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Court of Chancery Clarifies the Reach of *Revlon* in Mixed Consideration Deals

BY GREGORY P. WILLIAMS AND KEVIN M. GALLAGHER

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The Delaware Supreme Court's opinion in *Revlon* has guided corporate boards of directors and their advisors for twenty-five years.[1] Despite the abundance of case law, whether *Revlon* applies in any given case remains the subject of much debate. While the Delaware Supreme Court has not had occasion to address the issue, the Delaware Court of Chancery is beginning to apply *Revlon*'s heightened reasonableness review more frequently in mixed-consideration transactions (*i.e.*, stock and cash). This clarification should not come as a surprise, nor should it give boards of directors pause.

Based on Delaware Supreme Court precedent, boards of directors must seek a transaction offering the best price reasonably available to stockholders in three situations: (i) when a company initiates an auction seeking to sell itself; (ii) "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 (iii) when a transaction results in a change of control.[2] The Court of Chancery's focus in mixed-consideration transactions, guided by the foregoing *Revlon*-triggering categories, is on whether such a transaction constitutes a change in control for purposes of applying enhanced scrutiny. The Delaware Supreme Court advises that a change of control, for purposes of *Revlon*, does not occur when control of both companies remains in a "large, fluid, changeable and changing market."[3] The application of this standard, however, becomes more nuanced when

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From the EDITOR

Continually Changing Parameters

Our start-of-summer issue (the next ***M&A Lawyer*** will publish in August 2011) is very Delaware Court of Chancery-heavy. It's no surprise as the Court has been quite busy of late, with a series of rulings that could have an impact on future M&A deals and adding a greater nuance to such standards as the 25-year-old *Revlon*.

For example, our lead article is an in-depth examination of the recently-decided *In re Smurfit-Stone Container Corp. Shareholder Litigation*, in which Vice Chancellor Parsons noted that "the case provide[d] cause for the Court to address a question that has not yet been squarely addressed in Delaware law; namely, whether and in what circumstances *Revlon* applies when merger consideration is split roughly evenly between cash and stock."

As Richards, Layton & Finger's Gregory Williams and Kevin Gallagher write in their analysis of the case, "despite the abundance of case law, whether *Revlon* applies in any given case remains the subject of much debate. While the Delaware Supreme Court has not had occasion to address the issue, the Delaware Court of Chancery is beginning to apply *Revlon*'s heightened reasonableness review more frequently in mixed-consideration transactions (*i.e.*, stock and cash)." Now comes *Smurfit-Stone*, where the Court ruled that *Revlon* did apply to the merger of Smurfit-Stone and Rock Tenn, which was roughly 50% cash, 50% stock. "*Revlon* applie[d]…because, among other things, 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."

That said, any expanded application of *Revlon* shouldn't be too much of a burden for most companies. As the authors note, "satisfying this enhanced standard is not insurmountable...The Court stated that *Revlon* has always required reasonableness, not perfection."

Announced in the same week as *Smurfit-Stone* was *Krieger v. Wesco Financial Corp.*, where the Court of Chancery highlighted its growing willingness "to review both negotiated transactions, and unilateral tender offers, under a unified standard if the deal contains certain procedural protections," write Skadden Arps' Edward Welch and Joseph Larkin. "These decisions indicate that regardless of how the deal is structured, if it is reviewed and recommended by a fully-empowered special committee, and conditioned on a majority-of-minority voting provision, the transaction will be reviewed under the business judgment rule."

Welch and Larkin note that while although "it remains far from settled, three recent decisions indicate that the Court of Chancery may be willing to review a controlling stockholder merger under the business judgment rule if the requirements of the *CNX* unified standard are met." For example, Vice Chancellor Laster denied a motion for a preliminary injunction to enjoin the proposed merger between Berkshire Hathaway and its 80.1% owned subsidiary, Wesco Financial Corp, indicating "that the Merger would be reviewed under *CNX*'s unified standard," the authors write.

It's likely that there will be a host of new cases to write about upon our return in August. Until then, please have a great and productive summer.

CHRIS O'LEARY

MANAGING EDITOR

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stockholders of the target have a portion of their equity interest cashed out while the other portion of their interest remains in a large, fluid, changeable and changing market. For example, in *In re Santa Fe Pacific Corporation Shareholder Litigation*, the Delaware Supreme Court held that a merger involving consideration of 33 percent cash and 66 percent stock did not trigger enhanced reasonableness review.[4] On the other hand, Vice Chancellor Lamb in *In re Lukens Inc. Shareholders Litigation* assumed that *Revlon* applied to a transaction involving consideration of 60 percent cash and 40 percent stock.[5] Most recently, both Vice Chancellor Parsons and Vice Chancellor Laster have concluded that enhanced reasonableness review under *Revlon* applies to transactions involving consideration comprised of 50 percent stock and 50 percent cash.[6]

In *In re Smurfit-Stone Container Corp. Shareholder Litigation*, Vice Chancellor Parsons noted that "the case provide[d] cause for the Court to address a question that has not yet been squarely addressed in Delaware law; namely, whether and in what circumstances *Revlon* applies when merger consideration is split roughly evenly between cash and stock."[7] On January 23, 2011, the board of directors of Smurfit-Stone Container Corp. ("Smurfit-Stone") unanimously approved a merger agreement whereby Smurfit-Stone would be acquired by Rock-Tenn Company ("Rock-Tenn") in a cash and stock transaction worth approximately $3.5 billion.[8] Under the terms of the merger agreement, Smurfit-Stone's stockholders were entitled to receive $17.50 in cash and 0.30605 shares of Rock-Tenn common stock for each share of Smurfit-Stone common stock.[9] The total consideration amounted to $35 per share based on Rock-Tenn's closing price immediately prior to announcement of the merger.[10] Upon consummation of the merger, Smurfit-Stone's stockholders would own approximately 45 percent of Rock-Tenn's outstanding common stock.[11] Shortly after announcement of the merger, stockholders of Smurfit-Stone filed putative class actions in the Delaware Court of Chancery and in the Illinois Circuit Court of Cook County.[12]

