

CASE COMMENTS

HOSTILE TAKEOVERS AND THE *REVLON* PRINCIPLE: TRIGGERING THE DUTY OF AUCTIONEER UNDER DELAWARE LAW

Black & Decker Corp. v. American Standard, Inc.,
682 F. Supp. 772 (D. Del. 1988)

In *Black & Decker Corporation v. American Standard, Inc.*,¹ the United States District Court for Delaware expanded the reach of the *Revlon* principle in takeover battles.² The court recognized that a change in control through recapitalization may, in some circumstances, be equivalent to a “sale” of a corporation and thus trigger the directors’ duty to obtain the highest price for the shareholders’ benefit.³

In 1988, Black & Decker Corporation commenced a tender offer for American Standard, Inc.’s outstanding stock at \$56.00 per share.⁴ In response, American Standard enacted several defensive measures, including a poison pill,⁵ creation of a severance plan, amendments to its employee retirement and savings plans and a recapitalization plan (the “Plan”).⁶

The Plan represented the keystone of the board’s defensive tactics; it provided that each public shareholder would receive \$59.00 in cash and a subordinated debenture with a face value of \$10.80 in exchange for a

1. 682 F. Supp. 772 (D. Del. 1988).

2. Under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), when the sale of a company becomes inevitable, “the directors’ role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.” *Id.* at 182. For a discussion of *Revlon*, see *infra* notes 23-30 and accompanying text.

3. 682 F. Supp. at 780-82. Other courts considering what constitutes a “sale” under *Revlon* have focused primarily on whether an outside third party has purchased a majority of the company’s stock. Courts have also considered competitive bidding and the target board’s intent as convincing evidence of a sale. See *infra* notes 30, 34, 44-45, 62-63 and accompanying text.

4. 682 F. Supp. at 774.

5. On February 4, 1988, the American Standard board adopted a non-redeemable “poison pill” or rights plan that provided shareholders of record with a dividend of one contingent “right” for each share of stock. If any party acquired 15% or more of American Standard’s common stock, then each right entitled the holder to purchase five additional shares of common stock for \$32.50 per share. The rights of any party who crossed the 15% threshold were void. 682 F. Supp. at 774, 776.

6. The board decided that payments would be accelerated under the retirement and savings plans and certain employees would receive severance pay “in the event of a potential change in control” (the severance plan covered only salaried corporate staff). However, the board specifically exempted the internal recapitalization plan from the definition of “changes in control.” The total cost of these benefits would be \$130 million in the event of a change in control. *Id.* at 776.

percentage of their ownership interest.⁷ The Plan also included an Employee Stock Ownership Plan ("ESOP") that would purchase \$80 million worth of stub equity.⁸ In addition, management received the exclusive right, through options exercisable at their own discretion, to exchange each share of common stock owned for 11.7 shares of common stock in the recapitalized company.⁹ If fully implemented, the Plan would reduce the public's equity interest in American Standard from 92.6% to 45.5% and give management and the ESOP trustee control over 55.5% of the common stock.¹⁰

Black & Decker sought a preliminary injunction with respect to the Plan, the changes and additions to the employee benefits package, and the "poison pill."¹¹ Black & Decker argued that the Plan ensured American Standard management's control over a majority of the common stock and thus involved a sale of control of the company. Black & Decker further argued that a sale of control triggers the board's duty of auctioneer under *Revlon*.¹² Finally, Black & Decker pointed to the active bidding for American Standard as evidence that the target board recognized the company would be sold.¹³ The district court agreed and held

7. *Id.* at 782.

8. *Id.* at 782. "Stub equity" refers to the shareholders' remaining ownership interest in the company after the recapitalization. Here only a fraction of their previous ownership interest exists. *Id.*

9. *Id.* at 782-83.

10. *Id.* at 782.

