IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

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| MACANDREWS & FORBES HOLDINGS, INC., a Delaware corporation,<br><br>Plaintiff,<br><br>v.<br><br>REVLON, INC., a Delaware corporation, MICHEL C. BERGERAC, SIMON ALDEWERELD, SANDER P. ALEXANDER, JAY I. BENNETT, IRVING J. BOTTNER, JACOB BURNS, LEWIS L. GLUCKSMAN, JOHN LOUDON, AILEEN MEHLE, SAMUEL L. SIMMONS, IAN R. WILSON, PAUL P. WOOLARD, EZRA K. ZILKHA, FORSTMANN LITTLE & CO., a New York limited partnership, and FORSTMANN LITTLE & CO. SUBORDINATED DEBT AND EQUITY MANAGEMENT BUYOUT PARTNERSHIP-II, a New York limited partnership,<br><br>Defendants. | Civil Action No. 8126 |

PLAINTIFF'S OPENING BRIEF IN SUPPORT OF ITS MOTION FOR A PRELIMINARY INJUNCTION ON ISSUES RELATING TO THE AB INITIO INVALIDITY OF THE REVLON RIGHTS PLAN AND CERTAIN POISON PILL COVENANTS

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## PRELIMINARY STATEMENT*

This case presents in starkest terms the abuse by Revlon's board of poison pill defenses to stop any "unfriendly" acquisition efforts, including those completely lacking in any element of unfairness, coercion, or divisiveness. Delaware courts have never countenanced such conduct by any board. Revlon's stockholders, not its directors, own the corporation and are entitled under our law to decide when, to whom and on what terms to sell their shares. Revlon's board has a duty to protect stockholders from predatory or coercive takeover tactics. Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946 (1985). But Revlon's directors are not empowered to prevent its stockholders from receiving and responding to non-coercive, non-divisive acquisition offers. They cannot cut off the operation of the marketplace and supplant the stockholders' judgment of fair value with their own.

Pantry Pride has made an all cash, any-and-all tender offer for the common stock of Revlon. Revlon responded by erecting two separate poison pill defenses. First,

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* The opening brief filed on the plaintiff's behalf by Young, Conaway, Stargatt & Taylor contains statements of the nature and stage of the proceedings and facts which are adopted herein by reference. This brief addresses the ab initio invalidity of the poison pill rights plan adopted by Revlon's board and certain poison pill covenants. The brief filed on the plaintiff's behalf by Young, Conaway, Stargatt & Taylor addresses certain other issues raised in the Second Amended and Supplemental Complaint.

Revlon adopted a Note Purchase Rights Plan. This suicide poison pill deters all unfriendly acquisitions by threatening the liquidation of Revlon in the event of any acquisition of 20 percent or more of Revlon's common stock, and does so on terms designed and intended to inflict severe economic injury on any person or group of stockholders hapless enough to trigger the plan. Second, Revlon issued certain notes and preferred shares containing special poison pill covenants. These covenants were devised specifically to deter unfriendly acquisitions -- on any terms -- by threatening both Revlon and the acquiring entities (Pantry Pride and even MacAndrews & Forbes) with crippling restrictions on their normal business operations.

The Note Purchase Rights Plan -- adopted without statutory basis -- is an extraordinarily potent poison. The plan does not apply only to two-tiered or front-end loaded offers. It applies broadly to stop all acquisition efforts not approved by the directors. Revlon's directors testified that it would be economically irrational for anyone to trigger the rights by making a 20 percent acquisition. (Zilkha 48-49; Bergerac 272)* The poison pill rights are extreme in their effect. Revlon's own investment banker has conceded that if the rights are triggered, "as a practical

* Deposition excerpts are contained in Exhibit I to the Appendix to this brief.

matter it would be consummate or equivalent to a voluntary liquidation and winding up of the company...." (Loomis 142)

The poison pill covenants and terms of the notes and preferred stock are similarly overbroad and concededly without purpose except as anti-takeover devices. They bear no reasonable relation to preservation of value for the debt holders or preferred stockholders, but are designed only to strengthen the hand of Revlon's current directors and their hand-picked successors in resisting all hostile acquisition efforts.

The Revlon board's actions are all the more unreasonable in view of the utter absence of any element of coercion in Pantry Pride's tender offer. Pantry Pride is offering cash for all the shares, and proposes a second-step merger on the same terms. Revlon stockholders are not faced with the threat of receiving "junk bonds," nor are they being pressured to tender their shares by the prospect of receiving reduced second-step consideration if they do not. There is no threat of "greenmail," since MacAndrews & Forbes and Pantry Pride together own only 30,000 shares of Revlon common stock. Thus, the Pantry Pride tender offer "lacks the inherent coerciveness and potential for creating unfairness between groups of shareholders which characterize two-tiered offers." MacAndrews & Forbes Holdings, Inc. v.

Revlon, Inc., Del. Ch., C.A. No. 8126, Walsh, J., slip op. at 11 (Oct. 9, 1985) (Exhibit A).

