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To Our Clients:

Recaps as a Takeover Response

Based on a rather strained reading of the Delaware Supreme Court opinion in the Revlon case, the Federal District Court in Delaware, in the American Standard case, has held that where the directors of a target company approve a recapitalization plan under which more than a majority of the voting power would move to the management and employees, the company is "for sale" within the meaning of Revlon and the directors take on the status of auctioneers with the duty of obtaining the highest possible price.

Perhaps the case is explainable on the grounds of bad planning and bad public relations. First, the recap was structured and presented to the directors as one in which management and the employees would together own 55% (management 24%, employees through plans with confidential pass-through voting 31%). It would have been better structuring to hold this percentage below 50%. Second, the target treated the recap as amounting to a change of control and announced the recap as resulting in management and the employees controlling 55% of the company. It would have been better to disclose only the facts and not characterize them. Third, the recap was financed in part by increasing the severance benefits of management and by providing for management, but not the public shareholders, to exchange their shares for shares in the recapitalized company. It would have been better not to connect the improved severance benefits to the recap and to have foregone any tax or market advantages for the management and merely provided for the management to be treated like all the other shareholders. The management could buy shares of the recapitalized company in the market after the recap was effectuated.

While I think the American Standard case is wrong, both in the reading of Revlon and as a matter of policy, and should have been decided the other way, it is an important warning of the limits that the courts may impose on restructuring responses to tender offers.

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American Standard also raises a question as to the ability of directors to grant golden parachutes after they have decided to sell the target. The precise fault the court found in American Standard was that the golden parachutes were designed to deter bidding. The court acknowledged that in other contexts golden parachutes are valid. Therefore, the case can be limited to its specific facts. However, here again a warning must be sounded. It is of critical importance to provide severance contracts and protect employee benefits before a company becomes a target.

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