11. *Id.* at 773, 778. American Standard's board agreed to terminate the poison pill if a majority of the company's common stock was purchased via a formal tender offer. Black & Decker therefore withdrew its request for relief from the poison pill, leaving the court to decide only the propriety of the Plan, amendments to the employee benefits plans, and adoption of the severance plan. *Id.*

12. *Id.* at 778-79. Apparently, American Standard did not contest this purely legal issue, but argued that management would not, in fact, gain control as a result of the Plan because the ESOP would control 30% of the new common stock with "full, confidential, pass-through voting." *Id.* See also *supra* note 2 (statement of *Revlon's* holding).

13. In arguing that a "sale" occurred, Black & Decker emphasized that it increased the tender offer three times and American Standard enhanced the value of the Plan twice. *Id.* at 779. Black & Decker made its initial bid on January 27, 1988 at \$56.00 per share. On February 5, 1988, Black & Decker raised its offer to \$65.00 per share. American Standard's board determined that the bid was inadequate because a restructuring of the company could immediately exceed the \$65.00 bid. The Recapitalization Plan adopted by the board on February 18, 1988 provided an estimated value of \$70.00 to \$72.00 a share. Not to be outdone, Black & Decker, on February 23, 1988, increased its bid to \$68.00. On March 3, 1988, American Standard responded and enhanced its Plan to reflect a \$74.00 value. *Id.* at 774-78.

American Standard retorted "that the *Revlon* doctrine [should] not apply because the Board . . . acted consistently to preserve the independence of the company and does not, in fact, intend to sell." *Id.* at 779.

that the *Revlon* duty to auction the corporation applied to American Standard's board because adoption of a recapitalization plan that causes a change in control amounts to a sale of the corporation,¹⁴ demonstrating an intent to effectuate a sale of the corporation.¹⁵

Under Delaware law a board of directors has the ultimate broad power to manage the business and affairs of a corporation.¹⁶ Delaware courts have the ability to check this power by holding directors liable for a breach of their fiduciary duties, but under the guidance of the business judgment rule, they exercise this check only sparingly.¹⁷ The rule serves as a rebuttable presumption that a board of directors makes business decisions on an informed basis, in good faith, and in the best interests of the company.¹⁸ As a result, directors are protected from liability even if their decisions, with the benefit of hindsight, were poor.¹⁹

14. *Id.* at 778. The court recognized three facts supportive of this argument: 1) American Standard specifically exempted the Plan from the change in control definitions in the employee benefits plans; 2) an American Standard news release explained that management and the ESOP would control 55% of the company after recapitalization; and 3) Goldman Sachs, financial advisor for the target company, likewise explained that management and the ESOP would own a controlling interest. *Id.*

15. *Id.* at 784. In the second phase of the opinion, the court concluded that there was a probability American Standard's board violated the *Revlon* principle by enacting the severance plan and amending the retirement plans to the disadvantage of Black & Decker, without any commensurate benefit to the shareholders. *Id.* at 786-87. This Note, however, focuses solely on the threshold issue decided by the court: What facts and circumstances invoke the *Revlon* principle. *See infra* note 47-70 and accompanying text.

16. DEL. CODE ANN. tit. 8 § 141(a) (1983). *See generally* Note, *Corporate Directors' Liability for Resisting a Tender Offer: Proposed Substantive and Procedural Modifications of Existing State Fiduciary Standards*, 32 VAND. L. REV. 575, 589 (1979) (directors permitted to exercise substantial discretion in daily business decisions without judicial interference at the request of dissatisfied shareholders).

17. *See, e.g.,* *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (noting the importance of the board's managerial freedom and refusing to invalidate a board's business decision absent an abuse of discretion). *But see* *Smith v. Van Gorkum*, 488 A.2d 858, 873 (Del. 1985) (finding the directors liable for not making an informed decisions in approving a cash-out merger, thereby breaching their duty of care to the stockholders).

The business judgment rule derives from the corporate directors' statutory responsibility for making ultimate corporate decisions. *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). The directors have a fiduciary duty of care and duty of loyalty, owing to the company and its stockholders. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

18. *See Aronson*, 473 A.2d at 812 (requiring the challenger to rebut the presumption that the business decision was the product of an informed decision). *See also* Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1443 (1985) (business judgment rule is the embodiment of the court's presumption that directors are in a better position than judges to make business decisions).