Revlon's board adopted these multifaceted poison pill provisions simply to prevent free market activity in Revlon stock. This much is clear from their fixing the value of the poison pill rights at $65 when they knew that $65 was not a "fair price" for Revlon but, rather, so high a price that it would prevent hostile acquisitions. The point is made again by the board's use of the poison pill as a lock-up device to insulate the management sponsored leveraged buy-out from competition in the market place. Thus, "[i]n seeking to invalidate the Rights Plan, MacAndrews, in essence, is simply attempting to remove a restriction on market activity so that other shareholders may voluntarily participate in its tender offer. If successful, MacAndrews will have secured for itself and for all other shareholders the ability to bargain in the marketplace." MacAndrews & Forbes, slip op. at 11.

The Revlon board cannot be allowed to block access to that marketplace. To conclude otherwise is to transfer from the owners of Revlon to its management the ultimate control over the destiny of the corporation.

## STATEMENT OF FACTS

The opening brief filed on the plaintiff's behalf by Young, Conaway, Stargatt & Taylor contains statements of the nature and stage of the proceedings and facts which review in detail the history of Revlon's anti-takeover tactics and abuse of the corporate process. Such a review will not be undertaken here. However, to aid the Court in considering the arguments which follow in this brief, we will review the material terms of the rights plan and poison pill covenants adopted by Revlon's board.

### The Poison Pill Rights

The so-called Note Purchase Rights Plan (the "Rights Plan") was adopted by the Revlon board at its August 19, 1985 board meeting only hours before a scheduled meeting with Pantry Pride. The "rights" were distributed as a "dividend" to stockholders "of record" on August 30, 1985. At the same time, the board agreed that the "dividend" of a "right" would continue to be paid out by Revlon on each new share of common stock issued by Revlon until the "rights" expire in 1995 or are triggered. In response to the announcement of Revlon's actions, Pantry Pride announced that it intended to begin an any-and-all cash tender offer for Revlon.

The rights to be issued under the Rights Plan (the "Rights") are not exercisable (and separate certificates for the Rights will not be issued) unless a person or group acquires beneficial ownership of 20% or more of Revlon's common stock. The Rights are exercisable following such a 20% or more acquisition only if the 20% acquiror fails promptly to announce and consummate a transaction in which all remaining common shares are acquired for at least $65 per share in cash.

Once the Rights become exercisable, each Right will entitle the holder to exchange one share of common stock for $65 principal amount of Revlon notes bearing 12% interest and having a one-year maturity. No Rights certificate will be issued to or be exercisable by the person or group acquiring 20% or more of Revlon's common stock. If any statutory or contractual restrictions prevent or limit the exchange of the notes for common stock, the Rights will be exercisable on a pro rata basis. The Rights are redeemable by the Revlon board for $.10 per Right at any time prior to the 20% or more acquisition.

The Rights Plan effectively deters any hostile acquisition of Revlon. This deterrence results from the artificially high price of $65 per share put on the Rights by the Revlon board. That the $65 price is a sham valuation, meant only to drive away bidders, is crystal clear on the record in this case. The record demonstrates that:

- The $65 face amount of the Rights notes was set on the advice of Revlon's investment banker, William Loomis of Lazard Freres & Co. ("Lazard"). (Loomis 139-40)

- In approving the Rights Plan the directors were advised by and relied on Loomis concerning the value of Revlon shares. (Mehle 23; Alexander 111-12; Draft minutes of Revlon Board of Directors meeting, held on August 19, 1985, at 4-7) (Exhibit B)

- In rendering his oral opinion, Loomis did not explain in detail the basis for his valuation, which was purportedly contained in a Lazard board book which no director reviewed and of which Revlon has retained no copy. (Loomis 119, 129, 132-33; Zilkha 8-10, 91-92; Alexander 110; Mehle 16)

- At the same meeting at which the board approved the Rights Plan, Loomis advised it that the company as a whole has a value in the mid-50's. (Zilkha 19-20; Mehle 15; Draft minutes of Revlon Board of Directors meeting, held on August 19, 1985, at 7)

- In determining the $65 price, Loomis was unaware that

    — In 1984 and earlier, Lazard had advised Bergerac that the fair value for Revlon begins with a '5.' (Bergerac 18-20, 28-29, 46)

    — In mid and late 1984, Lazard did leveraged buyout studies for Revlon management that contemplated a sale of Revlon at $45 or $50 per share. (Bergerac 44-50, 57-62; Sayres 19)

— It was determined that a leveraged buyout at $45 or $50 was not feasible, because it was not clear what Revlon could realize on the sale of its divisions. (Sayres 21-22; Loomis 12-24)

- While Revlon's bankers view Revlon's fair value as $65 or more in a "hostile" transaction, it is somewhere in the $50's in a negotiated deal with a reputable buyer. This could be as low as $50. (Bergerac 124-25)

The Poison Pill Covenants

On August 26, 1985, Revlon announced an offer to purchase up to 10,000,000 of its common shares, or more than 25% of the shares outstanding. In exchange for each share of common, Revlon offered $47.50 principal amount of 11.75% notes and one-tenth of a share of a new $9.00 preferred stock with a stated value of $100 per share.

The notes and the preferred stock contain certain extraordinarily restrictive covenants (the "Poison Pill Covenants"), which if not subject to waiver by the board, would effectively eliminate Revlon's ability to function as a competitive entity. The Poison Pill Covenants were created for a single purpose -- deterrence. As is explained in the minutes of the August 26 board meeting:

> Mr. Brownstein [of Wachtell, Lipton] pointed out that the terms of the securities that were being

offered in the exchange offer contained certain provisions that were designed to deter or make more difficult an unsolicited takeover attempt, including the Pantry Pride takeover attempt.

