abandoned its long-term business and operating strategy. Instead, the Plaintiffs simply alleged that because the value of proposed merger consideration was divided equally between cash and Rock-Tenn's stock, a sale of control transaction had been entered into and agreed to by the Company's directors. The Court of Chancery noted that this precise fact scenario had never been addressed by a Delaware court, but concluded that Plaintiffs are likely to prevail on their argument that *Revlon* applies [illegible] even though this position is not free from doubt."

In reaching his conclusion, Vice Chancellor Parsons conducted a detailed review of Delaware precedent addressing the application and parameters of the *Revlon* doctrine. At the margins, his analyses initially involved an examination of 100% stock-for-stock combinations, on the one hand, and 100% cash acquisitions, on the other hand. The Court of Chancery noted that in a 100% stock-for-stock deal, if control of the resulting entity rests with a single stockholder or a control group such that the target's former stockholders are relegated to captive minority status in the newly combined entity, a sale of control has occurred for *Revlon* purposes.[6] Vice Chancellor Parsons noted, however, that "if ownership shifts from one large unaffiliated group of public stockholders to another, that alone does not amount to a change of control."[7] By contrast, the Court of Chancery observed that in all-cash merger transactions *Revlon* applies because, after the sale, "there is no tomorrow for the corporation's present stockholders, meaning that they will forever be shut out from future profits generated by the resulting entity as well as the possibility of obtaining a control premium in a subsequent transaction."[8]

With respect to transactions "in between the lines" - deals constituting neither a 100% stock-for-stock merger nor an all-cash merger - the Court of Chancery referred to the Delaware Supreme Court's decision in *In re Santa Fe Pacific Corporation Shareholder Litigation*,[9] in which the acquiror sought to purchase up to 33% of the target's outstanding common stock through a first-step cash tender offer and subsequently acquire the remainder of the target's outstanding common stock through a (second step) stock-for-stock

---

[4] Defendants argued that heightened scrutiny under *Revlon* is inapplicable and urged the Court of Chancery to review the claims alleged by Plaintiffs "through the lens of the business judgment rule." *Smurfit-Stone*, 2011 WL 2028076, at *11. The Court of Chancery held that, although "Plaintiffs are likely to prevail on their argument that *Revlon* applies here," whether *Revlon* applies or whether the business judgment rule applies, "the result would be the same." *Id.* The Court of Chancery held that "Plaintiffs have not demonstrated that they are likely to succeed on the merits of their claim" under either a business judgment rule analysis or a *Revlon* analysis. *Id.* Accordingly, it may be argued that this decision of the Court of Chancery (regarding the application of *Revlon*) is dicta.

[5] *Smurfit-Stone*, 2011 WL 2028076, at *12 (quoting *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 71 (Del. 1995)).

[6] See, *e.g., Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42-43 (Del. 1994).

[7] *Smurfit-Stone*, 2011 WL 2028076, at *13; See, *e.g., Paramount Commc'ns Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989).

[8] *Smurfit-Stone*, 2011 WL 2028076, at * 13 (citing *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 101-02 (Del. Ch. 2011) and *TW Servs., Inc. v. SWT Acq. Corp.*, 1989 WL 20290, at *1184 (Del. Ch. Mar. 2, 1989)).

[9] 669 A.2d 59, 71 (Del. 1995).

merger. In *Santa Fe*, the Delaware Supreme Court declined to apply *Revlon* because the plaintiffs in that case failed to allege that the target's directors pursued a sale of control transaction and failed to describe the acquiror's capital structure, which left the Delaware Supreme Court "with little reason to doubt that 'control of [acquiror] and [target] after the merger would remain in a large, fluid, changeable and changing market.'"[10]

Vice Chancellor Parsons was further informed by *In re Lukens Inc. S'holders Litig.*,[11] in which the Court of Chancery reviewed a cash election merger where each target stockholder could elect to receive a mix of cash and acquiror stock "subject to a maximum total cash payout equal to 62% of the total consideration."[12] In *Lukens*, the Court of Chancery applied *Revlon* with the following commentary:

> "The defendants argue that because over 30% of the merger consideration was shares of [acquiror] common stock, a widely held company without any controlling shareholder, *Revlon* and *QVC* do not apply. * * * Whether 62% or 100% of the consideration was to be in cash, the directors were obligated to take reasonable steps to ensure that the shareholders received the best price available because, in any event, for a substantial majority of the then-current shareholders, 'there is no long run.' * * * [This Court does] not agree with the defendants that *Santa Fe*, in which shareholders tendered 33% of their shares for cash and exchanged the remainder for common stock, controls a situation in which over 60% of the consideration is cash. . . . [This Court takes] for granted . . . that a cash offer for 95% of a company's shares, for example, even if the other 5% will be exchanged for the shares of a widely held corporation, will constitute a change of corporate control. Until instructed otherwise, [this Court believes] that purchasing more than 60% achieves the same result."[13]

Accordingly, the Vice Chancellor emphasized that, based on the foregoing precedents, a two-step acquisition in which 33% of the transaction value to be paid to the target's stockholders consists of cash (and 67% consists of acquiror stock) the directors' *Revlon* obligations are *not* implicated, whereas, a single-step cash election merger with a 62% cap on the aggregate cash consideration structurally triggers *Revlon*. Accordingly, the emphasis in each instance was on the form and mix of consideration to be paid to the target's stockholders and whether such "mix" translated into a sale or change of control transaction.

Vice Chancellor Parsons rationalized that at some reference point between the foregoing 33% cash and 60% cash component outliers, the directors' fiduciary obligations under *Revlon* are implicated. Therefore, relying principally on the rationale espoused by the Court of Chancery in *Lukens*, he held that a merger transaction with 50% cash and 50% stock consideration was more likely than not a sale of control transaction requiring the target's directors to satisfy their enhanced duties of care and loyalty under *Revlon*.

Vice Chancellor Parsons was not persuaded by Defendants' attempt to distinguish *Lukens*. Defendants argued that unlike the facts in *Lukens*, the Rock-Tenn/Smurfit-Stone merger was not a cash election merger "with a cap on the aggregate cash component, proration in the case of oversubscription, and the ability of stockholders to elect the relative percentages of cash and stock they wanted to receive in the merger." Defendants further argued that, unlike in *Lukens*, the merger agreement with Rock-Tenn, which provided each Smurfit-Stone stockholder with a fixed "50-50 split" of cash and Rock-Tenn stock. In response, Vice Chancellor Parsons noted that

> [w]hile the facts of this case and *Lukens* differ slightly * * *, Defendants lose sight of the fact that while no Smurfit-Stone stockholder will be cashed out 100%, 100% of its stockholders who elect to participate in the merger will see approximately 50% of their Smurfit-Stone investment cashed out. As such, like [the Court of Chancery's] concern that potentially there was no "tomorrow" for a substantial majority of Lukens stockholders, the concern here is that there is no "tomorrow" for approximately 50% of each stock-

---

[10] *Smurfit-Stone*, 2011 WL 2028076, at *13 (quoting *Santa Fe*, 669 A.2d at 71); *see also Arnold v. Soc'y for Sav. Bancorp.*, 650 A.2d 1270, 1289-90 (Del. 1994) (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).

[11] 757 A.2d 720 (Del. Ch. 1999).

[12] *Smurfit-Stone*, 2011 WL 2028076, at *13 (quoting *Lukens*, 757 A.2d at 725).

[13] *Id.*, at *14 (quoting *Lukens*, 757 A.2d at 732 n.25).

> holder's investment in Smurfit-Stone. That each stockholder may retain a portion of [the stockholder's] investment after the merger is insufficient to distinguish the reasoning of *Lukens*, which concerns the need for the Court to scrutinize under *Revlon* a transaction that constitutes an end-game for all or a substantial part of a stockholder's investment in a Delaware corporation.

