IN THE SUPREME COURT OF THE STATE OF DELAWARE

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,

Defendants Below,
Appellants,

v. Nos. 353 & 354, 1985

MACANDREWS & FORBES HOLDINGS, INC., a Delaware corporation,

Plaintiff Below,
Appellee.

REPLY BRIEF OF APPELLEE

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Dated: October 29, 1985

TABLE OF CONTENTS

TABLE OF CASES AND AUTHORITIES

PAGE

AUTHORITIES

PRELIMINARY STATEMENT

The lock-up at issue in this case is unique. It constituted a gift of between $100 and $200 million in Revlon assets. It procured a bid for the stockholders which was no better than the one already on the table from Pantry Pride. It was designed to insure that the higher bid the board knew Pantry Pride would make to the Revlon stockholders would not be made because no one could afford to pay more for Revlon stripped of between $100-$200 million than Forstmann would pay for the company intact. The lock-up was granted in an active bidding situation with the knowledge that Pantry Pride -- unless locked out -- would bid higher than Forstmann. It was part of a premeditated Revlon strategy to deceive Pantry Pride and keep it from bidding.

Revlon intentionally withheld from Pantry Pride the knowledge that a Board meeting was to be held on October 12, and that its bid was, in the Board's view, no longer the highest. That information was withheld because Revlon did not want Pantry Pride to make a higher bid. The record on this point is uncontroverted. (Drapkin Aff. ¶ 10, B 945) Although there were several contacts between Pantry Pride and Revlon on October 11, the Revlon representatives studiously avoided communicating that the auction was to be terminated the next day. (Drapkin Aff. ¶¶ 8-9, B 945-46; Gittis Aff. ¶ 5, B 948)

On October 11, when the court inquired of Revlon's counsel as to when the next Revlon Board meeting would be held, counsel refused to say and made it clear that Revlon did not want another bid from Pantry Pride:

> "Well, Your Honor, as I said, the board meeting has been scheduled, and I - am prepared to tell Your Honor in camera precisely what is going to occur, but I am concerned about something, frankly. I am concerned that the very reason for this meeting this afternoon as opposed to Monday is to find out precisely that, that is, an effort by Pantry Pride to find out. And if the Court wants me to tell them that in this context, I will do so. But I don't want to have happen what happened on October 1, which is for the Revlon board to get a proposal 15 minutes before its meeting.
>
> There has been abuse here. They knew about that [October 1 board] meeting and they took very unfair advantage of it,* and I don't want to contribute to that if I don't have to.

(10/11/85 Tr. 12-13, B 1070-71; emphasis added)

What makes Revlon's conduct all the more egregious is that as recently as October 10, as well as earlier, it had assured Pantry Pride "that Revlon would not grant a lock-up to any bidder and that the market would be permitted to determine the outcome of any competing bids." (Perelman Aff. ¶ 7, B 956; see also ¶ 6, B 956)

As a consequence of the premeditated Revlon strategy of active concealment, Pantry Pride did not know when the Board meeting was to be held, that the Board had received another bid which Revlon's advisors would recommend in preference to Pantry Pride's, or that Revlon intended to terminate the auction by granting Forstmann a lock-up option

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* On October 1 Pantry Pride submitted its $53 per share merger offer to the Revlon Board which was then meeting. (Perelman Aff. ¶ 5 and Ex. B, B 956 and B 965)

to purchase assets for $525 million that Revlon's own investment bankers had valued at $600-700 million. Rather, having been repeatedly assured that no lock-up would be granted, Pantry Pride believed that it would not be shut out of the auction. (Perelman Aff. ¶¶ 6-7, B 956)

For the directors now to seek to justify their decision to lock-up the Forstmann bid because Pantry Pride had not bid again, in the face of this uncontroverted evidence that Revlon had actively misled Pantry Pride into not bidding, is unconscionable. If the directors did not know the precise terms of what they knew would be Pantry Pride's higher bid, it was because Revlon had procured that directorial ignorance. An intentional ignorance does not satisfy the duty of care. The October 12 minutes reflect that not a single director either asked if Pantry Pride had been told that it must submit its best bid for their consideration at that meeting or suggested that Pantry Pride, like Forstmann and Adler and Shaykin, should be invited to the meeting to submit its final bid.

Equally unavailing is the defense, proferred below, that the directors owed some legal duty to the Noteholders which would justify taking a lower price for the stockholders. Revlon now tacitly concedes that no such duty exists. (Revlon Appellants Opening Brief ("RB") p. 40) In so doing, it concedes Justice Walsh's conclusion that the decision to take a lower bid for the stockholders to get a benefit for the noteholders violated the directors' duty of loyalty.

Revlon's attempts to trivialize the benefit being denied the stockholders (RB 32) do not work. Revlon's directors knew they were sacrificing a higher offer when they terminated the auction, even if they did not know by how much. What they did know was that even a 25¢ increase, because of the time value of money, represented over $30 million in value to the stockholders.* If, as their counsel predicted, Pantry Pride would bid $58, the value lost to the shareholders could be $60 million or more. These amounts are not trivial to the Revlon stockholders.