(Draft minutes of Revlon Board of Directors meeting, held on August 26, 1985, at 5-6) (Exhibit C)

The deterrent purpose of the Poison Pill Covenants is achieved by first prohibiting a wide range of ordinary corporate transactions and then making all such prohibitions subject to waiver by the "Independent Directors" -- a self-perpetuating subgroup of the sitting board. Thus, without the approval of the so-called Independent Directors, Revlon is crippled and cannot (with certain limited exceptions):

(a) Incur debt;

(b) Declare dividends other than regular dividends, repurchase or redeem shares; or

(c) Sell assets comprising more than two percent of net assets.

Indenture dated as of September 1, 1985 between Revlon, Inc. and Irving Trust Co., Trustee (the "Note Indenture"), ¶¶ 1005-7. (Exhibit D)*

The term "Independent Director" is defined to exclude any person elected by the stockholders who is not

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* Compliance with these covenants can also be waived before the time for such compliance by the act of the holders of 80% in principal amount of the notes. Note Indenture, § 1010.

first nominated by the board. Rather, it includes only non-management directors who either were Revlon directors prior to May 2, 1985 or who subsequently became Revlon directors and whose election, or nomination for election by the company's stockholders, was approved by a vote of a majority of the "Independent Directors." Id. at § 101.

If the Poison Pill Covenants in the Indenture are breached and Revlon defaults on the notes, Revlon's obligations to the noteholders, totalling approximately $475 million plus a $55.8 million premium, will become due and payable.

The preferred stock certificate of designations prohibits, among other things, the incurrence of any indebtedness that would result in a ratio of debt to capitalization of Revlon and its subsidiaries, or of Revlon and its "affiliates," of 0.6:1, unless either the "Independent Directors" or the holders of 80% of the preferred shares approve the incurrence of the indebtedness.* Section 3(D)(iii) (Exhibit E). This ratio would be exceeded by Pantry Pride's acquisition of Revlon and, in that case, the poison pill provisions of the preferred stock would purport

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* Although the holders of 80% of Revlon's preferred shares can approve the incurrence of debt resulting in a debt to capitalization ratio exceeding 0.6:1, obtaining such approval is not a practical alternative to Independent Director approval.

to limit the ability of Pantry Pride or even MacAndrews & Forbes to incur any new debt. That these provisions are intended as anti-takeover devices is made clear by Revlon's board's decision on October 12, 1985 to waive those provisions for the Forstmann Little & Co. leveraged buyout favored by management. While waiving for the leveraged buyout, the board refused to waive for Pantry Pride's superior and concededly fair $56.25 cash offer.

Finally, according to these Poison Pill Covenants, "Independent Director" approval cannot be given -- and, accordingly, actions restricted by Independent Director approval cannot be taken by Revlon -- if no "Independent Directors" exist. Thus, a new board selected by anyone other than the "Independent Directors" would be precluded from waiving the Poison Pill Covenants. Without the ability to waive these provisions, the Revlon board would be unable to exercise powers vital to effective day-to-day and long-term management of the company. Revlon stockholders are thereby coerced into reelecting the current "Independent Directors" or their handpicked nominees.

## I. THE POISON PILL RIGHTS ARE VOID BECAUSE THEIR AUTHORIZATION WAS NOT REASONABLY RELATED TO ANY THREAT POSED BY PANTRY PRIDE.

Revlon's board of directors does not have absolute power to defeat any perceived threat to its control by any Draconian means available. Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946, 955 (1985); Moran v. Household International, Inc., Del. Ch., 490 A.2d 1059, 1083 (1985), appeal pending, Del. Supr., No. 37, 1985 (filed Jan. 31, 1985). On the contrary, its response must be reasonable in relation to the "threat" posed. Revlon's poison pill "Rights Plan" manifestly is not.

In Unocal, the Supreme Court upheld the validity of Unocal's self-tender only after satisfying itself "that the selective exchange offer is reasonably related to the threats posed." 493 A.2d at 956 (emphasis added). See also id. at 949, 957, 958. The Court noted that "the threat posed was viewed by the Unocal board as a grossly inadequate two-tier coercive tender offer coupled with the threat of greenmail." 493 A.2d at 956. The Court found "that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." 493 A.2d at 956. The Court also found that the threat was posed by "a corporate raider with a national reputation as a 'greenmailer'." 493 A.2d at 956. Based on these findings, the Court concluded that Unocal's selective self-tender, which was designed to deter only Mesa's coercive efforts, was a permissible response.

The rule articulated in Unocal with respect to selective exchange offers applies with equal force to all defensive devices, including poison pills of the type presented here. Even commentators who have supported the validity of poison pills have recognized that they are invalid if not tailored to prevent specific coercive bidder tactics. One author has stated:

> If the terms of [poison pill] preferred stock are not narrowly tailored to prevent partial and two-tiered tender offers, however, it should be deemed illegitimate. Sometimes, for instance, protection against coercive partial and two-tiered tender offers is unnecessary--as when a bidder has made a cash offer for all the target's shares.