19. *See White*, *Auctioning the Corporate Bastion: Delaware Readjusts the Business Judgment Rule in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 40 SW. L.J. 1117, 1121 (1986) ("This

Courts have redefined the business judgment rule, however, by limiting the scope and application of the presumption when evaluating a board's actions taken in response to a hostile takeover bid.²⁰ The "enhanced scrutiny"²¹ of a board's decisions evolved out of judicial concern that directors implementing antitakeover devices may act on behalf of their own interests and not those of their shareholders.²² The *Revlon* duty of auctioneer reduces the risk of self-interest in battles for corporate control.²³

In *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*²⁴ the Delaware Supreme Court held that once it is inevitable that a company will be sold, the directors owe a duty to the company's shareholders to serve as an auctioneer.²⁵ As an auctioneer, a board's duty is to maximize the company's sale price; therefore, defensive tactics must be designed to obtain the highest price possible for the shareholder's stock.²⁶ In *Revlon*, a takeover bid within the range determined by Revlon to be adequate, coupled with the Revlon board's authorization to negotiate a merger or sale to a third party, indicated the inevitability of the company's sale.²⁷

deference to professional judgment is no different from that accorded surgeons or other professionals. An operation may appear disastrous in hindsight, but judges do not infer a doctor's or director's breach of duty from a bad result.") (footnotes omitted).

20. See *Van Gorkom*, 488 A.2d at 874; *Pogostin*, 480 A.2d at 627 (finding the business judgment rule applicable in the context of a takeover); Smith, *Recognition of the Fiduciary Duties of Corporate Directors and Officers Defending against Change of Control by Tender Offer*, 7 MISS. L. REV. 117, 124-26 (1987) (discussing recent formulations of the rule).

21. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (When the board responds to a takeover bid, "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."). See Smith, *supra* note 20, at 124-26 (discussing "enhanced scrutiny").

22. *Unocal*, 492 A.2d at 954; see also Lamb & Turezyn, *Revlon and Hanson Trust: Unlocking the Lock-Ups*, 12 DEL. J. CORP. L. 497, 501 (1987) ("If a board assumes such greater power by adopting a rights plan or by otherwise acting to influence the result of a battle for corporate control . . ., it must be prepared to meet the higher expectations the courts may imply.").

23. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181-82 (Del. 1986).

24. 506 A.2d 173 (Del. 1986). In *Revlon*, Pantry Pride Inc. made an unsolicited cash tender offer to the Revlon stockholders. In response, Revlon commenced an exchange offer for its own shares and authorized management to negotiate with other interested companies for sale of the company. *Id.* at 182.

25. *Id.* at 182.

26. Once the sale became inevitable, the court opined, [t]he duty of the board . . . changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot.

Id.

27. *Id.* at 182. The Revlon board advised shareholders to reject the offer on the basis of its

Two subsequent decisions have reaffirmed and expanded the *Revlon* doctrine. In *Edelman v. Fruehauf Corporation*²⁸ the Fruehauf board approved a two-tiered leveraged buyout by management as a defensive measure against the Edelman group's tender offer.²⁹ Even though the management proposal resulted in the acquisition of less than 100% of the common stock, the Sixth Circuit found that the duty of auctioneer applied.³⁰

In *Freedman v. Restaurant Associates Industries, Inc.*³¹ a Restaurant Associates management group proposed a "going private" transaction.³² After the management group publicly announced its offer, AWR Acquisitions Corp., an entity controlled by a Restaurant Associates competitor, answered with a merger proposal for the company. An active bidding process ensued.³³ The court applied the *Revlon* doctrine to measure the Restaurant Associates board's conduct, tacitly accepting AWR's contention that the sale became inevitable after the two parties announced their respective bids.³⁴ *Freedman* is significant because, unlike *Revlon*, the *initial* bid came from a group of insiders and both offers were contingent on the approval of an independent committee of the Restaurant Associates board.³⁵

investment banker's opinion that the bid was grossly inadequate; the bankers estimated a sale of the company as a "going concern" would bring a per share price in the "mid 50" dollar range. *Id.* at 177. After Pantry Pride's final bid, the Revlon board unanimously agreed to a leveraged buyout by a "white knight." *Id.* at 178, 183.