Revlon's final justification was that its Board was uncertain about Pantry Pride's ability to finance its offer and that Forstmann's financing had been secured. The court below properly rejected this claim. Pantry Pride had all but $350 million of its money firmly committed. Drexel Burnham, which never failed to deliver funds when it had said that it was "highly confident" it could do so, gave such an assurance. A few days later, it in fact delivered on the last $350 million. Forstmann, by its own admission, was short $400 million and had only a bank commitment to use its "best efforts" to attempt to raise the money. There was no financing issue on October 12 as Revlon had previously assured Pantry Pride. (Perelman Aff. ¶ 16)

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* Lazard calculated that the time value of money produced approximately a cost of 60¢ per month at these price levels. Thus, an equal price from Forstmann six weeks later was worth about 90¢ less. If Pantry Pride offered 25¢ more, its deal would be, in fact, $1.15 (X30 million - $34.5 million) better than Forstmann's.

As the court below found, at the point that Revlon's Board decided to sell the company, its paramount duty of loyalty required that the highest bid be sought for the owners of the company, the shareholders. Yet at every step Revlon's Board violated that duty by seeking to shut Pantry Pride out of the auction. The directors would naturally prefer to lock-up a deal which obviated their contingent liability for securities fraud to the noteholders and protected them from any takeover other than Forstmann's for up to three years,* but their duty of loyalty did not permit them to do that at the expense of the stockholders. That is what they did and it constituted, as the court below found, a manifest breach of fiduciary duty.

The business judgment rule provides no absolute shield for director actions in takeover situations. The function of the Chancery Court is, under the evidentiary constraints of that rule, to determine whether the particular actions taken by a board were proportionate to the requirements of the circumstances and satisfied their duties of loyalty and due care. This is all that Justice Walsh did. In the context of active bidding, the use of an asset lock-up at a grossly inadequate price to deny the stockholders a better bid achieved no legitimate purpose and violated the directors'

* The lock-up option provided that if anyone acquired 19.9% of Revlon's shares, its term would be extended for three years <u>even</u> if the Forstmann deal was not completed. Revlon has never offered any excuse for this extraordinary feature.

duties of loyalty and due care. The court below utilized the correct legal standard and fairly considered the facts. The decision below should be sustained.

STATEMENT OF FACTS

The Revlon appellants begin their argument in their Statement of Facts -- and predictably so because their appeal is essentially reargument of factual matters resolved below. They assert a number of supposed "factual errors" and proffer to this Court the same factual distortions they unsuccessfully advanced to the court below. We address their assertions of factual error in the order of their presentation in the Revlon brief. (RB 5-10)

1. <u>The Uncertainty of Forstmann's Financing</u>. Revlon takes exception to the conclusion of the court below that on October 12, when the Revlon board acted to lock-up the Forstmann deal and management withdrew from the "equity financing," $400 million of the necessary financing for that transaction was uncommitted. (RB 5; Opinion at 22, B 1042; <u>see also</u> FB 15) That conclusion was absolutely correct. Appellants appear to misconstrue the court's comment as indicating that the withdrawal of management caused the $400 million short-fall. But whatever the court intended, the material fact was correct -- the $400 million was indeed <u>uncommitted</u>. Nothing more pointedly shows this than language of the October 12 amendment, executed after Revlon management

was forced out, which changed Forstmann's financing caveat to put in only a "best efforts" basis.*

A further reason for "best efforts," instead of an unconditional commitment, is that the leveraged buyout financing came largely from a $1.2 billion bank credit facility which is, itself, not fully committed. (Merger Agreement ¶ 9.1(b), B 588 and Commitment Agreement dated October 2, 1985, B 1346-48)** As of October 3 and October 12, Forstmann had received a commitment letter from its lead banks for only $800 million of the necessary $1.2 billion bank financing. (B 1346) Any affidavits or references in the minutes to the contrary are wrong. Revlon's Schedule 14D-9 amendment filed on October 18 clearly stated that the $400 million is uncommitted. (Schedule 14D-9, Amendment No. 8, B 1346) And the "committed" $800 million was conditioned upon the acquisition of the additional $400 million.

2. <u>The Certainty of Pantry Pride's Financing</u>. Revlon asserts that the court erred by concluding that Drexel Burnham Lambert Incorporated ("Drexel") had fully committed financing for the Pantry Pride tender offer. (RB 5; Opinion at 22, B 1042; <u>see also</u> FB 16) Again, the court's conclusion is absolutely correct. Pantry Pride's tender offer was being financed from three sources: (a)

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* "F & L Companies covenant that they will use their best efforts in connection with the financing to have sufficient funds to consummate the transactions contemplated hereby...." (B 786)

** Filed with this brief is Appellee's Supplemental Appendix, pages B 1346 <u>et seq.</u>

general corporate funds; (b) a bank credit; and (c) the private placement of Pantry Pride notes by Drexel. As of October 9, when Pantry Pride increased its tender offer to $56 per share, Pantry Pride had a bank credit from Chemical Bank totaling $450 million, general corporate funds on hand of $750 million, and an opinion from Drexel that it was "highly confident" it could raise $700 million in the private placement. (B 663-64)* By October 12, Drexel had commitments for $350 million, and Revlon was so advised. (B 723) By October 18 the entire placement was committed. (B 969)