Note, "Protecting Shareholders Against Partial and Two-Tiered Takeovers: The 'Poison Pill' Preferred," 97 Harv. L. Rev. 1964, 1971-72 (1984) (footnote omitted).

Revlon's adoption of the poison pill Rights was not reasonable in relation to any threat posed by Pantry Pride. The evidence shows that Pantry Pride is not treating the stockholders of Revlon unfairly or in a coercive manner. Pantry Pride's tender offer is not a two-tiered offer; it offers cash for any and all shares of Revlon stock. Nor is "greenmail" an issue. MacAndrews & Forbes and Pantry Pride together own only 30,000 shares of Revlon stock. The Pantry Pride offer "thus lacks the inherent coerciveness and potential for creating unfairness between groups of shareholders which characterize two-tiered offers." MacAndrews & Forbes, slip op. at 11. None of the factors that led the Supreme Court to approve Unocal's self-tender is present here.

Even if the Pantry Pride offer did present some element of unfairness, the poison pill Rights would be overbroad in the extreme in relation to the threat posed. The impact of the Rights is not limited to two-tiered or front-end loaded offers. Under the Rights Plan, Revlon stockholders became entitled to exchange their shares for far more valuable Revlon notes immediately upon an acquisition of 20% or more of Revlon common stock by anyone and for any purpose. Thus in contrast to Unocal -- where the selective exchange offer affected only Mesa -- the Revlon poison pill Rights impose their prohibitive economic penalty on all acquirors and all acquisition proposals, irrespective of their nature and terms. In short, in response to no threat of unfairness or coercion, whatsoever, the Revlon board has taken defensive action of unprecedented reach and impact.

In the absence of any threat of coercion or other procedural unfairness, the defendants are left to argue that this extraordinarily sweeping device can be justified solely because they believe the price offered in a non-coercive, all cash tender offer is inadequate. As this Court has recognized, that argument amounts to nothing more than a claim that the Revlon board has a right to put themselves in the position of the marketplace to determine the value of Revlon.* See MacAndrews & Forbes, slip op. at 11. No case in Delaware or any other jurisdiction has suggested that a board has such a right.

The law guarantees stockholders the right to make their own decisions about tender offers. As Judge Weinfeld put it in Conoco Inc. v. Seagram Co., 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981):

* The consequences to our system of corporate governance would be extraordinary if defendants' alleged good faith belief that they were acting in the interests of stockholders in adopting the poison pill Rights Plan were alone sufficient to validate it. If the mere belief of a board of directors that it can more effectively exercise rights that concededly belong to stockholders furnishes sufficient basis for the board to arrogate those rights and then shield its decision from scrutiny under the claim of business judgment, it is difficult to imagine any stockholder right that would be secure or any entrenchment device that could not be so justified. In any event, this Court has flatly rejected the argument, holding that the business judgment rule does not foreclose inquiry into any board action that transfers any fundamental stockholder power -- including the power to consider tender offers -- to the board. Household, 490 A.2d at 1076.

> To be sure, the Board of Directors are under a duty to exercise their best business judgment with respect to any proposal pertaining to corporate affairs, including tender offers. They may be right; they may know what is best for the corporation, but their judgment is not conclusive upon the shareholders. What is sometimes lost sight of in these tender offer controversies is that the shareholders, not the directors, have the right of franchise with respect to the shares owned by them; "stockholders, once informed of the facts, have a right to make their own decisions in matters pertaining to their economic self-interest, whether consonant with or contrary to the advice of others, whether such advice is tendered by management or outsiders or those motivated by self-interest."

(emphasis added; footnote omitted.)* This overriding stockholder right was underscored by the Second Circuit in its landmark decision in Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984):

> Our most important duty is to protect the fundamental structure of corporate governance. While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.

The poison pill Rights adopted by Revlon's directors thus present a blatant case of the "misuse of directorial

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* See also Indiana National Corp. v. Rich, 712 F.2d 1180, 1185 (7th Cir. 1983) ("Management does not represent the interest of the shareholders in relation to who ultimately wins any potential struggle for control") (emphasis in original); Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 760 (2d Cir.), cert. denied, 104 S. Ct. 550 (1983) (it is for investors -- not management -- "to decide whether takeover offers were fair and equitable"); Kennecott Corp. v. Smith, 637 F.2d 181, 187-88 (3d Cir. 1980) (the Williams Act allows shareholders to "exercise a knowledgeable and unfettered choice" concerning tender offers).

authority" in connection with issuance of a rights plan that this Court warned against in Household. 490 A.2d at 1083. In the face of a non-coercive cash tender offer for all of Revlon's shares, Revlon's board has determined effectively to prevent its stockholders from receiving an offer for their shares. There is neither authority nor justification for their action. The poison pill Rights must be invalidated.

## II. THE POISON PILL RIGHTS ARE VOID BECAUSE THEY ARE WITHOUT STATUTORY BASIS.

### A. The Rights Are Illegal Under Section 151(a).

The Rights Plan is void as a unilateral attempt by Revlon's board to append poison pill terms to already issued Revlon common stock.* Delaware law has long recognized that a right to exchange existing stock for a specified consideration -- as the Rights contemplate -- is a right of the stock. Starring v. American Hair & Felt Co., Del. Ch., 191 A. 887, aff'd, Del. Supr., 2 A.2d 249 (1937); Hartford Accident & Indemnity Co. v. W.S. Dickey Clay Mfg. Co., Del. Supr., 24 A.2d 315, 319 (1942); 8 Del. C. §§ 151(b), (e).