Relying on the Delaware Supreme Court's decision in *Arnold v. Society for Savings Bancorp, Inc.*[14], Defendants further contended that because control of Rock-Tenn after consummation of the merger would remain in a large, fluid, changing and changeable market, the former stockholders of Smurfit-Stone would not be foreclosed from obtaining a future control premium and, as such, the proposed transaction did not constitute a sale of control under *Revlon*. Vice Chancellor Parsons disagreed, noting that, "[a]s with their attempt to distinguish *Lukens*, Defendants merely are asserting that even though a significant part of the [m]erger [c]onsideration is in cash, there is a 'tomorrow' for the Company's stockholders because they will own approximately 45% of Rock-Tenn after the merger."[15] The Vice Chancellor rejected Defendants' argument because even though "Rock-Tenn has no controlling stockholders and Smurfit-Stone stockholders will not be relegated to a minority status in the postmerger entity, half of [the investment held by the stockholders in Smurfit-Stone] will be liquidated."[16]

Lastly, the Defendants highlighted the fact that (i) the Rock-Tenn/Smurfit-Stone merger agreement contained a fixed exchange ratio (i.e., whereby Smurfit-Stone's stockholders were at risk of receiving less than $35 per share in total deal value if the price of Rock-Tenn's common stock decreased between signing and closing but, concomitantly, they would receive more than $35 per share in value (the benefit) if Rock-Tenn's stock price increased after signing), as opposed to a floating exchange rate with a "value protection collar"[17] and (ii) the Delaware Supreme Court in Santa Fe suggested that *Revlon* is inapposite to a merger transaction in which only 33% of the value of the merger consideration consists of cash. Defendants argued that these facts were relevant to the Court of Chancery's *Revlon* analysis because the price of Rock-Tenn's stock, in fact, increased after the merger agreement was signed and announced and, as a result, the "mix" of consideration shifted from 50% cash and 50% stock to 56% stock and 44% cash. Accordingly, Defendants asserted that a merger with (now) 44% cash consideration more closely resembled the (non-*Revlon*) facts in *Santa Fe* than the (*Revlon*) facts in *Lukens*.[18] The Court of Chancery disagreed and concluded that "a more logical and workable analysis . . . focuses on the relative proportion of cash and stock as of the date the parties entered into the Merger Agreement, which was 50% cash and stock." Vice Chancellor Parsons continued, stating that

> [a]ccepting Defendants' position would require the Court to base its determination as to whether to apply *Revlon* on its best guess as to the price of Rock-Tenn's stock as of the date the Transaction closes. Leaving this determination up to the vagaries of the stock market is not a workable method and potentially may lead to inequitable results. Therefore, [this Court] consider[s] Plaintiffs' claims in light of the 50% cash and 50% stock Merger Consideration that was in effect as of the date the parties entered into the Merger Agreement.

## Application of Revlon to the Sale Process, Deal Protections and Merger Price

Having determined that *Revlon* applied, Vice Chancellor Parsons substantively reviewed the decisionmaking process undertaken by the Company's directors to determine whether the directors sought to obtain the best value reasonably available. In so doing, Vice Chancellor Parsons relied on long-standing Delaware precedent to determine (i) whether the information relied on by the Company's directors was adequate and (ii) whether, under all of the circumstances (including the terms of the merger agreement and the pre-signing process undertaken by Smurfit-Stone's special committee), the directors' decision to sell control of the Company was a reasonable one.

---

[14] 650 A.2d 1270, 1289-90 (Del. 1994).

[15] Smurfit-Stone, 2011 WL 2028076, at *15.

[16] *Id.*

[17] *See Id.* at *11 n.80, 15 n.106.

[18] *See In re Nymex S'holder Litig.*, 2009 WL 3206051 (Del. Ch. Sept. 30, 2009), wherein the Court of Chancery reviewed a hybrid consideration merger involving 56% stock and 44% cash, but never decided whether the directors' Revlon obligations applied to the transaction.

The Court of Chancery concluded that the process, indeed, was a reasonable one and reiterated that *Revlon* does not require "perfection," and noted specifically that the directors (*i.e.,* the special committee and the full board) were knowledgeable about the Company and the industry and engaged in arms'-length bargaining, nine of the 10 directors were disinterested and independent, and that experienced outside counsel and financial advisors were properly utilized and relied upon for expert advice.