3. Sale of Norcliff Thayer and Reheis. Revlon complains that the court below erroneously stated "Revlon agreed" to sell its Norcliff Thayer and Reheis subsidiaries "to help finance Forstmann's transaction." (RB 6; Opinion at 10, B 1030) The nitpick is that Revlon is not a party to those sale agreements. While that may be true, the court below was correct nonetheless. There can be no question that the purpose of those sales was to retire part of the liability for the $1.2 billion credit facility Revlon would incur as part of the Forstmann transaction. The credit facility required such reduction in the level of the debt and antici-

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* That "highly confident" phrase also appears in the amendment to the merger agreement relative to Forstmann's financing. (B 786) But in Drexel's case, there had never been a case in which it had expressed a "highly confident" opinion and failed to deliver. (B 968)

pated that the reduction would be financed from the proceeds of sales of assets. (Commitment Agreement, B 1347)

4. Sale of Beauty Division. Revlon claims the court below erred by concluding that Revlon had agreed to the sale of the beauty products division to help finance Forstmann's transaction. (RB 6; Opinion at 10, B 1030; see also FB 6 ¶ (vi)) Again, the court below is correct and defendants are wrong. (Merger Agreement, ¶ 10.2(j), B 500) Revlon's minutes clearly state that this sale was to be used to "finance" the buyout by reducing the bank credit facility. (B 877)

5. Increasing Amounts. Revlon scolds the court below for concluding that Pantry Pride's offers, which appellants must admit were all for cash, were "in increasing amounts." (RB 7; Opinion at 17, B 1037) Revlon complains that Pantry Pride, at one point, had "decreased" its offer from $47.50 to $42. The court below was not in error. Revlon's minutes contain Lazard's statement that the $42.00 offer was the equivalent of the $47.50 offer in light of the intervening exchange offer. (September 24 Minutes, B 854).

6. Threat of Litigation. Revlon challenges the court's conclusion that "the threat of litigation by the Noteholders" had become a source of concern to the directors. (RB 7-8; Opinion at 20, B 1040) But Revlon must concede that there were threats of litigation (B 940), that the

directors were deluged with complaints from the Noteholders (B 840), that litigation actually was instituted and that four Revlon directors hired independent counsel before the October 12 Board meeting. To deflect these objective facts, appellants parade their self-serving assertions that they were unconcerned about potential liability. These proclamations do not explain what changed between the October 3 Board meeting, which approved the leveraged buyout requiring the subordination of the Exchange Notes (and anticipating their devaluation) and October 12, when the directors were prepared to lock-up Forstmann's offer in return for consideration to the Noteholders. The only thing which changed was the firestorm of protest from the Noteholders and the ensuing directorial concern.

7. Waiver of the Covenants. Revlon argues that the court below erred when it suggested that the directors, on October 3, had agreed to waive the restrictive covenants in favor of the leveraged buyout. (RB 8; Opinion at 9, 10, 23, B 1029, 1030, 1043; see also FB 6 ¶ (iii)) Revlon then suggests the court misunderstood the supposed fact that the directors' concern about the Noteholders had antedated the market price drop and any threat of litigation.

It is true that on October 3 there was no formal waiver of the restrictive covenants, but the merger buyout approved then by the directors was conditioned upon such a waiver. (B 595-96) Under the merger agreement Revlon was obligated to use its best efforts to fulfill all the conditions to the merger. (B 586) Surely Revlon is not suggesting that the directors committed Revlon to this agreement and to the potential payment of a $25 million cancellation fee, without a firm conviction that the covenants would be waived so that the transaction could be consummated.* Otherwise, the directors were committing Revlon to a waste of $25 million.

Revlon's second point, that the directors' concern about the Exchange Notes antedated the price fall, is half true. On October 3 the directors were informed of the probable effect of the leveraged buyout on the Notes. (B 881) Lazard advised the Board that all that need concern the Board was Forstmann's ability "to repay the principal and interest." (B 896) By October 12 such repayment was no longer sufficient, since Pantry Pride had offered to do just that and it was considered "nothing" of value to the Noteholders. (B 902-93) The directors' awareness of the effect of the leveraged buyout may have antedated the price fall, but the conviction to cure that problem for the

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* On October 3, the Board was advised as follows:

> [Mr. Lipton] emphasized that although the Board was not taking action [on the waiver] at this time, they were indicating acceptance of the Forstmann, Little capital structure and that Forstmann, Little was being led to believe that the Board would waive the covenants.

(October 3 Minutes, B 880-81)

Noteholders only came later. The court below misunderstood nothing on this point.

8. Failure to Share Financial Data. Revlon is offended that the court below, noting that Revlon refused to share financial data with Pantry Pride, "ignored" their facile explanation that Revlon would have shared the data if Pantry Pride had agreed to a standstill. (RB 9; Opinion at 19, B 1039) But to have signed a standstill agreement, which was not required of Forstmann (B 1103), would have ended any bidding. As Rifkind explained, Revlon's Board would not have pursued any sale but for Pantry Pride's persistence. (Rifkind Dep. 44-45, B 1392-93)

9. Same Level of Negotiation. Finally, Revlon claims that the court below erred when it concluded that Revlon did not "invite Pantry Pride to participate on the same level of negotiation [as Forstmann]." (RB 9; Opinion at 19, B 1039; see also FB 7) Revlon ignores the specific reasons given by the court in support of this conclusion and offers its own description of negotiations in general terms, without any citation to the record except for a long string citation at the end of the paragraph. It is appellants' description which is unsupported by the record, even by their string citation.