Section 151, which governs such rights, provides, in pertinent part:

> Every corporation may issue 1 or more classes of stock ... which classes or series may have such voting powers, full or limited, or no voting

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* The common stock is the consideration required for exercise of the Rights; therefore, the exercise of each Right depends on ownership of a corresponding common share. The only circumstances in which some consideration other than common stock is required for exercise are those covered in the anti-dilution provisions of the Rights Agreement. In contrast, the rights to purchase newly issued preferred stock under Household's poison pill plan become exercisable regardless of ownership of common stock because the consideration for exercising the right is not the existing common but $100 cash. See Household, supra.

> powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation.

(Emphasis added.) Section 151(a) provides that rights in stock may be created in only two ways: (1) in the certificate of incorporation or a certificate amendment, and (2) in a board resolution "providing for the issue of such stock" pursuant to board authority conferred by the certificate of incorporation. See S. Arsht and W. Stapleton, "Analysis of the 1967 Delaware Corporation Law", at 328-29 (1976). Unless unequivocally conferred in the certificate or in a board resolution issuing the stock pursuant to authority granted by the certificate, the right does not exist. Shanghai Power Co. v. Delaware Trust Co., Del. Ch., 316 A.2d 589, 593 (1974). See also Rothschild International Corp. v. Liggett Group Inc., Del. Supr., 474 A.2d 133, 136 (1984); Ellingwood v. Wolf's Head Oil Refining Co., Del. Supr., 38 A.2d 743, 747 (1944). In either case, it is the certificate -- the fundamental document embodying the stockholders' will -- that is the sole source of power to create stock rights.

Delaware courts have repeatedly invalidated attempts to confer rights upon stock by methods other than those authorized by Section 151. In Hodgman v. Atlantic Refining Co., 2 F.2d 893, 894 (D. Del. 1924), the Court stated:

> The rights conferred by stock ownership in a Delaware corporation are to be determined as a matter of law from the Constitution and the laws of the state of Delaware and the charter of the company. Those rights cannot be increased, diminished, or otherwise altered by a contract between the corporation and the person to whom the shares are issued.

In Gaskill v. Gladys Belle Oil Co., Del. Ch., 146 A. 337, 338-41 (1929), the Chancellor invalidated a by-law amendment which purported to add rights to preferred stock beyond those stated in the certificate, despite unanimous stockholder approval of the amendment reciting it was to have the same effect as a certificate provision. Construing the predecessor of Section 151, this Court stated that the statute's provision that rights of stock be as stated in the certificate of incorporation must be taken to mean that unless the rights are stated in the certificate, they do not exist, even if there is unanimous stockholder approval of an attempt to create such rights by means not authorized by the statute. Id. at 339-40. The Court held:

> My conclusion is that if the stockholders wish to confer special rights upon a given class of stock they must express their wish in the instrument which the statute designates as the place for its recordation. That place is the certificate of incorporation.

Id. at 340-41. See also Aldridge v. Franco Wyoming Oil Co., Del. Ch., 7 A.2d 753, 760 (1939), aff'd, Del. Supr., 14 A.2d

380 (1940) (rights can only be given by the certificate of incorporation); Loew's Theatres, Inc. v. Commercial Credit Co., Del. Ch., 243 A.2d 78 (1968) (a certificate or by-law provision, even though approved by a majority of the stockholders, cannot waive a statutory requirement).

More recently, in Telvest, Inc. v. Olson, Del. Ch., C.A. No. 5798, Brown, V.C. (Mar. 8, 1979) (Exhibit F), this Court enjoined the issuance of a preferred stock, as a dividend on the common stock, purportedly pursuant to board authority to issue blank check preferred under Section 151(a) and the corporation's certificate. The Court held that the stock was not a legitimate preferred and, therefore, the purported dividend* was merely an attempt to alter the existing rights of the outstanding stock:

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* Here, the "dividend" is itself a sham. The "dividend" declaration was merely a device to affix Revlon's poison pill to each share of its common stock, whether currently outstanding or to be issued in the future.

Moreover, to accomplish its purpose of attaching the poison pill to every share of common stock, the board violated the record date setting provisions of Section 213 of the Delaware General Corporation Law (the "DGCL"). Rather than fix a certain date for the so-called "dividend" distribution, Revlon's board provided that the distribution would continue indefinitely until the Rights expire or are triggered. Thus, for example, shares subject to stock options held by management will also carry with them the poison pill. The board's failure to comply with Section 213 invalidates the so-called dividend declaration. See Bryan v. Western Pacific Railroad, Del. Ch., 35 A.2d 909 (1944).

> Thus, I think it clear that the action taken by the board in creating the First Series Preferred and declaring it as a common stock dividend will, if permitted to stand, alter the previously existing voting rights granted to OSI's common shareholders by OSI's certificate of incorporation. Telvest concedes that under the Delaware Corporation Law the voting rights of the common stock can be altered in this fashion by means of an amendment to the certificate of incorporation. The question here is whether this same change can be accomplished by resolution of the board of directors in the absence of shareholder approval.