From the outset, plaintiffs argued that "*Revlon* [applied] to this case because the Merger Consideration was comprised of 50% cash and 50% stock at the time the parties entered into the Agreement, which qualifie[d] the Proposed Transaction as a 'change of control' transaction."[13] The Court agreed.[14] In so holding, the Court reasoned that "*Revlon* applie[d]…because, among other things, 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."[15] This reasoning demonstrates the Court of Chancery's focus on end-game or final-stage transactions, whereby the target's stockholders lose the ability to participate in the resulting entity's future growth. Vice Chancellor Parsons explained 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 Vice Chancellor Lamb's concern [in *Lukens*] 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 stockholder's investment in Smurfit-Stone. That each stockholder may retain a portion of her 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.[16]**

As the Court noted, "the fact that control of Rock-Tenn after consummation will remain in a large pool of unaffiliated stockholders, while important, neither addresses nor affords protection to the portion of the stockholders' investment that will be converted to cash and thereby be deprived of its long-run potential."[17]

While the application of *Revlon* requires the Court of Chancery to review a board of directors' actions for reasonableness, as opposed to deferring to the board's business judgment, satisfying

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this enhanced standard is not insurmountable. In *Smurfit-Stone*, Vice Chancellor Parsons determined that the Smurfit-Stone board of directors relied on adequate information in its decision-making process and acted reasonably under the circumstances.[18] The Court stated that *Revlon* has always required reasonableness, not perfection.[19] As a result, the Court rejected the plaintiffs' assertion that the Smurfit-Stone board acted unreasonably in deciding to enter into the merger agreement with Rock-Tenn.

Vice Chancellor Parsons' decision in *Smurfit-Stone* comes on the heels of comments made by Vice Chancellor Laster at a preliminary injunction hearing in *Steinhardt v. Howard-Anderson*.[20] In *Steinhardt*, the target stockholders were to receive approximately 50 percent cash and 50 percent stock, and the former target stockholders would own approximately 15 percent of the surviving corporation. Vice Chancellor Laster expressed that "enhanced scrutiny applies…when you have a final stage transaction. The reason enhanced scrutiny applies to a change of control is because it's a constructive final stage transaction. You're giving up control to a person who could then cash you out because he's the new controller. This is a situation where the target stockholders are in the end stage in terms of their interest in [the target]."[21] Thus, Vice Chancellor Laster concluded, just as Vice Chancellor Parsons did in *Smurfit-Stone*, that "[t]his is the only chance that [the target] stockholders have to extract a premium, both in the sense of maximizing cash now, and in the sense of maximizing their relative share of the future entity's control premium. This is it. So I think it makes complete sense that you would apply a reasonableness review, enhanced scrutiny to this type of transaction."[22] As a result, Vice Chancellor Laster reviewed the board's actions for reasonableness, but declined to enjoin the proposed transaction based on plaintiff's *Revlon* claims. The Court, however, preliminarily enjoined the transaction to remedy certain disclosure violations.[23]

The Court of Chancery's recent decisions evidence a clarification in the application of *Revlon* and a focus on end-game or final-stage transactions for the target's stockholders. A board of directors considering a transaction where all or a portion of the stockholders' equity interests will be liquidated should be prepared to defend, if challenged, the reasonableness of its actions under *Revlon* and its progeny. As noted by Vice Chancellor Laster, "back in 1989, it made sense for people to be worried over the line between *Revlon* and non-*Revlon*…We now know it's a reasonableness test."[24] Although enhanced scrutiny involves a more searching inquiry into a board's actions than the deferential business judgment rule, a board of directors, advised by experienced legal and financial advisors and acting in the stockholders' best interests, should be able to satisfy this standard.

NOTES

1. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
2. *In re Santa Fe Pac. Corp. S'holder Litig*., 669 A.2d 59, 71 (Del. 1995) (citing *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42-43, 47 (Del. 1993); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990)).
3. *Id*.
4. *Id.* at 70-71.
5. *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 731-32 & n.25 (Del. Ch. 1999); *see also id.* at 732 n.25 ("I nevertheless note that although there is no case directly on point, I cannot understand how the Director Defendants were *not* obliged, in the circumstances, to seek out the best price reasonably available. The defendants argue that because over 30% of the merger consideration was shares of Bethlehem common stock, a widely held company without any controlling shareholder, *Revlon* and *QVC* do not apply. I disagree. Whether 62% or 100% of the consideration was to be in cash, the directors were obliged 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.'") (citations omitted). Further, Vice Chancellor Noble considered, but did not decide, whether *Revlon* applied in a transaction involving 56 percent cash and 44 percent stock in *In re NYMEX Shareholder Litigation*. 2009 WL 3206051, at *5-6 (Del. Ch. Sept. 30, 2009).
6. *See In re Smurfit-Stone Container Corp. S'holder Litig.*, 2011 WL 2028076 (Del. Ch. May 20, 2011, revised May 24, 2011); *Steinhardt v. Howard-Anderson*, C.A. No. 5878-VCL (Del. Ch. Jan. 24, 2011) (Transcript).
7. *Smurfit-Stone*, 2011 WL 2028076, at *1.
8. *Id*.