Missing is any advice to Pantry Pride that the auction was about to close and that its best offer should be put forward. <u>Missing</u> is any attempt by Revlon to inquire concerning Pantry Pride's best offer before locking up Forstmann and locking out Pantry Pride. These facts are missing because they never occurred. When asked for an explanation, Rifkind explained that Revlon knew Pantry Pride's response -- it would <u>increase</u> its bid! (Rifkind Dep. 88, B 1087) (<u>See also</u> the statement of Revlon's counsel at the October 11 scheduling hearing, page 2 <u>supra</u>.)

*   *   *

Hoping to have discredited the court below (with these allegations of error), Revlon proceeds to offer its own version of reality -- a reality nowhere reflected in its own minutes -- which were a principal factual source upon which the court below relied. Treating its factual contentions in the order in which they arise:

(a) Revlon belatedly contends that the restrictive covenants in the Exchange Notes were intended to protect the value of those Notes, in addition to deterring takeovers. (RB 11) Nowhere do the minutes suggest such a purpose, and the ability of independent directors of the <u>debtor</u> to waive those provisions in their discretion belies any intent to have those covenants protect the creditor-Noteholders.

(b) Revlon asserts that "Pantry Pride ... was explicitly invited to raise its bid and was requested --

both orally and in writing -- to come forward with a plan for <u>refinancing</u> the notes." (RB 16) Lazard, on October 9, did inquire of Pantry Pride, among many other matters, about its "intentions with respect to refinancing Revlon's outstanding debt." (B 721) And Pantry Pride responded that it would pay the principal and interest. (B 723) Revlon's use of the letter is only an attempt to mask its refusal to deal with Pantry Pride. In conversations between counsel, Pantry Pride advised it was "willing to satisfy Revlon's concern for the noteholders and that the issue should not block a deal." (B 943)

Pantry Pride was never "invited to raise its bid." The self-serving minutes state only that Mr. Lipton referred Pantry Pride's counsel to Mr. Forstmann, who was seeking to "settle" with Pantry Pride by dividing Revlon. (A 908-09) Certainly, Revlon never "emphasized the need" for Pantry Pride "to come forward with its best offer" before the October 12 meeting, as Revlon's brief describes its message to Forstmann. (RB 16)

(c) Revlon continues to assert that Forstmann would "walk away" if its new bid and lock-up were rejected. (RB 23-25) But it would have cost Forstmann the $25 million cancellation fee to "walk away" in breach of the existing agreement. And, there is a sublime illogic in granting a lock-up to a party who threatens to breach the agreement being "locked up," especially when the "lock-up" would survive a breach. (B 811-22)

(d) Throughout the Revlon brief, and in the Forstmann brief, it is declared (as if repetition would make it true) that Forstmann's $57.25 October 12 merger price was higher than Pantry Pride's $56.25 tender offer price (a matter of simple arithmetic, it is implied). This is flatly wrong. The Forstmann offer was subject to delay. The Pantry Pride offer was (and is) immediate. When the October 3 Forstmann $56 offer was made known, that offer was valued at $52-53 per share. (B 730-31) Here the October 12 Forstmann merger price of $57.25 was valued by Drexel to be at best $54-55 per share. (B 969-70) Even Lazard, Revlon's investment banker, valued Forstmann's $57.25 merger proposal at possibly "slightly less" in value than the Pantry Pride $56.25 tender offer. (B 918-19)

ARGUMENT

I. THE LOCK-UP WAS A BREACH OF THE DIRECTORS' FIDUCIARY DUTIES.

A. Unocal; Duty of Care; Duty to Seek Best Price.

Defendants utterly fail to address the reasonableness of the lock-up in the light of Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946 (1985), this

Court's most recent discussion of a board's defensive powers. In Unocal, this Court stated that "[i]f [a] defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." 493 A.2d at 955. Revlon's grossly undervalued lock-up -- designed to preclude the "threat" of a better bid for stockholders -- can never meet this test.

As Justice Walsh found (and defendants concede), by late September the objective of Revlon's Board had become "to secure the highest price for the pieces of the Revlon enterprise." (Opinion at 18-19, B 1038-39) Thus, under the Unocal standard, the evidence condemns the Board's action in granting the lock-up as both unreasonable and, indeed, not rationally related to that objective.

The Board failed and refused to take the one step by which they could have assured themselves that they had obtained top dollar -- they never asked Pantry Pride. In their self-imposed state of ignorance, the Board and their advisors simply had no basis for knowing what Pantry Pride was willing to do. Moreover, as Justice Walsh found, the Revlon Board had a heightened duty to negotiate by reason of their adoption of the Rights Plan which had precluded Pantry Pride from bidding effectively in the marketplace. (Opinion at 16, B 1036) Nevertheless, they proceeded to "deliberate" and to reach a "business judgment" in a vacuum. In fact, it was not a deliberation but only a ritual to which Pantry Pride was not invited. The behavior of the directors was unreasonable, irrational and in breach of their fiduciary duty of care. Smith v. Van Gorkom, Del. Supr., 488 A.2d 858 (1985).