28. 798 F.2d 882 (6th Cir. 1986).

29. *Id.* at 884-85. Management proposed the formulation of a shell corporation to purchase 77% of the Fruehauf stock in a cash tender offer and a subsequent merger of the acquiring corporation and Fruehauf, exchanging the remaining Fruehauf shares for securities in the acquiring corporation. *Id.*

30. *Id.* at 886-87 ("All sides agree that Fruehauf is on the auction block."). In *Revlon*, the board had approved a leveraged buyout by a third party for 100% of its stock, 506 A.2d 173, 178-79, whereas in *Edelman* the target corporation's management would purchase 77% of the common stock, followed by a merger. See *supra* note 29. Ostensibly, the *Fruehauf* court recognized that a two-tiered acquisition is the functional equivalent of a sale of 100% of a corporation's stock.

31. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502 (Del. Ch. 1987).

32. *Id.* at 97,216. The first step of the management-sponsored leveraged buy-out included a cash offer for any and all shares of the company's stock at \$18 per share. The second step in the transaction proposed a merger in which the remaining public shareholders would have their shares converted into a right to receive \$18 in cash. *Id.* at 97,217.

33. *Id.* at 97,217-218. AWR arrived at a final proposal of \$20 per share. *Id.* at 97,217.

34. The court characterized the situation as one in which, "it appears that the public shareholders are to be eliminated by one technique or another." *Id.* at 97,221.

35. In fact, the independent committee twice rejected the management group's offers. *Id.* at 97,217-218. The court concluded that Restaurant Associates' board did not violate its auctioneer duty. *Id.* at 97,220.

On the other hand, in *Buckhorn, Inc. v. Ropak Corporation*,³⁶ the Southern District Court of Ohio limited the scope of the *Revlon* doctrine.³⁷ The court held that the target board's³⁸ authorization to management to explore a variety of defensive measures, including the possible sale of the company, did not establish the board's duty of auctioneer.³⁹ The court reasoned that this "open-door" policy could not be equated with a board's definitive authorization to sell the company.⁴⁰ Further, the court placed a significant amount of emphasis on the fact that the board repeatedly maintained that it intended the company to remain a "going concern."⁴¹

The Delaware Supreme Court had another opportunity to address the *Revlon* doctrine in *Ivanhoe Partners v. Newmont Mining Corporation*.⁴² The Newmont board adopted a restructuring proposal and entered into a standstill agreement with a third party in order to avoid Ivanhoe's hostile takeover attempt.⁴³ In holding that *Revlon* did not apply,⁴⁴ the court concluded that the board did not "sell" the corporation because the third party purchased a minority share of the common stock from private sellers and did not gain control of the corporation's board.⁴⁵ In addition,

36. 656 F. Supp. 209 (S.D. Ohio 1987).

37. *Id.* at 228.

38. The Buckhorn Corporation received an unsolicited tender offer from the Ropak Corporation. *Id.* at 215.

39. *Id.* The board actually adopted \$750,000 in executive stock options and severance pay plans which would vest immediately upon a change of control not approved by the board. *Id.* at 217. The board also authorized management to explore other alternatives including:

a) a public or private sale of Buckhorn securities; b) a self-tender; c) a sale of a significant portion of Buckhorn; d) a spin-off of certain assets; e) a business combination or joint venture between Buckhorn and one or more companies; and f) acquisition by Buckhorn of all or part of the business of any other company.

Id. at 218.

40. *Id.* at 228. Specifically, the court stated, "Thus, unlike the facts of *Revlon*, Buckhorn's directors did not inevitably commit themselves to selling any part or all of Buckhorn." *Id.*

41. *Id.*

42. 535 A.2d 1334 (Del. 1987).