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9. *Id.* at *9.
10. *Id.*
11. *Id.*
12. *Id.* The actions filed in Illinois were stayed pending resolution of the actions filed in Delaware. *Id.*
13. *Id.* at *12.
14. Vice Chancellor Parsons noted that "[t]he Supreme Court has not yet clarified the precise bounds of when *Revlon* applies in the situation where merger consideration consists of an equal or almost equal split of cash and stock." *Id.* at *13.
15. *Id.*
16. *Id.* at *14.
17. *Id.* at *15.
18. *Id.* at *16-24.
19. *Id.* at *16 (citing *In re Dollar Thrifty S'holders Litig.*, 14 A.3d 573, 595 (Del. Ch. 2010)).
20. *Steinhardt v. Howard-Anderson*, C.A. No. 5878-VCL (Del. Ch. Jan. 24, 2011) (Transcript).
21. *Steinhardt*, C.A. No. 5878-VCL, Tr. at 4.
22. *Id.* at 5-6.
23. *Id.* at 18-20.
24. *Id.* at 6.

After *CNX*, an Evolving Standard for Controlling Stockholder Buyout Transactions

BY EDWARD P. WELCH AND JOSEPH O. LARKIN

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Until a recent string of opinions from the Delaware Court of Chancery, Delaware courts traditionally applied a different standard of review to controlling stockholder buyout transactions depending on how the deal was structured. However, beginning with *In re CNX S'holders Litig.*[1] (hereinafter "*CNX*") and most recently in *Krieger v. Wesco Financial Corp.*[2], the Court of Chancery appears willing to review both negotiated transactions, and unilateral tender offers, under a unified standard if the deal contains certain procedural protections. These decisions indicate that regardless of how the deal is structured, if it is reviewed and recommended by a fully-empowered special committee, and conditioned on a majority-of-minority voting provision, the transaction will be reviewed under the business judgment rule.

The Traditional Standards of Review for Controlling Stockholder Buyouts

Until *CNX*, a negotiated transaction between the controlling stockholder and the target was traditionally reviewed under the entire fairness standard.[3] In an entire fairness context, the initial burden of establishing entire fairness lies with the controlling stockholder.[4]

Historically, the only refuge from entire fairness was burden-shifting through either minority shareholder approval ***or*** approval by an independent and disinterested special committee.[5] There was no benefit to getting both minority stockholder approval ***and*** approval by a special committee in terms of a wholesale change to the standard of review.[6] Nevertheless, using both procedural protections made it difficult for a plaintiff to prove unfairness on the merits. From a litigation standpoint, the practical difficulty is that the *Lynch* standard "makes it impossible for a controlling stockholder to structure a going private merger in any fashion that will enable a successful attack on a complaint that alleges financial unfairness on a notice pleading basis."[7]

Unilateral tender offers made by the controlling stockholder directly to the minority stockholders offered something of a solution for parties seeking to avoid entire fairness review. Until *CNX*, unilateral tender offers were reviewed under an evolving standard far less onerous than *Lynch's* inescapable entire fairness review. Historically, unilateral tender offers were not reviewed for entire fairness; rather, the inquiry focused on whether the tender offer was coercive.[8]

Shortly after *Siliconix* was decided, Vice Chancellor Strine in his *Pure Resources* opinion pro-

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vided a menu of protective measures that would result in a tender offer not being deemed coercive.[9] *Pure Resources* holds that a unilateral tender offer made by a controlling stockholder will be deemed non-coercive, only when: (i) it is subject to a non-waivable majority-of-the-minority tender condition; (ii) the controlling stockholder promises to consummate a prompt short-form merger at the same price if it obtains more than 90% of the shares; (iii) the controlling stockholder has made no retributive threats; and (iv) the independent directors on the target board have free rein and adequate time to react to the tender offer (the "*Pure Resources* Test").[10]

A few years later, in *In re Cox Communications Shareholder Litig.*,[11] 879 A.2d 604 (Del. Ch. 2005), Vice Chancellor Strine suggested in dicta that the standard for both negotiated mergers and tender offers could be collapsed into a so-called "unified standard" for reviewing controlling stockholder buyout transactions, although he recognized that would change the existing and accepted law.[12] The Court suggested it might make sense that a negotiated merger could escape entire fairness and also that a tender offer could be deemed non-coercive and not subject to entire fairness if the deal involved ***both*** minority stockholder approval and approval by an independent and disinterested committee.[13] This would have the effect of avoiding *Lynch* (allowing an escape from entire fairness review) and adding an additional element to the *Pure Resources* menu (requiring independent and disinterested director approval to avoid entire fairness review). However, prior to *CNX*, the Court of Chancery did not apply the unified standard outlined in *Cox* to controlling stockholder buyouts.

The *CNX* Court Adopts *Cox*'s "Unified Standard"

In *CNX*, Vice Chancellor Laster reviewed a unilateral tender offer that was conditioned on the formation of a special committee to review—but not recommend—the transaction, and a majority-of-the-minority condition.[14] In a departure from *Lynch* and the *Siliconix/Pure Resources* line of cases, Vice Chancellor Laster reviewed the transaction under the unified standard articulated in *Cox*.[15] According to the Court, if either a negotiated merger or unilateral tender offer is both (i) negotiated and recommended by a special committee of independent directors, and (ii) conditioned on the affirmative vote or tender of a majority of minority stockholders, then the deal will not be enjoined ***and*** the business judgment standard presumptively applies in a damages action.[16]

Ruling on a motion for a preliminary injunction, the Court found that entire fairness review would apply to the proposed transaction because the special committee did not recommend in favor of the tender offer, but rather remained neutral. The Court also noted problems with the effectiveness of the majority-of-the-minority condition to the tender offer because, prior to commencing the tender offer, the controlling stockholder had entered into a tender agreement with the subsidiary's second largest stockholder (which had a possible conflict of interest because it was also a significant stockholder of the parent) under which that stockholder agreed in advance to tender its shares.