The directors' excuses for their agreement to grant the $75 - $175 million bargain lock-up only underscore the conclusion. They claim to have secured "$100 million in additional value." This is nonsense. They secured no additional dollars for the stockholders over the Pantry Pride offer. They were told as much on October 12 by Mr. Loomis of Lazard Freres. They also may have gotten nothing for the Noteholders. Forstmann, in its brief ("FB"), claims that the Note exchange offer in the amendment to the merger saved Forstmann $56 million in payments to the Noteholders. (FB 14) Even if, as Revlon maintains, the Note exchange offer is valuable to the Noteholders, that value comes at the expense of the stockholders. How can that result be rationally related to the Board's only proper objective -- getting the maximum value for the stockholders? (Opinion at 18-19, B 1038-39)

No case ever condoned, as an exercise of business judgment, a lock-up in even remotely similar circumstances.

It is remarkable that defendants never mention that the $525 million exercise price is $75 to $175 million below the fair market value of the optioned assets, as estimated by Revlon's own investment bankers. No court ever has suggested that directors can agree to sell assets at a grossly inadequate price to "lock-up" a deal.*

In GM Sub Corp. v. Liggett Group, Inc., Del. Ch., C.A. No. 6155, Brown, V.C. (Apr. 25, 1980), Liggett sold a subsidiary to the highest of nine bidders at a price "very favorable to Liggett" and one not shown to be in any way inadequate. Slip op. at 4. Here, the option is on terms very favorable to Forstmann. The high-priced open auction** in GM Sub cannot serve as precedent here for Revlon's bargain basement giveaway.

Similarly, in Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill.), aff'd, Dkt. Nos. 82-1305, 82-1307 (7th Cir. Mar. 5, 1982), the target company sold a subsidiary to a third party, at a price in excess of the price at which the tender offeror had valued the same subsidiary.

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* Forstmann's claim that no prior court ever has enjoined an asset option agreement adds nothing since no court ever has decided a case involving a lock-up at a price below fair value or one intended to block a higher offer known to be available.

** The open auction conducted by Liggett is but one method of obtaining the highest price. We do not suggest that any particular method of sale is required in every case. Simkins Industries v. Fibreboard Corp., Del. Ch., C.A. No. 5369, Marvel, C. (July 28, 1977), is thus inapposite.

535 F. Supp. at 949. Thus, Whittaker bears no resemblance to this case, where the target's investment banker, Lazard Freres, had valued the asset substantially above the lock-up price.* Moreover, the Whittaker court found that the asset sale "has not created an artificial ceiling in the tender offer market for Brunswick common shares." Id.

Finally, in no case cited by defendants has a board ever been allowed to "lock-up" a lower bid. Thus, in Thompson v. Enstar Corp., Del. Ch., C.A. Nos. 7641 and 7643,

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* The three decisions cited by the defendants that involved sales of stock or stock options also do not support their case. In Buffalo Forge Co. v. Ogden Corp., 555 F. Supp. 892 (W.D.N.Y.), aff'd, 717 F.2d 757 (2d Cir.), cert. denied, 464 U.S. 1018 (1983), the target company issued an option to a tender offeror to acquire a block of treasury stock at its tender offer price of $32.75 per share, well above the $25 per share price of the rival tender offer. The rival offeror increased its low offer price only after the option had been issued and exercised. Both the district court and the Second Circuit expressly relied on the fact that the negotiations were at arm's length and that the price received from the treasury stock "exceeded the cost of the stock, its book value and its normal trading price." Buffalo Forge, 717 F.2d at 759 (2d Cir. 1983). Here, Revlon entered into its heavily discounted lock-up even while a higher competing offer was pending.

In Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980), the target company's exchange offer, intended to facilitate a merger and to stop a rival tender offer, involved the issuance of target company shares at the full merger price, the adequacy of which was not at issue. Moreover, the vote of target company shareholders was required to effectuate the exchange offer. Id. at 696, n.9. In Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980), the target company sold a block of its shares, at market price, to facilitate a merger, at a time when the board had no competing offer before it. It did not involve the board's taking steps to thwart an ongoing higher offer.

Hartnett, V.C. (June 20, 1984, revised Aug. 16, 1984), the lock-up was granted only after the board's extensive search for potential acquirors yielded "only one firm offer" -- that of the party to whom the board granted the lock-up. Slip op. at 7. That offer also was one which the target company's directors reasonably could conclude "was the best which could be obtained under the circumstances." Slip op. at 13. Here, by contrast, the Revlon Board knew Pantry Pride would pay a better price than that offered by the "locked-up" Forstmann proposal.*

B. The Duty Of Loyalty.

Revlon's opening brief (40-45) contests the finding by the court below that the Revlon directors were conflicted by the threat of personal liability to the Noteholders when they granted the lock-up option, and Justice Walsh's conclusion that "[b]y agreeing to the lock-up and no shop clause in exchange for protecting the ... Noteholders," the Revlon Board failed to fulfill its "primary responsibility" to the shareholders. (Opinion at 24, B 1044) The record and the law support these conclusions.