43. In response to Ivanhoe's tender offer, Newmont declared a \$33 per share dividend to all its stockholders. This dividend provided Gold Fields, Newmont's largest shareholder, with the impetus to engage in a street sweep which increased its ownership in Newmont from 26% to 49.7%. Newmont also amended a standstill agreement with Gold Fields which ensured that its interest in Newmont would not exceed 49.9% and that its representation on Newmont's board would be limited to 40%. *Id.* at 1339-340.

44. The record did not convince the court that the sale of Newmont was "inevitable." *Id.* at 1345.

45. *Id.* The *Newmont* court also concluded that a bidding contest had not taken place. "The only bidder for Newmont was Ivanhoe. Gold Fields was not a bidder, but wished only to protect its already substantial interest in the company. It did so through the street sweep." *Id.*

the court noted that the Newmont board never swayed from its decision to keep the company independent.⁴⁶

In *Black & Decker Corporation v. American Standard, Inc.*,⁴⁷ the United States District Court for Delaware adopted the broad interpretation of *Revlon* suggested by the earliest decisions on this issue.⁴⁸ The court, initially acknowledged that Delaware law does not impose the duty of auctioneer on a board until the sale of the corporation is inevitable.⁴⁹ In this case, the court framed the initial question as "whether a transaction which results in a change in control . . . amounts to a 'sale' under *Revlon, Inc.*"⁵⁰ First, the court concluded that exempting "sale of control" transactions from *Revlon* would immunize directors from the duty of auctioneer when faced with a two-tiered tender offer. This result would undermine the shareholders' interest in profit maximization.⁵¹

Second, the court espoused the analysis utilized in *Edelman v. Fruehauf Corporation*.⁵² The Sixth Circuit recognized that the duties outlined in *Revlon* apply not only in cases where all shares of the company have been sold but also where a simple majority of the shares are purchased.⁵³ *Edelman* involved a two-tiered, management-led leveraged buyout.⁵⁴ The *Black & Decker* court's conclusion to apply *Revlon* was guided by *Edelman*, which the court viewed as virtually indistinguishable from the facts of the case before it.⁵⁵

Finally, the court acknowledged that the Delaware Supreme Court, in *Ivanhoe Partners v. Newmont Mining Corporation*,⁵⁶ strictly construed

46. *Id.*

47. 682 F. Supp. 772 (D. Del. 1988).

48. *See supra* notes 27-34 and accompanying text.

49. 682 F. Supp. at 780.

50. *Id.* at 780-81. Labelling the case as one of first impression, the federal court found it must determine what course the Delaware Supreme Court would take if confronted with the same facts and circumstances. *Id.* at 781 n.3.

51. *Id.* at 781 (quoting *Freedman v. Restaurant Associates*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. ¶ 93,502, at 97,219 (Del. Ch. 1987)). "In a two-tiered tender offer, the raider makes a cash tender offer for a controlling interest in the target and, upon obtaining control, merges the target into itself at a lower second-tier price." 682 F. Supp. at 781 n.5 (citing Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 18 (1987)).

52. 798 F.2d 882 (6th Cir. 1986). *See supra* notes 28-30 and accompany text.

53. *Black & Decker*, 682 F. Supp. at 781.

54. *See supra* note 28.

55. 682 F. Supp. at 781 n.6. Ultimately, each target board in *Edelman* and *Black & Decker* would acquire control of the company and the shareholders would retain a fractional equity interest. *Id.*

56. 535 A.2d 1334 (Del. 1987). *See supra* notes 42-46.

