

“Revlon Duties” — Not A Matter To Be Glossed Over

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Change of control transactions are of paramount concern to stockholders of a public company. Such transactions often result in the stockholders having their investment in the company “cashed out” or converted into securities of a different issuer. Understandably, given the multitude of public companies incorporated in Delaware, Delaware case law has developed a standard of procedural conduct, commonly known as “Revlon duties,” against which the actions of directors in the context of change of control transactions are measured.

Fiduciary Duties Generally

Under Delaware law, the board of directors is responsible for the direction of the business and affairs of a company. To facilitate the directors’ decision-making process, the Delaware courts have developed a policy of affording substantial deference in most situations to business decisions made by directors. This policy, generally referred to as the “business judgment rule,” presumes that each business decision is made by disinterested and independent directors on an informed basis and with a good faith belief that the decision will serve the best interests of the company. In cases where the business judgment rule applies, a board’s decision is protected unless the claimant is able to show that the board did not meet its duty of care or loyalty. The business judgment rule, however, is inapplicable when evaluating directorial conduct in situations involving a change in control of a company. Instead, the courts seek to determine whether the directors fulfilled their Revlon duties.

Revlon Duties

The Revlon duties were first articulated by the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (1985). In the face of an active bidding contest for the acquisition of Revlon, Inc., the court invalidated “lock-up,” “no-shop” and “break-up fee” provisions finding that the adoption of such provisions violated the directors’ fiduciary duties because they ended rather than intensified the board’s involvement in the bidding contest. The court ruled that, once the directors had decided to sell control of the company, “[t]he directors’ role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.” In subsequent decisions, this obligation has been consistently emphasized.

The Revlon duties arise only if the board has decided to sell control of the company. Prior to such time, a board may “just say no” to an acquisition proposal. Nonetheless, while a board may have no duty to accept a particular offer or to negotiate with a potential acquiror, it does have a duty to consider any offer and determine whether that offer is in the best interests of the company and its stockholders.

There is no single methodology that a

board must follow to fulfill its Revlon duties. Any method chosen, however, that does not involve some form of a realistic, market-based equity valuation may be difficult to sustain. Two of the preferred methods that a board can utilize are the closed auction and market check.

In a closed auction, prospective bidders make a sealed bid for the company by a fixed deadline. Prior to the bidding, the company will typically send a draft contract and related documentation to multiple parties. Interested bidders are allowed to engage in limited due diligence and then submit their bids, together with any comments on the draft contract. The closed auction often has multiple rounds and may involve simultaneous negotiations with more than one bidder. A significant advantage of a closed auction is that it can be effective even if there is only one bidder. A bidder has no way to know whether there are other bidders and can be expected to put forward its best bid, especially if the process is structured to involve only a single round. In addition, the company in a closed auction can negotiate with the bidders to try to elicit higher bids.

The prevalent type of market check is the post-agreement market check. Under this type of market check, a transaction is agreed to, subject to public announcement of the transaction and a fair opportunity for other bidders to make competing offers. An advantage of a post-agreement market check is that it ensures that the company may secure the offer put forth by the first bidder while leaving the company open to pursue higher offers.

The effectiveness of a post-agreement market check depends on the ability of bidders to have a real opportunity to make higher bids. A transaction that is truly locked up because of stock or asset options or proxies from large stockholders, or that is otherwise structured to deter third-party interest, may well have the effect those devices are intended to cause, and the market check will be of little value.

The Special Committee

When Revlon duties apply, the board’s conduct will be evaluated by review of both its process and result. As a consequence, a board assessing a change of control transaction must establish basic procedures to preserve the integrity of its evaluation of the options that may arise. One critical element is to ensure that only disinterested directors evaluate and vote on the proposed transaction. If the interested directors constitute a minority of the board, the disinterested majority (usually acting as a special committee) can act for the board, with the interested members abstaining from both deliberations and the vote on the proposal. The special committee must have real bargaining power that it can exercise with the bidder on an arm’s length basis.

It is advisable that the special committee, rather than management, choose its financial and legal advisors. The Delaware Supreme Court has criticized the conduct of an auction to sell the company in which a financial advisor selected by the company’s chief executive officer, rather than by the special committee, played a dominant role. The special committee should receive independent financial and legal advice, negotiate diligently and possess all relevant material information. Particular attention should be paid to written materials prepared by or for a special committee. Change of control trans-

actions are generally subject to disclosure requirements under the federal securities laws. As a result, certain documents or descriptions thereof will need to be publicly filed or disclosed. Moreover, many documents (including drafts and notes) will be subject to discovery in the event of litigation.

The special committee must also have a clear conception of its role. In one case, a Delaware Chancery Court criticized the role of the special committee which relied almost exclusively on the efforts of its investment banker in evaluating the fairness of the price offered and negotiating the terms of the proposed transaction. Similarly, in another case, the Delaware Supreme Court criticized the special committee for neither taking reasonable steps to investigate whether a bidder considered by management to be hostile would increase its offer price nor attempting to negotiate improvements in management’s competing bid.

Fairness Opinions

While there is no absolute requirement that a special committee obtain an investment banker’s fairness opinion, virtually all companies and many bidders do so. Delaware courts have commented favorably on the use of investment bankers by special committees in evaluating change of control proposals. Under Delaware law, a special committee is entitled to rely in good faith

upon the records of the company, the advice of management, as well as analyses, opinions, reports or statements presented to the company by experts or professionals selected with reasonable care by or on behalf of the company. Directors should understand the assumptions on which the analyses are based, the methodologies used and how the analyses could have varied.

Conclusion

Although Revlon duties are by their nature flexible and thus cannot be articulated with precision, directors are not without guidance. Since judicial inquiry looks primarily to the process utilized, there should be a significant number of meetings with active participation by directors. Analyses, opinions, reports and other documents considered by directors should be carefully prepared. Directors who act without active involvement or without adequate information in the decision to approve or reject a change of control transaction will have difficulty defending their conduct in court. Whenever possible, directors should seek to reach agreement on an unanimous basis. Finally, directors should carefully document the basis for their decisions because courts always inquire as to whether they acted on an informed basis. By following these guidelines, directors will be well on their way toward ensuring that they have fulfilled their Revlon duties.

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