1. Revlon's Evidentiary Arguments.

Revlon's brief twists and turns through various presumptions, assignments of the burden of proof, and

* Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555, 1563 (9th Cir. 1984), which validated an exclusive merger agreement, is irrelevant. The issue here is Revlon's duty to act reasonably to obtain the best offer before entering into a binding merger agreement with a strict "no shop" clause.

evidentiary rules to which they claim to be entitled and by reason of which they claim insulation from this Court's scrutiny. There is no attempt at all, however, to justify the Board's grant of the lock-up in terms of fairness to the shareholders. Rather than grapple with the impossible task of even arguing fairness, the Revlon defendants turn to three evidentiary arguments and even those are misapplied or mischaracterized.

First, Revlon argues that Pantry Pride has not met its burden of showing a "sole" or "primary" wrongful motivation, citing Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981). Revlon is flatly wrong in asserting (RB 34-35) that the "sole or primary" purpose test of Johnson v. Trueblood has any bearing on this case. Johnson dealt only with the question whether "a" motive to retain control was enough to conflict a director and strip him of the protection of the business judgment rule. The court held that because "control is always arguably 'a' motive in any action taken by a director," a showing of a sole or primary purpose to retain control is required. 629 F.2d at 292-93. Johnson does not deal with other forms of self-interest, such as the directors' use of the lock-up to rid themselves of potentially ruinous personal liability to creditors. That sort of objective financial self-interest is always enough in and of itself to deprive a director of the protection of the business judgment rule. Aronson v. Lewis, Del. Supr., 473 A.2d 805, 812 (1984); Sinclair Oil Corp. v. Levien, Del. Supr., 280 A.2d 717, 720 (1971); Bergstein v. Texas International Co., Del. Ch., 453 A.2d 467, 471 (1982); Stein v. Orloff, Del. Ch., C.A. No. 7276, Hartnett, V.C., slip op. at 13-14 (May 30, 1985) (Exhibit A); 8 Del. C. § 144.

Revlon's second evidentiary argument is based on the incorrect legal proposition that a preliminary injunction cannot be issued on a "conflicting record." (RB 37) The cited cases, instead, stand for the obvious but here irrelevant proposition that the plaintiff's burden of showing a reasonable probability of ultimate success cannot be met solely from affidavits which conflict concerning the existence of material facts.

Revlon's last point is that Aronson v. Lewis, Del. Supr., 473 A.2d 805 (1984) held that the threat of suit by the Noteholders was not an "interest." Aronson concerns the requirement of demand futility in derivative actions and holds that directors are not disabled from considering a demand simply because the same party has threatened suit. 473 A.2d at 815. If this were not the case, demand would be excused in all derivative suits. Aronson also holds that where there is a reasonable doubt that the business judgment rule will apply to protect the directors in the event of suit, the directors are "interested" and, thus disabled from considering the demand. 473 A.2d at 815.

But in a suit by the Noteholders, the business judgment rule would be wholly irrelevant. The directors could not defend claims of federal securities law violations or breach of contract by asserting business judgment. Thus, Revlon's reference to Aronson does not refute the argument that the threat of suit by the Noteholders put the directors in a conflicted position when they acted to approve the lock-up and, thus, eliminate a damage claim by the Noteholders. See also Beatty v. Bright, 318 F. Supp. 169, 174 (S.D. Iowa 1970) (elimination of personal liability by sale of company found to be a "very keen self-interest" and a "serious conflict of interest").

2. The Alleged Holding That The Board Is Forbidden To Treat The Noteholders Fairly.

As to the interests of the Noteholders, Revlon makes two brief points: (1) the court below erred in "forbidding" the directors to treat the Noteholders fairly (RB 39-40); and (2) there was no conflict between the best interests of the stockholders and the best interests of the Noteholders. (RB 41) Both contentions are absurd on their face.

The lower court held only that the interests of the shareholders were the "primary responsibility" of the directors and that the directors could not lawfully sacrifice those interests in favor of the interests of the Noteholders whose rights had been defined by contract. (Opinion at 24, B 1044) The court forbade nothing. Revlon's citation to Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946 (1985), for the proposition that directors may "consider" the interests of creditors has no application here. Neither Unocal nor any other case sanctions the directors' preference for creditors at the expense of shareholders.

Revlon next argues that it was "appropriate" to take steps to maintain the value of the Notes and that they "arguably" had an obligation to do so. No legal support is cited to establish such an obligation, and Revlon fails even to discuss Harff v. Kerkorian, Del. Ch., 324 A.2d 215 (1974), modified on other grounds, Del. Supr., 347 A.2d 133 (1975), the case relied on by Justice Walsh in negating the existence of that obligation. (Opinion at 24; B 1044).