Indeed, the principal difference between the *CNX* and *Pure Resources* standards concerns whether the target board should be required (or effectively required to avoid entire fairness review) to negotiate with the controller, and make a recommendation in favor of the proposed transaction. In applying the "unified standard," Vice Chancellor Laster recognized that there was a split in the Court of Chancery on the appropriate standard of review for unilateral tender offers, but added that he believed the unified standard from *Cox* offers the "coherent and correct approach." The Court recognized that the law on this issue was in flux, and later granted a motion for interlocutory appeal of this issue to the Delaware Supreme Court, but the Supreme Court declined to hear the interlocutory appeal.[17] The Delaware Supreme Court denied a similar request for interlocutory relief in *In re Cox Radio, Inc. S'holders Litig.*[18]

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Recent Decisions Indicate a Trend Towards the *CNX* Unified Standard

Although it remains far from settled, three recent decisions indicate that the Court of Chancery may be willing to review a controlling stockholder merger under the business judgment rule if the requirements of the *CNX* unified standard are met.

Most recently, Vice Chancellor Travis Laster denied a motion for a preliminary injunction to enjoin the proposed merger between Berkshire Hathaway, Inc. ("Berkshire") and its 80.1% owned subsidiary, Wesco Financial Corp. ("Wesco"). Under the terms of the Merger, Wesco's stockholders had the opportunity to receive cash or shares of Berkshire Class B common stock in whatever proportion they choose, without any proration or reallocation. The Merger was approved by a fully-empowered, independent special committee of Wesco directors, and is subject to a non-waivable majority-of-the-minority voting condition.

In denying the motion, the Court indicated that the Merger would be reviewed under *CNX*'s unified standard. The Court concluded that based on the record, both prongs of the unified standard had been met. Importantly, the Court rejected plaintiff's argument that the Special Committee was conflicted because one of its members held approximately $20 million of stock in Berkshire Hathaway, which accounted for approximately 30-50% of his net worth. The Court accepted the Special Committee's argument that the director's interest in Berkshire was not material because the Merger did not have a material impact on the value of his Berkshire stock. Moreover, the Court rejected plaintiff's argument that the majority-of-the-minority condition was tainted because it failed to exclude Wesco's largest individual stockholder, who was also a member of the Special Committee. This is the first case since *CNX* where the Court has apparently applied *CNX*'s unified standard to a controlling stockholder merger.

In *Reis v. Hazelett Strip-Casting Corp.*,[19] the CEO and controlling stockholder used a reverse stock split to freeze out minority stockholders without implementing any procedural protections, including forming an independent special committee or making the stock split contingent on majority-of-the-minority approval.[20] The beneficiary of the estate that would have received shares in the company but for the stock split sued, alleging, among other things, that the defendants breached their fiduciary duties by orchestrating the reverse stock split.[21]

After a full trial, Vice Chancellor Laster found that where, as here, the controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections, the transaction will be reviewed for entire fairness with the burden of proof on the defendant fiduciaries.[22] The Court concluded that the transaction was not entirely fair to the corporation's minority stockholders, and awarded damages, plus pre- and post-judgment interest, based on the Court's determination of the fair value of the shares.[23]

In reaching its decision, the Court noted that if the controlling stockholder had permitted the board to form a duly empowered and properly functioning special committee, or if the transaction was conditioned on a correctly formulated majority-of-the-minority vote, then the burden could have shifted to the plaintiff to prove that the transaction was unfair.[24] Importantly, the Court stated that if the controlling stockholder permitted the use of both protective devices, then the transaction could have avoided entire fairness review altogether.[25] Notably, however, neither condition was met in *Reis*, and the transaction was reviewed for entire fairness.

In *S. Muoio & Co. LLC v. Hallmark Entertainment Investments Co.*,[26] plaintiff shareholders challenged the fairness of the recapitalization of Crown Media Holdings, Inc. orchestrated by Crown's controlling stockholder and primary debt holder, Hallmark Cards, Inc. and its affiliates.[27] For years, Crown was unable to make its debt payments, and was forced to obtain extensions on the debt from Hallmark.[28] In the Recapitalization, Hallmark exchanged its Crown debt for an increased percentage of Crown's Class A common stock, new preferred stock and a new and far smaller amount of debt with longer ma-

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turities, thereby permitting Crown to avoid a debt default and bankruptcy.[29]

After a full trial, the Court found in favor of defendants after concluding that the process and the price of the recapitalization were entirely fair. Importantly, the Court found that plaintiff would bear the burden of proof under entire fairness because the recapitalization had been approved by a fully-empowered, independent special committee.[30] The Court also left open the possibility that the transaction could have "avoid[ed] entire fairness review completely" if the recapitalization had been subject to a majority-of-the-minority vote, and could have been reviewed under the business judgment rule.[31]

NOTES

1. 4 A.3d 397 (Del. Ch. 2010).
2. C.A. No. 6176-VCL (Del. Ch. May 14, 2011).
3. *See Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994) (hereinafter *Lynch*); *see also In re CNX S'holders Litig.*, 4 A.3d 397, 406 n.1 (Del. Ch. 2010); *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 956-57 (Del. Ch. 2010); *Abrons v. Marée*, 911 A.2d 805 (Del. Ch. 2006).
4. *Id.* at 1117.
5. *Lynch*, 638 A.2d at 1117
6. *Id.*
7. *See In re Cox Comm'ns S'holders Litig.*, 879 A.2d 604, 643 (Del. Ch. 2005).
8. *See In re Siliconix Inc. S'holders Litig.*, 2001 WL 716787, at *6-8 (Del. Ch. June 19, 2001); *see also In re Aquila Inc. S'holders Litig.*, 805 A.2d 184, 190 (Del. Ch. 2002). These cases are commonly referred to as "*Siliconix* transactions."
9. *Pure Res.*, 808 A.2d 421 (Del. Ch. 2002).
10. *Id.* at 445.
11. 879 A.2d 604 (Del. Ch. 2005).
12. *Id.* at 643-46.
13. *Id.*
14. *CNX*, 4 A.3d at 412-13.
15. *Id.*
16. *CNX*, 4 A.3d at 412-13.
17. *In re CNX S'holders Litig.*, 2010 WL 2705147 (Del. Ch. July 5, 2010).
18. 2010 WL 1806616, *10-12 (Del. Ch. May 6, 2010).
19. C.A. No. 3552-VCL, 2011 WL 303207, at *10 -11 (Del. Ch. Feb. 1, 2011),
20. *Id.* at *1.
21. *Id.* at *6.
22. *Id.* at *10 (internal citations omitted).
23. *Id.* at *28.
24. *Id.* (citing *Cox Comm'ns, Inc. S'holders Litig.*, 879 A.2d 604, 644 (Del. Ch. 2005)).
25. *Id.* (citing *CNX*, 4 A.3d 397, 400 (Del. Ch. 2010); *In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2009 WL 3165613, at *12 (Del. Ch. Oct. 2, 2009); Cox, 879 A.2d at 606.)
26. C.A. No. 4729-CC, 2011 WL 863007 (Del. Ch. Mar. 29, 2011)
27. *Id.* at *1.
28. Id.
29. *Id.*
30. *Id.*
31. *Id.* at *9 n.73 (citing *Reis*, 2011 WL 303207, at *10) (citing *CNX*, 4 A.3d at 400; *John Q. Hammons*, 2009 WL 3165613, at *12; *Cox*, 879 A.2d at 606)).