Although the entire sale process—from receipt of Rock-Tenn's first concrete expression of interest until the signing of the definitive merger agreement—occurred in only 19 days, Vice Chancellor Parsons cautioned that "while the length of time a company has to determine its options is important in assessing the reasonableness of a board's actions under *Revlon*, it is not dispositive" and "a relatively quick sales process is not a per se ground for a *Revlon* violation."[19] In this regard, the record before the Court of Chancery suggested that there was sufficient "push back" on price and other material deal terms, there was no evidence of management influence or directorial bias in the sale process, adequate proactivity was demonstrated on the part of the special committee, and reasonable channels of communication and lines of authority were established for the deal negotiation and director information process. Moreover, Vice Chancellor Parsons observed that Smurfit-Stone's recent emergence from bankruptcy—although not directly related to the current sale or conduct to Rock-Tenn and, therefore, not a substitute for current knowledge about the value of the Company and the availability of alternatives to maximize current value—nonetheless was helpful from a director information standpoint.

The Vice Chancellor concluded that the fact that Smurfit-Stone did not conduct a pre-sign market canvass and instead agreed to exclusivity with Rock-Tenn, was not unreasonable under the totality of circumstances. Moreover, the Court of Chancery acknowledged that prior to the current sale process that led to the execution of the merger agreement with Rock-Tenn, the Company had entertained and, in fact, rejected as inadequate, a $29 per share acquisition offer from another suitor that helped inform the Company's directors what a financial buyer might be willing to pay in an arms'-length, third party sale transaction.

With respect to Rock-Tenn's "deal protection" package—the 3.4% break up fee (based on total deal equity value), unlimited matching ("last-look") rights for Rock-Tenn, and the no-shop/window shop provisions of the merger agreement, the Court of Chancery found that such provisions individually and collectively were neither preclusive nor coercive and, under all the circumstances, fell within a range of reasonableness from a *Unocal/Unitrin*[20] perspective. In addition, such provisions were not inconsistent with the directors' *Revlon* objective to seek to obtain the best price and overall deal terms reasonably attainable under the circumstances.

Lastly, with respect to Plaintiffs' challenge that $35 per share was an inadequate sale price, Vice Chancellor Parsons noted that public company "valuation is an art and not a science" and determined that Lazard Freres & Co. LLC ("Lazard") provided the directors with sufficiently extensive analyses to support its opinion that $35 of blended cash and Rock-Tenn stock consideration was fair to the Company's stockholders, from a financial point of view, and that Lazard's advice was unbiased and based on reasonable and customary valuation methodologies.

## Some Takeaways

1. A Fixed or a Floating Exchange Ratio Would Not Have Impacted the Revlon Analyses

The *Smurfit-Stone* decision may offer directors of Delaware corporations and transaction planners some guidance in designing a mixed stock and cash merger for purposes of determining whether that structure triggers the *Revlon* standard of judicial review. The Court of Chancery deemed insignificant the fact that the merger agreement provided for a fixed-exchange ratio (i.e., no value protection collar) that resulted in the initial 50% cash – 50% stock value to shift to a 44% cash – 56% split due to the post-signing increase in the price of Rock-Tenn's common stock and declined to entertain Defendants' post-hoc argument.

Vice Chancellor Parsons instructed that the date the merger agreement is entered into is the appropriate time to measure the allocation of cash and acquiror stock value for purposes of determining whether

[19] *Smurfit-Stone*, 2011 WL 2028076, at *17 (quoting *Lyondell Chem Co. v. Ryan*, 970 A.2d 235, 243-244 (Del. 2009).

[20] *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985); *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995).

*Revlon* is implicated. Certainly the decision whether to include a value protection collar in a merger agreement is based first and foremost on a variety of value, dilution/accretion and various economic factors and commercial risks impacting the acquiror and the target's stockholders; however, for now at least it appears clear that the use of a fixed or floating exchange ratio will have no impact regarding whether the *Revlon* standard of judicial review applies.