Finally, as to the claim that there was not real conflict between the best interests of the Noteholders and the shareholders, Revlon contends that the Forstmann deal was better by $1 per share and if that deal had not been locked up, shareholders would have been paid the $56.25 offered by Revlon while the Noteholders would have been allowed to "twist in the wind." (RB 41)

It is flatly wrong that Forstmann's deal was more advantageous to stockholders. Revlon's own advisors confirmed this fact to the Board on October 12 when they were advised that the $57.25 could be worth "slightly less" than Pantry Pride's $56.25 (B 918-19), and Wall Street valued the $57.25 as being worth much less. (B 970)

II. FORSTMANN'S SEPARATE ARGUMENTS LACK MERIT.

Preliminary

Forstmann notes in the beginning of its brief that "FLC is the only party harmed by the Chancery Court's injunction...." (FB 4) It is true that Revlon's stockholders are plainly benefited by the injunction since now they may take advantage of Pantry Pride's $58 offer, and Revlon also is benefited by being relieved of the lock-up and cancellation fee escrow obligations. Forstmann, however, has lost only what it should never have had. The wasteful turnover to Forstmann of the assets "hastily placed in escrow" (B 1049) was correctly enjoined.*

A. The Payment Of The Cancellation Fee Was Correctly Enjoined.

Forstmann first argues that the probability of a successful defense against its cancellation fee claim has not been shown, claiming that the court below made no

* The escrow arrangements for the stock lock-up and cancellation fee were furtively put in place on October 14 in order to try to remove those assets from the reach of the court. (See Motion for Temporary Restraining Order, B 774, et seq.) The escrow was restrained by Justice Walsh the next day. (B 837-38)

findings on the issue. (FB 18-22) But Justice Walsh found from the record that" ... Forstmann Little and Revlon considered the two [the $25 million cancellation fee and the lock-up] as combined security to secure the exclusion of Pantry Pride from further participation." (Opinion at 29, B 1049) This finding amply supports the court's decision to preserve the status quo pending final adjudication. It has abundant basis in the history of sweetheart dealings between Forstmann and Revlon related in Justice Walsh's decision and amplified in the Statement of Facts to plaintiff's opening brief.

The cancellation fee is not payable for the additional reason that Forstmann has taken the position that the October 3 merger agreement which provided for the $25 million penalty was not binding on it. Forstmann contends that if Revlon had gone to Pantry Pride with Forstmann's $57.25 proposal, Forstmann "simply would have withdrawn, leaving Pantry Pride to take the Company at whatever price it chose." (FB 27) If Forstmann did not consider itself bound by the same terms in the October 3 contract as are in the October 12 amendment, Revlon was not obliged to perform either. Sheehan v. Hepburn, Del. Ch., 138 A.2d 810, 812 (1958).

None of Forstmann's arguments undercuts the correctness of Justice Walsh's injunction against release of the cancellation fee escrow.

B. The Consummation Of The Lock-Up Was Correctly Enjoined.

1. The Asset Option Foreclosed The Bidding.

Justice Walsh found that the asset lock-up here was given "to foreclose further bidding in an active bidding situation...." (Opinion at 25, B 1045) Forstmann devotes four pages of prose to attacking that finding. (FB 24-28) Revlon's own minutes of the October 12 Board meeting prove the point: (1) Forstmann wanted the lock-up for the very reason that otherwise Pantry Pride would top Forstmann's bid (B 905), and (b) the Revlon Board was told it "was dealing with something [the lock-up] designed to deter further offers." (B 922) The finding of the court below was compelled by the evidence.

2. Forstmann's New Slant On The Notes.

The Forstmann brief declares: "It was always [Forstmann's] intention to make some provision for the Note-holders...." (FB 14) From this unsupported assertion springs a full grown argument which appears for the first time in the Forstmann brief here: it was advantageous to Forstmann to exchange the Notes, which had a $56 million five-year call penalty, for new notes which could and would be redeemed without penalty.

Forstmann states:

> The $56 million saved by virtue of the exchange offer [New Notes for Old Notes] would provide

the additional $1.25 per share which FLC would provide to Revlon's common shareholders and FLC so advised Revlon's management.

(FB 14) The suggestion is that, since Forstmann was going to exchange for the Notes and thereafter redeemed them in any event, Pantry Pride's claim that the commitment was demanded to protect the Revlon directors against liability lacks merit. (FB 15)

Save for one line in the Loomis affidavit (A 945), which is studiously unspecific, there is no record support that Forstmann always had intended to exchange the Notes, and there is absolutely no record support for Forstmann's newly constructed rationale. To the contrary, at the October 3 Board meeting, when concern was expressed about waiving the debt covenants, there is not a hint of a Forstmann suggestion that it promptly would exchange for the Notes. Indeed, the minutes state that the Notes will remain outstanding (B 868, 871, 880-881, 896)

Again at the October 12 Board meeting, instead of telling the Revlon Board that he planned to exchange for the Notes -- as he now says was his intention from the start -- Mr. Forstmann made the point that exchanging for the Notes "would result in an increased cost of $15 million more per year for him, which was substantial." (A 916) Director Glucksman viewed the October 12 Forstmann offer as sweetening the prior proposal by "the $50 or $60 million that were involved in the improvement to the noteholders."

(A 1492) It is evident that Revlon's Board was not told, and was not aware, that Forstmann intended all along voluntarily to bring the Notes up to par -- if such was the fact.

The purpose of Forstmann's new contention is to sanitize the self-interest of Revlon's Board pertaining to their potential Noteholder liabilities. If one believes Forstmann's submission that it always intended to bring the Notes up to par, the question becomes: <u>what then was the reason for the $100 - $200 million bargain lock-up?</u> Revlon received only two things in return: (1) an exchange for the Notes which Forstmann says it would do without a lock-up, and (2) an increase in Forstmann's bid from $56 to $57.25, which was less valuable than Pantry Pride's $56.25 immediate cash offer because of the built-in time lag and uncertainty in the Forstmann offer.