Revlon, but emphasized that the distinctions inherent in *Ivanhoe* permitted the conclusion that a sale was inevitable in the instant case.⁵⁷ First, in *Ivanhoe*, Gold Fields purchased its stock from private sellers, not the company.⁵⁸ Second, by agreement of the parties, Gold Fields was prohibited from gaining majority control.⁵⁹ Here, by contrast, the American Standard board initiated the sale of stock and retained options for itself enabling it to acquire majority control from the shareholders.⁶⁰ Thus, unlike the Newmont board that manifested its intent in the "standstill" agreement to keep the company independent, the American Standard board made a change in control inevitable.⁶¹

This combination of factors led the *Black & Decker* court to conclude that "a sale of control of a corporation could amount to a 'sale' under *Revlon, Inc.*"⁶² In addition, the court agreed with *Black & Decker's* contention that American Standard's enhanced recapitalization in response to each increased offer by *Black & Decker* constituted active bidding for control of the company.⁶³ The court found the objective accounts by observers of this takeover contest more than sufficient to rebut American Standard's contention that no bidding contest had ensued.⁶⁴ This elaborate analysis led the court to conclude that "approval of the Recapitalization Plan 'was a recognition that the company was for sale.'"⁶⁵

The *Black & Decker* court, in examining the board's actions, adopted the same criteria implemented in the previous decisions.⁶⁶ The court correctly held that the change in control of a majority of American Standard

57. 682 F. Supp. at 781-82.

58. See *supra* note 43.

59. *Id.*

60. See *supra* notes 7-10 and accompanying text.

61. 682 F. Supp. at 783-84.

62. *Id.* at 782. The court therefore focused its attention on the Plan as adopted by the American Standard board. In response to American Standard's argument that the shareholders would control 55% of the stock immediately after the Plan's adoption, the court emphasized that management could unilaterally take control via the stock options. ("Merely stopping at [55%] . . . does not do justice to the situation faced by American Standard's shareholders. To ignore the presence of the stock options would result in overlooking the complete offer to the public shareholders."). *Id.* The court concluded that "the transfer of control occurs now, while the relegation to minority status occurs sometime in the future under the exclusive control of management." *Id.* at 783.

63. *Id.* at 784.

64. *Id.* The court noted that the Wall Street Journal printed accounts of the transactions between the parties. Thus, the court stated, the public must have perceived that American Standard was for sale. *Id.*

65. *Id.* (quoting *Revlon*, 506 A.2d at 182).

66. See *supra* notes 24-46 and accompanying text.

stock to the board represented the sale of the company under *Revlon*. Although the court did not stress the rationale behind the *Revlon* doctrine, the court's conclusion is consistent with protecting shareholders from directors who may take advantage of a takeover threat by increasing their ownership interest in the company.⁶⁷

More importantly, the holding further defines which acts suffice to place a company on the auction block.⁶⁸ The *Black & Decker* court's focus on whether a company has undergone a change in control alleviates much of a board's difficulty in determining when its role transforms from defending to selling the corporation.

Revlon could be further refined, however, if subsequent courts focused on how a board's decision in a takeover contest affects the shareholders' equity position. The *Black & Decker* court's analysis and application of *Revlon* appear to allow management, faced with a hostile takeover, to preserve the company at any cost short of management obtaining a majority of the stock.⁶⁹ If, for example, the facts of the *Black & Decker* case existed but management could only achieve a forty-nine percent ownership of American Standard, the court would be less likely to impose the duty of auctioneer. This is so because management would not obtain control.⁷⁰ The result of the *Black & Decker* formulation is that the shareholders would be unable to consider competing offers. Further, the shareholders' equity position would decrease substantially.⁷¹ However, if a court recognizes that a defensive tactic that substantially reduces shareholders' equity position triggers the auctioneering duty, then stockholders would be guaranteed the maximum sale price for their stock.

M.R.B.

67. See *supra* notes 22, 23 and accompanying text.

68. See *supra* notes 52-65 and accompanying text.

69. 682 F. Supp. at 782-85. The Court determined the Plan was a sale of the corporation because management would acquire 55% of the stock. *Id.*

70. In *Black & Decker*, management's ability to achieve a majority interest through stock options caused the court to rule that the Plan was a sale of the corporation. 683 F. Supp. at 782-85.

71. For example, under the facts of *Black & Decker*, the shares were worth between \$70 and \$71. Under the Plan, the shareholders retained equity would be only \$6 to \$8. *Id.* at 782.