Competition M&A Rules in India Finalized

BY DAVID A. CARPENTER, PAUL C. DE BERNIER, KIRAN DESAI AND MANU MOHAN

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The Competition Commission of India (CCI) recently published the CCI Regulations (Procedure in regard to the transaction of business relating to combinations), 2011 ("Combination Regulations"). This follows the publication of Draft Combination Regulations ("Draft Regulations") setting out the scheme for implementing the merger control provisions[1] and the extensive consultation period which followed.

The Combination Regulations are certainly a step forward and seem to have taken on board most of the suggestions made by stakeholders (including Mayer Brown) during the consultation process. Key reforms include:

- prescription of a list of combinations that 'normally need not be notified' such as a combination taking place entirely outside In-

dia with insignificant local nexus and effect on markets in India;

- simplification of Form I;
- clarification of 'ongoing deals' that need to be notified after 1 June 2011; and
- reduction of the filing fees.

Filing Requirements

The requirement to notify the CCI is mandatory under the Competition Act, 2002 (as amended) ("Act"). The filing thresholds relate to either (i) the acquirer and the target (the "Parties") or (ii) the group to which the target/merged entity will belong post-acquisition (the "Group") and are as follows:

- The Parties have combined assets in India of Rupees 1500 crores (approx. $333 million) or combined turnover in India of Rupees 4500 crores (approx. $1 billion); or
- The Parties have combined worldwide assets of $750 million or combined worldwide turnover of $2.25 billion and combined assets in India of Rupees 750 crores (approx. $166 million) or combined turnover in India of Rupees 2250 crores (approx. $500 million); or
- The Group has assets in India of Rupees 6000 crores (approx. $1.3 billion) or turnover in India of Rupees 18000 crores (approx. $4 billion); or
- The Group has worldwide assets of $3 billion or worldwide turnover of $9 billion and assets in India of Rupees 750 crores (approx. $166 million) or turnover in India of Rupees 2250 crores (approx. $500 million).
- For a period of 5 years from 1 June 2011 a proposed transaction that would have to be notified under Section 5 of the Act will not have to be notified if the target enterprise has assets of not more than Rupees 250 crores (approx. $55 million) or a turnover of not more than Rupees 750 crores (approx. $166 million) in India.

The Combination Regulations now provide for categories of transactions not likely to have an appreciable adverse effect on competition in India for which a notification "*need not normally be filed.*" The categories of transactions include an:

(i) Acquisition of shares or voting rights:

- solely as an investment or in the ordinary course of business in so far as the total shares or voting rights held by the acquirer directly or indirectly, do not exceed 15% percent of the total shares or voting rights of the target company, of which shares or voting rights are being acquired, directly or indirectly or in accordance with the execution of any document including a shareholders' agreement or articles of association, not leading to acquisition of control of the target company;
- where the acquirer, prior to acquisition, has 50% or more shares or voting rights in the enterprise whose shares or voting rights are being acquired, except in the cases where the transaction results in transfer from joint control to sole control;
- pursuant to a bonus issue or stock splits or consolidation of face value of shares or subscription to rights issue to the extent of their entitled proportion, not leading to acquisition of control;
- by a person acting as a securities underwriter or a registered stock broker of a stock exchange on behalf of its clients, in the ordinary course of its business and in the process of underwriting or stock broking, as the case may be;

(ii) Acquisition of assets not directly related to the business activity of the party acquiring the asset or made solely as an investment or in the ordinary course of business, not leading to control of the enterprise whose assets are being acquired except where the assets being acquired represent substantial business operations in a particular location or for a

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particular product or service of the enterprise, of which assets are being acquired, irrespective of whether such assets are organized as a separate legal entity or not;

(iii) Amended or renewed tender offer where a notice has been filed before the CCI by the party making the offer, prior to such amendment or renewal of the offer provided that the compliance with regulation relating to intimation of any change is duly made;

(iv) Acquisition of stock–in-trade, raw materials, stores and spares in the ordinary course of business;

(v) Acquisition of current assets in the ordinary course of business; and

(vi) Acquisition of control or shares or voting rights or assets by one person or enterprise of another person or enterprise within the same Group.

Local Nexus

The filing requirements thresholds can be satisfied even though one party, for example, the target, has no assets in India or turnover in/into India. Consequently the Act would catch transactions with no local nexus. This was the subject of criticism from several quarters. The Combination Regulations have greatly improved the situation by providing that "a combination taking place entirely outside India with insignificant local nexus and effect on markets in India" "need not normally be filed."

This test will need to be interpreted either through guidance or through decisional practice.