Slip op. at 9. The Court found no policy in the DGCL empowering the board to alter the rights of outstanding common stock for the supposed good of the stockholders without permitting the stockholders to be heard on the matter and concluded that the rights of existing common stock could not be altered without a certificate amendment adopted in accordance with Section 242 of the DGCL. Slip op. at 14.

The poison pill Rights represent a unilateral attempt to alter the rights of outstanding common stock through a means not permitted under the DGCL. The Rights should be declared invalid.

### B. The Rights Are Illegal Under Section 151(b).

The poison pill Rights grant Revlon stockholders an option to compel the company to purchase the common stock at a stated price upon the occurrence of a specified event.

They are therefore void under Section 151(b), which precludes redeemable common stock except in limited circumstances not present here.* The Rights are also invalid because Section 151(b) requires that redemption terms be stated in the certificate or in a board resolution providing for the issuance of the redeemable stock pursuant to board authority granted in the certificate.

Section 151(b) provides, in pertinent part:

> Any stock which is entitled upon any distribution of the corporation's assets, whether by dividend or by liquidation, to a preference over another class or series of stock may be made subject to redemption by the corporation at its option or at the option of the holders of such stock or upon the happening of a specified event. ... Any stock which may be made redeemable under this section may be redeemed for cash, property or rights, including securities of the same or another corporation, at such time or times, price or prices, or rate or rates, and with such adjustments, as shall be stated in the certificate of incorporation or in the resolution or resolutions providing for

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* The Rights have all the essential features of a right of redemption. By their own terms, the Rights are a "right" to compel the purchase of Revlon common stock. That right is not exercisable apart from the common shares (i.e., the right to compel the purchase is always dependent upon ownership of common stock). The right to compel purchase is at the option of the common stockholder and is triggered by the happening of a specified event: the acquisition of 20% or more of Revlon's outstanding common stock by any person or group. There is a stated redemption price -- $65 principal amount of 12% one-year Revlon Notes. There are also stated adjustments for the redemption rights dependent upon the Company's ability to redeem the common stock in light of legal prohibitions, contractual obligations and the availability of funds.

the issue of such stock adopted by the board of directors as hereinabove provided.

Section 151(b) does not authorize redeemable common shares, except in certain limited circumstances not applicable here. Starring, 191 A. at 889-91; Hartford Accident & Indemnity Co., 24 A.2d at 319. See also E. Folk, The Delaware General Corporation Law : A Commentary and Analysis, at 113 (1972) ("Folk").

The Rights are an unlawful unilateral attempt by Revlon's board to create, without statutory or certificate authorization and without stockholder approval, rights to redeem Revlon's common stock which violate Section 151(b). They should be declared invalid.

C. The DGCL Does Not Authorize Issuance Of Rights To Purchase Debt Instruments.

In addition to their invalidity under Sections 151(a) and 151(b), the poison pill Rights are invalid because the DGCL does not authorize issuance of rights to purchase debt instruments. While Revlon may, as did Phillips, point to a variety of statutory sections empowering the company or its board to take certain actions, these provisions, either individually or in combination, do not authorize the issuance of Rights making already issued common stock exchangeable for debt:

(a) Section 122(13) generally authorizes the corporation to issue notes, but Revlon has not issued notes -- it has issued rights to exchange common stock for notes.

(b) The board's general power to manage the business and affairs of the corporation under Section 141(a) cannot validate corporate actions unauthorized by the DGCL. Unocal, 493 A.2d at 953;* Edelman v. Phillips Petroleum Co., Del. Ch., C.A. No. 7899, Walsh, V.C., slip op. at 9-10 (Feb. 12, 1985) (Exhibit G). Here, issuance of the Rights is not only not authorized, it is expressly prohibited under Sections 151(a) and (b).

(c) Section 151(e) does not authorize the creation of rights to exchange or convert common stock into debt; it only empowers the corporation to make stock exchangeable for or convertible into other stock, and then only by certificate provision or a board resolution issuing the stock pursuant to board power expressly conferred by the certificate.

(d) Section 157 authorizes rights to purchase stock, not rights to purchase notes. Furthermore, Section 157 was enacted to permit the use of rights and options to

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* In Unocal, 493 A.2d at 953, the Court noted that the powers the board was exercising pursuant to its general managerial authority under Section 141(a) were expressly conferred on the corporation by Section 160(a).

purchase stock as a means of financing the corporation. S. Arsht, "A History of Delaware Corporation Law", 1 Del. J. Corp. L. 1, 11 (1976). The poison pill Rights will never bring any money into Revlon's treasury.

(e) Section 160(a) authorizes the corporation to purchase or redeem its shares, subject to certain conditions; it does not authorize boards to create rights to compel the corporation to purchase or redeem shares for a specified price and form of consideration for the next ten years. See Dalton v. American Investment Co., Del. Ch., 490 A.2d 574, 586-87 (1985).

(f) Sections 170 and 173 authorize the payment of a dividend in property; they do not authorize using the dividend procedure to create rights in existing stock that are contrary to the DGCL and Revlon's certificate. The dividend power is expressly limited by the certificate and applicable statutory provisions. Folk, at 184; Gaskill, 146 A. at 338-39.