2. Judicial Sensitivity Analyses—Narrowing the Revlon "Spread"

Vice Chancellor Parsons narrowed the spread between the 33% cash component in *Santa Fe* (which did not trigger the directors' *Revlon* obligations), and the 62% cash cap in *Lukens* (that constituted a *Revlon* transaction). Therefore, it appears that in hybrid consideration mergers in which 50% or more of the value of the deal consideration consists of cash, the *Revlon* standard of judicial review will be applied.

However, the threshold at which *Revlon* may be implicated remains unclear in deals where more than 33% but less than 50% of the aggregate value to be paid to the target's stockholders will be paid in cash and where the resulting entity is not controlled by a stockholder or group and the acquiror's stock is a listed security that trades in a fluid, changing and [illegible] market. It continues to appear that where the merger consideration consists of 33% cash or a lesser percentage, *Revlon* does not apply (at least where the resulting entity is not controlled by a single stockholder or group).

3. No Pending Appeal to the Supreme Court

The *Smurfit-Stone* decision was somewhat predictable in view of the precedent established in *Santa Fe*, *Arnold*, *Nymex* and *Lukens*. However, as recognized by the Court of Chancery, the Delaware Supreme Court has yet to weigh in and, unless and until the Delaware Supreme Court does so, the Court of Chancery's decision—by its own admission—is not free from doubt.

Although the Plaintiffs were successful in arguing that the merger triggered the directors' enhanced value-maximizing obligations under *Revlon*, the Court of Chancery nonetheless denied Plaintiffs' motion for a preliminary injunction because, as a procedural matter, Plaintiffs failed to demonstrate a reasonable probability of success on the merits that the directors violated their fiduciary duties. Neither party has sought an appeal of the Court of Chancery's decision to the Delaware Supreme Court. Despite the decision, future arguments may continue to be made as to whether the form or mix of merger consideration payable by an uncontrolled publicly traded company should, without more, dictate whether the *Revlon* obligations of a target's directors are implicated.

4. The Importance of Disinterested and Independent Directors

Although the Court of Chancery noted that the Plaintiffs are likely to prevail on their argument that *Revlon* applies to the merger, it noted that irrespective of whether *Revlon* applies, Plaintiffs' injunction motion would have been denied. In so holding, the Court of Chancery noted the importance of having a properly composed and properly functioning independent and disinterested Special Committee (as well as the vast majority of the Company's board) running the sale process and negotiating and approving the merger agreement. Indeed, irrespective of the standard of judicial review applied, a transaction overseen, negotiated and approved in a fully informed manner by disinterested and independent directors creates a significant obstacle that a plaintiff must overcome in order to demonstrate that the target's directors breached their fiduciary duties.

As articulated by the Delaware courts over the years, "disinterestedness" is a state of fact, whereas "independence" is a state of being. Disinterestedness requires that a director have no pecuniary or other interest in, or benefit from, a transaction that is not shared generally by the company's stockholders. Independence requires that a director's decision is based entirely on the corporate merits of the transaction and not on other influences, biases or considerations.

5. No Blueprint for a Sale

Once again, the *Smurfit-Stone* decision illustrates that there is no judicial blueprint for Delaware directors to properly discharge their *Revlon* obligations in a sale of control.

A formal auction, a more limited pre-sign canvass of prospective financial and strategic buyer candidates, an exclusive negotiation (such as Smurfit-Stone and Rock-Tenn conducted), a passive post-sign market check or, in certain instances, an affirmative post-signing "go-shop" period (with a subsequent "window shop" period) may be appropriate or inappropriate, depending on the totality of facts and circumstances. Delaware law requires a contextually reasonable process; not a perfect one.

6. Deal Protections

There is a conceptual correlation between (i) the sufficiency and extent of the directors' pre-sign sale process (and, thus, the reliability and magnitude of the information available to the directors to enable them to be fully informed as to the intrinsic value of the company and the condition and prospects of the industry when they definitively agree to sell control of a Delaware company) and (ii) the interrelated package of deal protection covenants, fiduciary outs, conditions to closing and termination rights and remedies the parties negotiate and agree to in the definitive merger agreement.