Forstmann's freshly minted contention concerning Notes is at odds with what it had led the Revlon Board to believe, and undercuts its claim to the lock-up.

C. Damages Are Not An Adequate Substitute For The Assets.

1. Both Pantry Pride And All Shareholders Of Revlon Are Irreparably Harmed By The Lock-Up.

Again making an argument that it did not present below, Forstmann urges that there is no irreparable harm created by its option agreement, claiming an adequate remedy at law exists in the form of damages. (FB 44)* Forstmann ignores the fact that the asset lock-up precludes Revlon shareholders from obtaining the best offer for their shares, and prevents Pantry Pride from "market[ing] its bid free of the restrictions imposed by the lock-up option, with its triggering mechanism...." (Opinion at 28, B 1048)

A board's failure to obtain the best price available for its stockholders, especially when it is aware of but has not seriously considered competing offers, calls for injunctive relief, which "is essential if the best interests of the stockholders are to be served." Thomas v. Kempner, Del. Ch., C.A. No. 4138, Marvel, V.C., slip op. at 11 (Mar. 22, 1973).

The court below properly found that the asset lock-up, which would defeat its higher offer, caused irreparable harm to Pantry Pride and the Revlon shareholders, which consequently, is not compensable by monetary damages.

2. Revlon Should Not Be Obliged To Sue Its Directors.

The second half of the Forstmann adequacy-of-remedy argument is best left to its own words:

> Pantry Pride, however, has an adequate remedy at law. If Pantry Pride acquires Revlon for its current offer of $58 per share and FLC exercises its asset option, Pantry Pride can pursue its litigation against the Revlon board for the difference

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* Forstmann makes a similar argument with respect to the cancellation fee. (FB 19)

> between the $525 million in cash to be paid by FLC upon exercise of the option and any higher amount that a court holds Revlon was entitled to receive for those assets.

(FB 44-45).

This is a cynical argument: give Forstmann the lock-up assets (as well as its $25 million cancellation fee) and let the Revlon directors be at risk to answer in damages for the consequences. A similar contention was directly rejected, for good reason, in Thomas v. Kempner, slip op. at 11:

> I am also of the opinion that while, in the absence of the granting of injunctive relief, plaintiffs could be expected to proceed derivatively, any recovery for the corporation in such litigation would presumably have to come from the pockets of corporate director stockholders, a laborious and internally unproductive procedure not presently adequate for plaintiffs' present needs and those of the corporation.

Kempner is in step with the rule that when a trustee is in breach of his fiduciary duties in granting an option to purchase assets included within the estate for which he is responsible, the option cannot be enforced. See Wilmington Trust Co. v. Coulter, Del. Supr., 200 A.2d 441, 453-54 (1964); Equitable Trust Co. v. Delaware Trust Co., Del. Ch., 54 A.2d 733, 737 (1947). Williston makes clear that "any bargain, the tendency of which is to lead ... one subject to a private duty to violate his duty for money or favor is opposed to public policy." 15 W. Jaeger, Williston on Contracts § 1726 (3d ed. 1972). Moreover,

> [a] promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy.

Restatement (Second) of Contracts § 193 (1979).

Forstmann's argument is even more egregious because it did not enter the lock-up option agreement as a bona fide purchaser for value without notice. Revlon's obligation to proceed with the merger agreement was expressly "subject to its fiduciary duties" (Merger Agreement of October 3 at 2, B 540) and thus subject to the settled principle of agency law that "a person with notice of a limitation of an agent's authority cannot subject the principal to liability upon a transaction with the agent if he should know that the agent is acting improperly." Restatement (Second) of Agency § 166 (1957). Forstmann's decision to demand a lock up of assets at a price substantially below their fair value with full knowledge that the Revlon Board might be found to have breached its fiduciary duties, precludes Forstmann from enforcing the agreement since "[i]t is well settled that a third party who knowingly participates in the breach of a fiduciary's duty becomes liable to the beneficiaries of the trust relationship." Gilbert v. El Paso Co., Del. Ch., C.A. Nos. 7075 and 7079, Walsh, V.C. slip op. at 13 (Nov. 27, 1984) (Exhibit B). See Laventhol, Krekstein, Horwath & Horwath v. Tuckman, Del. Supr., 372

A.2d 168 (1976); Thomas v. Kempner, supra; Penn Mart Realty Co. v. Becker, Del. Ch., 298 A.2d 349 (1972).

For Forstmann to try to run with its pot of assets and gold, leaving the bag of potential liability in the hands of the Revlon directors, is in keeping with what has been, as plaintiff sees it, Forstmann's overreaching. Pantry Pride believes that the Revlon directors should not be placed at risk to the enrichment of Revlon's erstwhile merger partner. The injunction granted by Justice Walsh against the asset lock-up and cancellation fee should be affirmed.

CONCLUSION

For the foregoing reasons, the decision of the court below should be affirmed.

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CERTIFICATE OF SERVICE

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