The Rights lack the necessary statutory basis. They should be declared invalid.

## III. THE POISON PILL COVENANTS ARE NOT REASONABLY RELATED TO ANY THREAT TO REVLON.

To ensure absolutely their continuing control of Revlon's destiny, the Revlon directors have adopted extraordinary defensive measures -- the Poison Pill Covenants -- which will have the effect of drastically crippling Revlon as a viable economic entity not only in the event of an unwanted take-over but also in the event the sitting board of Revlon loses its control over Revlon at any time in the future for any reason. That the Poison Pill Covenants are defensive is admitted. Revlon's advisors told the Revlon board that the covenants were designed "to deter or make more difficult an unsolicited takeover attempt, including the Pantry Pride takeover attempt." (Draft minutes of Revlon Board of Directors meeting, held on August 26, 1985, at 5)

The covenants achieve their deterrent purpose by restricting severely Revlon's ability to conduct its business. The covenants limit Revlon's ability to:

- Incur debt other than its existing debt, the debt represented by the notes or the debentures into which the preferred shares are exchangeable, debt for working capital or the one-year notes issuable under the Rights Plan.

- Make restricted payments such as dividends.

- Assign, sell, lease or otherwise transfer assets of Revlon, except in the ordinary course of business, where the assets exceed two percent of the consolidated adjusted net assets, or between Revlon and a Revlon subsidiary.

- Incur indebtedness that would result in a ratio of debt to capitalization of Revlon and its subsidiaries, or of Revlon and its "affiliates" (defined to include any person who directly or indirectly controls Revlon), of in excess of 0.6:1.

The Poison Pill Covenants hamstring the ability of Revlon to engage in fundamental activities necessary to the day-to-day and long-term operation of the company as a viable economic entity.

There is not even a suggestion that the purpose of the covenants is to serve a financing function or to preserve the value of the notes and preferred shares in the interests of Revlon note holders and preferred shareholders,* nor could such purposes be demonstrated. As financing provisions the covenants are sham. They contain greater protections than the noteholders and preferred shareholders can possibly need or use. Moreover, they are designed to be avoided by Revlon's

* That the restrictive debt provisions in the preferred are not for the benefit of preferred stockholders is conclusively demonstrated by the fact the Revlon's board has now agreed to waive that provision "immediately upon consummation of any transaction in which all stockholders will receive $57.25 or more per share <u>for all their shares of common stock</u>." (Revlon press release, October 13, 1984, Transcription at 4) (Exhibit H) Preferred stockholders cannot have received any benefit from this waiver. The board's acknowledgement that Forstmann Little's $56.00 deal was <u>fair</u> required tht they redeem the pill for Pantry Pride's $56.25 cash offer. They did not and, thus, breached their fiduciary obligations. <u>See</u> <u>Unocal Corp. v. Mesa Petroleum Co.</u>, <u>supra</u>.

sitting directors. If they were legitimate, if they actually existed for the benefit of noteholders and preferred shareholders and were bargained for by them, the directors would not have the power to waive them. This power to waive the restrictions is simply the equivalent of the board's power to redeem the poison pill Rights. As this Court recognized in Household, such a provision is intended to give the board of directors vastly increased power over all acquisition proposals; it is a device for transferring power from the stockholders to the board. Household, 490 A.2d at 1083.

The power to waive these covenants, in turn, is reposed only in the so-called "Independent Directors," who possess unlimited discretion to approve the restricted actions. If there are no Independent Directors, the actions may not be taken at all (in the case of the $9.00 preferred) or only at the cost of defaulting on the notes and accelerating their maturity. The evil of the Independent Director mechanism is that the only individuals who can qualify as Independent Directors are either current Revlon directors or their handpicked successors. Thus, if Revlon stockholders desire to preserve Revlon's power to take the actions otherwise restricted by the covenants, they have no choice but to re-elect the current directors or their nominees. If Revlon stockholders, for whatever reason, exercise their right to replace the current directors, Revlon will be crippled. There can exist no legitimate basis for reposing in the so-called Independent Directors -- rather than the full board as it may be constituted from time to time -- the power to approve the restricted actions. The covenants, coupled with the "Independent Director" mechanism, are no more than an entrenchment device designed to consolidate in the hands of the current board and its designated successors power over the destiny of the company.

The avowed anti-takeover purpose of the covenants, their extraordinary breadth and radical nature all require that they be struck down as unreasonable in relation to the threat posed and Draconian in operation. Unocal, 493 A.2d at 955; Household, 490 A.2d at 1083.

Here, in contrast to Unocal, any "threat" to Revlon posed by Pantry Pride's tender offer is imaginary. Pantry Pride's tender offer, originally and as amended, is an all-cash, "any-and-all" offer; remaining shareholders will receive the same amount of consideration in the contemplated second-step merger. Thus it "lacks the inherent coerciveness and potential for creating unfairness between groups of shareholders which characterize two-tiered offers." MacAndrews & Forbes, slip op. at 11. Nor, as only a nominal

Revlon shareholder, is MacAndrews & Forbes or Pantry Pride a greenmailer.