Form of Notice

The Draft Regulations had provided for three different notification forms, *i.e.* Form I (short form), Form II (long form) and Form III (where acquisition, share subscription or a financing facility is entered into by a financial institution, foreign institutional investor, venture capital etc. under a loan or investment agreement). This continues to be the case but it is to be noted that on the positive side the Combination Regulations now provide for a less burdensome Form I. However the CCI could direct the parties to file a Form II notification and the time required to file such notice would be excluded from the calculation of the time period under which the CCI is required to pass orders.

The Combination Regulations also provide for some indication as to when a Form I notification is appropriate and two of such instances are provided below:

- where the parties to a combination are engaged in the production, supply, distribution, storage, sale or trade of similar or identical or substitutable goods/service and the combined market share of the parties to the combination is less than 15%;
- where the parties to a combination are engaged at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or trade in goods or provision of services and their individual or combined market share is less than 25%.

If the market shares are greater than those stated above the implication is that the longer more detailed Form II should be used. The Combination Regulations further provide that where the intended effect of a business transaction is achieved by way of a series of steps or smaller individual transactions which are inter-connected or inter-dependent on each other one or more of which may amount to a combination, a single notice covering all these transactions may be filed by the parties to the transaction.

Time Period for Filing of Notification and Fees

Although the clause relating to pre-notification consultation has been deleted, the Chairman of the CCI in a press statement declared that the doors of the CCI remain open to such consultations. The deletion of this clause may not be of much significance for now as there seems to be a lot of apprehension among corporations about

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the ability of the CCI to guarantee confidentiality of information.

The Act provides that a notification has to made within 30 days of the:

- approval of the proposed merger or amalgamation by the Board of Directors of the enterprises concerned;
- execution of any agreement or other document for the acquisition or acquiring of control.

Although it is not expressly stated as such it seems that the notification requirement is met when the earlier of either of these events occurs. It is clarified in the Combination Regulations that the words 'other document' above shall mean any binding document, by whatever name called, conveying an agreement or decision to acquire control, shares, voting rights or assets. In case of a hostile takeover 'other document' refers to any document executed by the acquiring enterprise, by whatever name called, conveying a decision to acquire control, shares or voting rights. In case such a document has not been executed but the intention to acquire has been communicated to the Central Government or State Government or a Statutory Authority, the date of such communication shall be deemed to be the date of execution of the 'other document' for acquisition.

A marked improvement from the Draft Regulations is the fact that the CCI clarifies in the Combination Regulations that a notification needs to be provided for:

- mergers or amalgamations, only in regard to proposals approved by the Board of Directors on or after the 1 June 2011 and this approval refers to the final decision of the Board of Directors;
- acquisitions, where the binding document(s) is executed on or after 1 June 2011.

As for filing fees, whereas the Draft Regulations had provided for a sliding scale of fees ranging from Rupees 10 lakhs (approx. $22,000) to Rupees 40 lakhs (approx. $89,000), it would come as a relief to many corporations that this has been significantly reduced to Rupees 50,000 (approx. $1,100) and Rupees 10 lakhs (approx. $22,000) for a Form I and Form II notification respectively.

Time Required for Issue of Orders

The provisions contained in the Draft Regulations that the CCI is to form a prima facie opinion on the proposed transaction within 30 days of submission of the notification form is retained. The proposed transaction will then be cleared or subject to what could possibly be termed as a second 'phase' investigation. The Combination Regulations provide that the CCI "shall endeavour to pass an order" in a second 'phase' investigation within 180 days from the date of submission of the notification form. It is to be noted, however, that the time limit under the Act to pass a final order continues to remain as 210 days. As an improvement to the Draft Regulations it has been clarified that reference to 'days' shall be to calendar days.

Conclusion

The Combination Regulations is a much improved version compared to the Draft Regulations. It does show willingness on the part of the CCI to engage in consultations with stakeholders and make improvements to the legislation. There is scope for improvement such as the explanation of the situations in which it may be deemed that there is a change from sole to joint control and for synchronization of the laws with other laws and regulations in India. It is hoped that this will happen soon and that the CCI will continue to demonstrate its willingness to engage with stakeholders in the future.

NOTES

1. "No more 'cry wolf'—India's merger control provisions come into effect on 1 June 2011," http://www.mayerbrown.com/publications/article.asp?id=10596.

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Corporate Governance Feature: Delaware Courts Weigh In On Books and Records Inspections

BY BOB REDER, DAVID SCHWARTZ AND ROXANA AZIZI

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Over the past nine months, Delaware courts have been asked to resolve several disputes arising from books and records inspection requests. In each of these decisions, the court asserted the importance of the inspection right as a mechanism for equity holders to police the actions of company managers. The purpose of this article is to discuss one of these decisions, issued by the Delaware Supreme Court, in order to provide some insight into the manner in which aggrieved shareholders can gain access to books and records for purposes of investigating potential breaches of fiduciary duty.

DGCL §220—Corporate Books and Records Inspections

Delaware boards of directors generally are afforded significant discretion in the exercise of their duties and obligations through the broad reservation of powers provided to them by Section 141(a) of the Delaware General Corporation Law ("DGCL"). Moreover, with certain notable exceptions, Delaware courts typically defer to decisions and actions of boards of directors through

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application of the business judgment rule. In view of the limited rights allocated to shareholders by the DGCL (principally, electing directors, approving charter amendments, mergers and substantial asset sales, and adopting bylaws), Delaware courts zealously guard those rights that are granted to shareholders by applying higher standards of review when board actions touching upon these rights are challenged. For instance, in the line of cases beginning with *Blasius Industries, Inc. v. Atlas Corp.*,[1] Delaware courts have applied a "compelling justification" standard to protect the right of shareholders to vote in director elections.

One other right specifically allocated to shareholders is the right granted by DGCL §220 to inspect corporate books and records for a "proper purpose."[2] A "proper purpose" is one "reasonably related to such person's interest as a stockholder."[3] Last year, in *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*,[4] the Delaware Supreme Court sought to protect and give meaning to the right of shareholders to conduct books and records inspections.