As has been oft-repeated by the Delaware courts, the reasonableness of a particular mix of deal protections is context-specific and not formulaic. That is to say, a prescribed amount of pre-sign market check, director knowledge of the Company's business and value and of the industry or certain level of deal premium to the buyer's unaffected price, does not correspondingly require a prescribed level of buyer deal protections or target fiduciary outs.

Buyer deal protections should continue to be reviewed individually and collectively to determine (i) whether they are "preclusive" or "coercive" and, if not, whether they fall within a range of substantive reasonableness and (ii) whether they are consistent with the directors' obligation in a sale of control (and *Revlon's* enhanced duty of care and loyalty) to seek to obtain the best value (and overall transaction terms) reasonably attainable.[21]

---

[21] *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003); *In re Cogent S'holder Litig.*, 7 A.3rd 487 (Del. Ch. 2010); *Ryan v. Lyondell Chem Co*, 2008 WL 2923427 (Del. Ch. July 29, 2008)

A sister publication of the popular newsletter, *The Corporate Counsel*, *Deal Lawyers* is a bi-monthly newsletter for M&A practitioners to keep them abreast of the latest developments and analyze deal practices.

Publisher: **Jesse M. Brill.** Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is the Publisher/Editor of *The Corporate Counsel*, Chair of the National Association of Stock Plan Professionals, CompensationStandards.com and DealLawyers.com.

Editor: **Broc Romanek**, former SEC attorney and Editor of DealLawyers.com and TheCorporateCounsel.net. Broc can be reached at broc@deallawyers.com.

DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com

# "Tackling Your 2012 Compensation Disclosures: 6th Annual Proxy Disclosure Conference"

## Tuesday, November 1, 2011

### Full-Day Agenda and Schedule

*(Times are Pacific—but all panels will be archived and available at your discretion)*

9:00 – 9:40 am **"Say-on-Pay Disclosures: The Proxy Advisors & Investors Speak"**

**Speakers:** **Carol Bowie**, ISS; **David Eaton**, Glass Lewis; **Vineeta Anand**, AFL-CIO

9:40 – 10:20 am **"Say-on-Pay: The Executive Summary"**

**Speakers:** **Mark Borges**, Compensia; **Howard Dicker**, Weil Gotshal & Manges; **Keith Higgins**, Ropes & Gray; **Ira Kay**, Pay Governance; **Scott Spector**, Fenwick & West

10:35 – 11:30 am **"Drafting CD&A in a Say-on-Pay World"**

**Speakers:** **Mark Borges**, Compensia; **Keith Higgins**, Ropes & Gray; **Dave Lynn**, TheCorporateCounsel.net and Morrison & Foerster; **Ron Mueller**, Gibson Dunn & Crutcher; **Laura Thatcher**, Alston & Bird

11:30 – 12:15 pm **"The In-House Perspective: Changing Your Processes for 'Say-on-Pay'"**

**Speakers:** **Lydia Beebe**, Chevron; **Marian Block**, Lockheed Martin; **Mark Borges**, Compensia; **Ira Kay**, Pay Governance

1:15 – 2:00 pm **"Getting the Vote In: The Proxy Solicitors Speak"**

**Speakers:** **Art Crozier**, Innisfree M&A; **David Drake**, Georgeson; **Reid Pearson**, Alliance Advisors

2:00 – 2:45 pm **"Handling the New Golden Parachute Requirement"**

**Speakers:** **Mark Borges**, Compensia; **Mike Kesner**, Deloitte Consulting; **Ron Mueller**, Gibson Dunn & Crutcher; **Scott Spector**, Fenwick & West

3:00 – 3:40 pm **"The Latest SEC Actions: Compensation Advisors, Clawbacks, Pay Disparity & Pay-for-Performance"**

**Speakers:** **Mark Borges**. Compensia; **Dave Lynn**, TheCorporateCounsel.net and Morrison & Foerster; **Martha Steinman**, Dewey & LeBoeuf