In approving the selective exchange offer at issue in Unocal, the Court reasoned that "[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out." 493 A.2d at 959 (citation omitted) The Revlon shareholders cannot express their displeasure with the Poison Pill Covenants. As a result of the covenants, the power of Revlon shareholders to turn out their board has been effectively eliminated.

These covenants bear no reasonable relation to any threat to Revlon. They should be struck down.

## IV. THE "INDEPENDENT DIRECTOR" PROVISIONS OF THE POISON PILL COVENANTS ARE VOID UNDER SECTION 141.

Section 141(a) of the DGCL provides that the power and obligation to manage the business and affairs of a Delaware corporation is vested in the full board. Abercrombie v. Davies, Del. Ch., 123 A.2d 893 (1956), rev'd on other grounds, Del. Supr., 130 A.2d 338 (1957). By adopting Poison Pill Covenants requiring the approval of certain so-called Independent Directors for a wide variety of corporate actions essential to the long-term competitive operation of a billion dollar multinational corporation such as Revlon, the Revlon board has improperly — and irrevocably — contracted away its essential managerial authority.

It is a "longstanding rule that directors of a Delaware corporation may not delegate to others those duties which lay at the heart of the management of the corporation." Chapin v. Benwood Foundation, Inc., Del. Ch., 402 A.2d 1205 (1979), aff'd sub nom. Harrison v. Chapin, Del. Supr., 415 A.2d 1068 (1980). See also Clarke Memorial College v. Monaghan Land Co., Del. Ch., 257 A.2d 234 (1969); Lehrman v. Cohen, Del. Supr., 222 A.2d 800 (1966); Abercrombie v. Davies, 123 A.2d 893; Adams v. Clearance Corp., Del. Supr., 121 A.2d 302 (1956); Field v. Carlisle Corp., Del. Ch., 68 A.2d 817 (1949). As Chancellor Seitz stated in Abercrombie v. Davies, 123 A.2d at 899:

So long as the corporate form is used as presently provided by our statutes this Court cannot give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters.

Accord In re Acadia Dairies, Inc., Del. Ch., 135 A. 846 (1927).

That, however, is precisely the effect of the Independent Director provisions of the Poison Pill Covenants. As noted above at pages 27-31, those covenants prohibit the Revlon board from taking fundamental corporate actions without first obtaining the approval of the so-called Independent Directors. As a practical matter, the board as a whole has contracted away its ability to take such action. The powers thus delegated are far broader and more essential to the operation of Revlon's business and affairs than the powers found to have been illegally delegated in any of the cases cited above.*

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* Chapin v. Benwood Foundation, Inc., 402 A.2d 1205 (illegal agreement by members of board of directors to appoint named individuals to fill future board vacancies); Clarke Memorial College v. Monaghan Land Co., 257 A.2d 234 (board resolution illegally authorizing officers to fix "terms and conditions" of asset sales); Abercrombie v. Davies, 123 A.2d 893 (illegal contract binding directors to vote as directors as a block); Field v. Carlisle, 68 A.2d 817 (illegal delegation by board of duty to determine value of property to be acquired in consideration for issuance of stock).

Moreover, the nature and extent of the delegation is more extreme here than in any of the cited cases. In most, the delegation of authority was accomplished by agreement among the directors themselves or stockholders they directly represented. See Abercrombie; Field; Chapin. In no other case has there ever been a delegation of authority purportedly accomplished in a contract with outside third parties, making the delegation essentially and permanently irrevocable. And in no other case has the delegation been to a group which may cease to exist, raising the very real (and, for Revlon stockholders, frightening) possibility that the delegated powers will in effect vanish -- in short, that Revlon will lose the power to take fundamental and essential corporate actions that touch on virtually every aspect of its business and affairs. Here, the power to manage the corporation is not only delegated -- it may well be destroyed irrevocably. Such an abdication of directors' managerial authority cannot be sanctioned.

Nor can Revlon's board take any comfort from an argument that the so-called Independent Directors are a *de facto* committee authorized by Section 141(c). That section -- the *only* statutory authority for delegation of the board's managerial power -- *requires* that any delegation of board authority to a committee be reflected in a resolution of the full board. No such resolution exists. Instead, as noted, the delegation of authority is purportedly accomplished in a contract with a third party.

This is not a trivial or technical distinction. The board of a Delaware corporation has a duty under Section 141 at any given time to be in a position fully to exercise its own independent business judgment. See, e.g., Lehrman v. Cohen, Del. Supr., 222 A.2d 800 (1966); Adams v. Clearance Corp., Del. Supr., 121 A.2d 302 (1956). Proper delegation of authority to a committee by resolution is fully consistent with that duty, because the board can at any time dissolve the committee, reassume its managerial authority and exercise its judgment.

By contrast, the Poison Pill Covenants have no such escape valve. If they are valid, the Revlon board has forever relinquished its ability to exercise its judgment with respect to corporate actions essential to the efficient and competitive operation of a large multinational corporation. That is an impermissible abdication of the board's managerial authority. The Independent Director provisions of the Poison Pill Covenants must therefore be struck down.

## CONCLUSION

On the basis of the authorities and arguments in this brief and in the brief filed on the plaintiff's behalf by Young, Conaway, Stargatt & Taylor, plaintiff's motion for a preliminary injunction should be granted.

Respectfully submitted,

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