City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.

In *Axcelis*, the Delaware Supreme Court upheld a Court of Chancery ruling that denied a disgruntled Axcelis shareholder access to corporate books and records. The shareholder's stated purpose in seeking access was to investigate potential wrongdoing in connection with the Axcelis board's rejection of tendered resignations by three of its members pursuant to a "plurality plus" corporate governance policy. The Delaware Supreme Court agreed with the Court of Chancery that, although the shareholder stated a "proper purpose," the fact that the board rejected the tendered resignations—without more—was not "credible evidence"[5] of wrongdoing sufficient to support granting access. The Court of Chancery was particularly mindful of the negative impact that a contrary ruling could have on the willingness of boards of directors to adopt "plurality plus" policies.

While affirming the Court of Chancery's ruling, the Delaware Supreme Court also took the opportunity to bless an alternate—and ultimately less rigorous—path for shareholders to gain access to corporate books and records as a prelude to challenging decisions made pursuant to a board-adopted "plurality plus" policy. *First*, the Delaware Supreme Court indicated that investigation of the suitability of directors to continue in office is a "proper purpose" under DGCL §220. And, *second*, the Delaware Supreme Court stated that if enough shareholders withhold their votes from incumbent directors so as to trigger their resignations under a "plurality plus" policy, that fact alone can constitute sufficient "credible basis" of the directors' unsuitability to warrant a books and records inspection. Ironically, this seemingly advisory aspect of the Delaware Supreme Court's ruling may have precisely the negative impact on "plurality plus" policies that the Court of Chancery sought to avoid in denying access to Axcelis' disgruntled shareholder.

Background

Axcelis Technologies, Inc., a Nasdaq-traded company specializing in the manufacture and sale of semiconductor equipment, was an equal partner with Sumitomo Heavy Industries, Ltd. in a joint venture called "SEN." In early 2008, Axcelis twice rejected unsolicited take-over bids from Sumitomo on the basis that they "materially discounted Axcelis' true net worth."[6] Axcelis did indicate to Sumitomo that it was willing to discuss privately a transaction involving SEN, but no such talks apparently were held at that time.

Subsequently, at Axcelis' 2008 annual shareholders meeting, three members of Axcelis' classified board of directors ran unopposed for re-election. Although the directors were re-elected by a plurality vote in accordance with Axcelis' bylaws,[7] a greater number of votes were "withheld" from their candidacies than were voted in their favor. Therefore, as required by Axcelis' board-established "plurality plus" policy, the three directors submitted their resignations.[8] The board, citing the advice of its independent Nominating and Governance Committee, as well as the

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experience and knowledge of the three directors, their service on key board committees and the importance of retaining the directors if negotiations with Sumitomo proceeded, decided not to accept the resignations.

Following the annual meeting, Axcelis began discussions of a potential buy-out transaction with Sumitomo. In September, however, Sumitomo put these discussions on hold without submitting a revised bid. Following public announcement of this development, the trading price of Axcelis common stock dropped precipitously. Then, in February 2009, in order to finance the repayment of outstanding notes that had fallen into default, Axcelis sold its stake in SEN to Sumitomo at a price reflecting only a fraction of the valuation implicit in Sumitomo's earlier offers. When this sale was announced, Axcelis' share price again took a dramatic fall.

Disappointed with these developments, an Axcelis shareholder—the City of Westland Police & Fire Retirement System ("Westland")—delivered a demand to inspect Axcelis' books and records for the purpose of investigating "the Board members' compliance with their fiduciary duties."[9] After Axcelis rejected this demand, Westland filed a complaint in the Court of Chancery under DGCL §220, contending that its desire to investigate potential wrongdoing on the part of the Axcelis board constituted a "proper purpose." Specifically, Westland argued, the board's failure to accept the resignations of the three directors following the triggering of Axcelis' "plurality plus" policy was motivated by an improper desire to entrench the directors in office. Westland also cited the board's rejection of Sumitomo's earlier offers as further evidence of the directors' desire to entrench themselves. In Westland's view, these circumstances provided a "credible basis" from which to infer potential wrongdoing.

The Court of Chancery's Analysis

The Court of Chancery rejected Westland's claim, determining that although investigation of potential directorial wrongdoing is a proper purpose for a books and records claim, Westland failed to establish the other key element developed by the Delaware judiciary for shareholders to gain access to corporate books and records—"credible evidence" of the alleged wrongdoing. The Court of Chancery expressed particular concern that "[i]f mere acting in accordance with the terms of a [plurality plus] policy is to be found credible evidence of wrongdoing, then its death knell has been rung."[10] The Court of Chancery also deferred to the board's handling of the Sumitomo offers, ruling that "[r]ejecting an acquisition offer, without more, is not [a] 'defensive action' under *Unocal*" that triggers enhanced scrutiny of the board's actions.[11] Westland appealed this ruling to the Delaware Supreme Court.

The Delaware Supreme Court's Analysis

The Delaware Supreme Court agreed with the Court of Chancery that, to support a books and records investigation, a plaintiff must present "some evidence"[12] to "suggest a credible basis"[13] from which a court can infer the existence of directorial wrongdoing or mismanagement. A relaxation of the "credible basis" standard, characterized by the Delaware Supreme Court as the "lowest possible burden of proof,"[14] would "be tantamount to permitting inspection based on the plaintiff-stockholder's mere suspicion of wrongdoing."[15] The Delaware Supreme Court also agreed with the Court of Chancery's application of the facts, ruling that its denial of Westland's claim "must stand, because the record provides no credible basis to infer that [the board's actions] were other than good faith business decisions."[16]