3:40 – 4:00 pm **"Dealing with the Complexities of Perks"**

**Speakers:** **Mark Borges**, Compensia; **Alan Dye**, Hogan Lovells

4:00 – 4:30 pm **"Conducting—and Disclosing—Pay Risk Assessments"**

**Speakers:** **Keith Higgins**, Ropes & Gray; **Mike Kesner**, Deloitte Consulting; **Dave Lynn**, TheCorporateCounsel.net and Morrison & Foerster; **Laura Thatcher**, Alston & Bird

4:30 – 5:00 pm **"Say-on-Frequency & Other Form 8-K Challenges"**

**Speakers:** **Ning Chiu**, Davis Polk & Wardwell; **Alan Dye**, Hogan Lovells; **Dave Lynn**, TheCorporateCounsel.net and Morrison & Foerster; **Martha Steinman**, Dewey & LeBoeuf

5:00 – 5:45 pm **"How to Handle the 'Non-Compensation' Proxy Disclosure Items"**

**Speakers:** **Carol Bowie**, ISS; **Ning Chiu**, Davis Polk & Wardwell; **Howard Dicker**, Weil Gotshal & Manges; **Beth Ising**, Gibson Dunn & Crutcher; **Dave Lynn**, TheCorporateCounsel.net and Morrison & Foerster

# "The Say-on-Pay Workshop Conference"
# 8th Annual Executive Compensation Conference

## Wednesday, November 2, 2011

### Full-Day Agenda and Schedule

*(Times are Pacific—but all panels will be archived and available at your discretion)*

7:45 – 8:00 am **A Keynote Address by SEC Chair Mary Schapiro**

8:00 – 9:30 am **"Say-on-Pay Shareholder Engagement: The Investors Speak"**

**Speakers:** **Vineeta Anand**, AFL-CIO
**Donna Anderson**, T. Rowe Price Associates
**Anne Chapman**, Cap Re
**Michelle Edkins**, BlackRock
**Anne Sheehan**, CalSTRS

9:45 – 10:15 am **"Say-on-Pay: The Proxy Advisors Speak"**

**Speakers:** **Carol Bowie**, ISS
**Bob McCormick**, Glass Lewis

10:15 – 11:00 am **"How to Work with ISS & Glass Lewis: Navigating the Say-on-Pay Minefield"**

**Speakers:** **Rhonda Brauer**, Georgeson
**Art Crozier**, Innisfree M&A
**Jim Kroll**, Towers Watson
**Chris Pereira**, General Electric

11:30 – 12:45 pm **"Putting Your Best Foot Forward: How to Ensure Your Pay Practices Pass"**

**Speakers:** **Myrna Hellerman**, Sibson Consulting
**Mike Kesner**, Deloitte Consulting
**James Kim**, Frederic W. Cook & Co.
**Donna Anderson**, T. Rowe Price Associates

2:00 – 2:45 pm **"Say-on-Pay: The Director's Perspective"**

**Speakers:** **George Anderson**, Tapestry Networks
**Bonnie Hill**, The Home Depot, Yum! Brands, AK Steel Holding and California Water Service Group
**Linda Fayne Levinson**, DemandTec, Ingram Micro, Jacobs Engineering Group, NCR and Western Union
**Wesley von Schack**, AEGIS Insurance Services, The Bank of New York Mellon, Edwards Lifesciences and Teledyne Technologies

2:45 – 3:15 pm **"Failed Say-on-Pay? Lessons Learned from the Front"**

**Speakers:** **Jayme Collins**, Monsanto
**James Kim**, Frederic W. Cook & Co.
**Eric Marquardt**, Pay Governance

3:45 – 5:00 pm **"Say-on-Pay: Best Ideas for Putting It All Together"**

**Speakers:** **Ken Bertsch**, Society of Corporate Secretaries & Governance Professionals
**Carol Bowie**, ISS
**Michelle Edkins**, BlackRock
**Robbi Fox**, Exequity
**Mike Kesner**, Deloitte Consulting
**Bob McCormick**, Glass Lewis

**Do not delay. Hold your place. Register today!**

**Go to CompensationStandards.com now—or contact us at info@CompensationStandards.com or 925-685-5111 with questions.**