However, because "this dispute arises in connection with a shareholder vote,"[17] the Delaware Supreme Court was not content merely to affirm the Court of Chancery's decision, but proceeded to "a further elaboration of the 'proper purpose' requirement" in the context of "plurality plus" policies. In this connection, the Delaware Supreme Court cited, with approval, the analytical framework articulated by the Court of Chancery in *Pershing Square, L.P. v. Ceridian Corp.,*[18] noting that "to reconcile legitimate interests of shareholders with the ever-changing dynamics and technology of corporate governance,"[19] an

inquiry "to determine an individual's suitability to serve as a director"[20] constitutes a "proper purpose" under DGCL §220.[21]

The Delaware Supreme Court next considered whether, had Westland asserted the "suitability" purpose, it could have been considered to have presented facts sufficient to satisfy the *Pershing Square* requirement that "a plaintiff who states a proper purpose must also present some evidence to establish a credible basis from which the Court of Chancery could infer there are legitimate concerns regarding a director's suitability."[22] In addressing this issue, the Delaware Supreme Court emphasized that Axcelis' "plurality plus" policy "conferred upon the shareholders the right to elect directors by majority vote…[b]ut…conditioned that right upon the board's discretionary power to accept (or reject) the resignations of those directors who were elected by a plurality, but not a majority, shareholder vote."[23] Because the Axcelis board-adopted "plurality plus" policy conferred upon the board, *without* shareholder approval, "the power to override an exercised shareholder voting right,"[24] in the Delaware Supreme Court's opinion, the board "should be *accountable* for its exercise of that unilaterally conferred power." [emphasis added].[25]

The Delaware Supreme Court then declared that, in this context, accountability means "being subject to a shareholder's [DGCL §220] right to seek inspection of any documents and other records upon which the board relied in deciding not to accept the tendered resignations."[26] The goal of this inspection is to determine "whether the directors, as fiduciaries, made a disinterested, informed business judgment that the best interests of the corporation require the continued service of these directors, or whether the Board had some different, ulterior motivation."[27] Thus, "a showing that enough stockholders withheld their votes to trigger a corporation's (board-adopted) 'plurality plus' policy satisfies the *Pershing Square* requirement that 'a stockholder must establish a credible basis to infer that a director is unsuitable, thereby warranting further inspection.'"[28] In contrast to the standard when the shareholder's purpose is to investigate potential directorial wrongdoing, under the fact pattern presented in *Axcelis*, no other credible evidence is required beyond the board's decision not to accept a director's resignation.

The Delaware Supreme Court did note, however, that *Pershing Square* requires two other elements for establishing a DGCL §220 claim relating to director suitability—namely, that "a plaintiff must also prove that the information it seeks is necessary and essential to assessing whether a director is unsuitable to stand for re-election,"[29] and the need to limit "access to board documents…to protect confidential board communications."[30] In the Delaware Supreme Court's view, these elements, together with the requirements to state a "proper purpose" and to present "credible evidence" thereof, "strikes the appropriate balance between the shareholders' entitlement to information and the directors' entitlement to make decisions in the corporation's best interest free from abusive litigation."[31]

Conclusion

The Delaware Supreme Court's decision in *Axcelis* to provide "sharper focus for future guidance"[32] with respect to DGCL §220 creates a clear path for future plaintiffs to gain access to corporate books and records to investigate decisions made under a board-adopted "plurality plus" policy. The *Axcelis* decision should enhance the ability of shareholders who cite as their purpose investigation of director suitability (as opposed to investigation of potential wrongdoing or mismanagement) to gain access to corporate books and records when a board of directors rejects director resignations tendered pursuant to a "plurality plus" policy. Moreover, the Delaware Supreme Court's willingness in *Axcelis* to provide guidance to future plaintiffs in DGCL §220 disputes, even though not required in connection with the appeal before it, demonstrates the importance attributed by the Delaware Supreme Court to the DGCL §220 inspection right.

NOTES

1. 564 A.2d 651 (Del. Ch. 1988).
2. DEL. CODE ANN. tit. 8 § 220 (2011).
3. *Id*.
4. 1 A.3d 281 (Del. 2010).

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5. *City of Westland Police & Fire Ret. Sys. v. Axcelis Techns, Inc.,* C.A. No. 4473-VCN (Del. Ch. Sept. 28, 2007) at 16.
6. *Id.* at 283.
7. Under plurality voting, in an uncontested election, those directors receiving any favorable votes are elected so long as a quorum is present, no matter how many votes are withheld from their election. Plurality voting is the default provision under the DGCL for corporations which do not specify the required vote for the election of directors in their charter documents.
8. Under Axcelis' policy, any board nominee who receives "a greater number of votes 'withheld' from his or her election than votes 'for' such election," although technically elected under the corporation's bylaws, must submit his or her resignation to an independent board committee. The committee must then, in its discretion, recommend to the board whether to accept or reject the resignation.
9. *Axcelis*, 564 A.2d at 285.
10. *Axcelis*, C.A. No. 4473-VCN at 16.
11. *Id.* at 17.
12. *Axcelis*, 564 A.2d at 287.
13. *Id*.
14. *Id*.
15. *Id.* at 287-88.
16. *Id.* at 288.
17. *Id.* at 289.
18. 923 A.2d 810 (Del. Ch. 2007).
19. *Axcelis*, 564 A.2d at 289
20. *Id.* at 289-90.
21. Because Westland had not cited investigation of the directors' suitability as its purpose in seeking access to Axcelis' books and records, in the Delaware Supreme Court's own words, its analysis "does not change the outcome of this case." *Id.* at 290.
22. *Id*.
23. *Id.* at 290-91.
24. *Id.* at 291.
25. *Id.* Because the Delaware Supreme Court's analysis focuses on unilaterally-adopted "plurality plus" policies, the ruling leaves open the question whether a shareholder-adopted plurality plus policy granting directors the discretion to accept or reject tendered resignations would yield the same result.
26. *Id*.
27. *Id*.
28. *Id*.
29. *Id.* at 290.
30. Id.
31. *Id.* at 291.
32. *Id.* at 290.

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