Revlon Duties and Empty Voting: Opportunities, Danger or Both?

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REVLON DUTIES IN CHAPTER 11 (?)

Hypothetical: Company X, debtor in possession, provides the Official Committee of Unsecured Creditors with a term sheet for a stand-alone reorganization, as follows:

Secured Claims	Unimpaired – 100% recovery
Bondholder Claims	Shares of common stock of the Reorganized Debtor based upon allocable share of TEV – 100% recovery
Trade Claims	Two-year interest bearing note equal to 100% of allowed claim
Other General Unsecured Claims	Shares of common stock of the Reorganized Debtor based upon allocable share of TEV – 100% recovery
Equity Interests	(i) shares of common stock of the Reorganized Debtor based on residual TEV and (ii) if TEV exceeds certain threshold, options in an amount TBD

During preliminary negotiations over the term sheet, a third party ("Purchaser") with whom the Debtor had had very preliminary and general prepetition discussions, provides the Debtor with a term sheet for the purchase of 80% of the common stock of the Reorganized Debtor, as follows:

Secured Claims	Unimpaired – 100% recovery
Bondholder Claims	100% plus interest in cash
Trade Claims	100% plus interest in cash
Other General Unsecured Claims	Two-year interest bearing note equal to 100% of allowed claim
Equity Interests	Pro rata share of (i) $300m of cash or (ii) 20% of the common stock of the Reorganized Debtor

Questions/Issues

- Does the Debtor have *Revlon* duties such that, at a minimum, the Debtor is required to negotiate with the Purchaser?
- Can the Debtor ignore the Purchaser's offer and proceed with its stand-alone plan, thus giving unsecured creditors equity with speculative value rather than 100% in cash?
- If the Debtor proceeds with its stand-alone plan, should exclusivity be terminated to allow the Committee to join forces with the Purchaser and propose a competing plan? (or to allow any other third party to come forward with a competing plan?)

History and Evolution of *Revlon* Duties

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the Delaware Supreme Court held that when a company is "in play" and its breakup is "inevitable," the fiduciary duties of the board of directors change from preserving the company as a corporate entity to maximizing the company's value at a sale for the benefit of stockholders. The directors' role changed "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Revlon*, 506A.2d at 182.

But, when/how do you determine whether the sale of breakup of the company is inevitable?

Ivanhoe Partner, Inc. v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) narrowly holds that *Revlon* duties only triggered by a sale, but *Ivanhoe* is expanded by *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1242 (Del. 1988) which held that a "sale" includes any transfer of "effective corporate control." As a result, a transfer of 100% ownership is not required to trigger *Revlon* duties and, instead, a sale of less than an "absolute majority interest" could "constitute a sale of effective control of [the corporation[] that would warrant a control premium." *Id.*

Matters evolve even further with *Paramount Communications v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), which significantly narrows *Revlon* and holds that *Revlon* only applies in one of two circumstances: "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company . . . [or] a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company."

History and Evolution Cont'd

Paramount Communications v. QVC Network, Inc., 637 A.2d 34 (Del. 1994) reiterates the "special obligations" imposed upon the board when there is a sale or potential sale of control. "In the sale of control context, the directors must focus on one primary objective – to secure the transaction offering the best value reasonably available for the stockholders – and they must exercise their fiduciary duties to further that end. *Id.* at 44. The court rejected the idea that *Revlon* is only triggered by a change of control and a break-up, and explicitly shifted the relevant focus to objective factors. Thus, whether *Revlon* applies depends upon whether (i) after the transaction occurs, stockholders objectively continue to have leverage to demand a control premium and (ii) such leverage was sufficiently threatened or foreclosed. *Id*. at 43.

Most recently, in *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009), the Delaware Supreme Court held that "the duty to seek the best available price applies only when a company embarks on a transaction – on its own initiative or in response to an unsolicited offer – that will result in a change of control." *Id*. at 242. But, an auction is not required: "There is no single blueprint that a board must follow to fulfill its duties." Rather, the board "must confirm that [it has] obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating 'an impeccable knowledge of the market.' " *Id*. at 243-44.

Bankruptcy Overlay

We all know the “black letter law” that a debtor in possession is under a duty to maximize the value of its estate for the benefit of its creditors. *In re Big Rivers Elec. Corp.*, 233 B.R. 726, 734 (Bankr. W.D. Ky. 1998). As a result, the court will scrutinize any/all terms for the purchase of the debtor that would damage or impair this goal. *Id.* Constituents are thus protected from the disposition of assets at an undervalued price. *In re Bidermann Indus., U.S.A. Inc.*, 203 B.R. 547 (Bankr. S.D.N.Y. 1997).

Some courts have confirmed the application of *Revlon* duties in chapter 11 when there is active bidding or an auction for the debtor has occurred. *In re LTV Steel Corp.*, 333 B.R. 397, 410 (Bankr. N.D. Ohio 2005); *cf. In re Integrated Resources, Inc.*, 147 B.R. 650, 659 (S.D.N.Y. 1992) (“the debtors’ duty to obtain the highest price from a sale of assets for the estate in bankruptcy is entirely different from the duties which management owes to shareholders when conducting an auction for a company, whether the company is in bankruptcy or not.”)

But, there are public policy concerns in bankruptcy that may outweigh application of *Revlon* duties. *E.g., In re Financial News Network*, 980 F.2d 165, 170 (2d Cir. 1992) (noting that court’s duty in connection with auction of debtor’s assets is to weigh interests of creditors in securing the best price with competing considerations); *In re United Healthcare Sys., Inc.*, 1997 WL 176574 at *5 (D.N.J. March 26, 2997) (stating that bankruptcy court may “entertain higher and better offers, which means that the bankruptcy court may not focus solely on price); Erica M. Ryland, *Bracing for the “Failure Boom”: Should a Revlon Auction Duty Arise in Chapter 11?*, 90 Colum. L. Rev. 2255, 2273 (1990) (discussing situations where *Revlon* duties may cause results inconsistent with bankruptcy policy goals, such as where the market for the debtor’s enterprise is not sufficiently deep to accurately value the debtor). *Compare* Robert A. Klyman and Michael S. Lurey, *The Revlon Duty as Cause to Terminate Exclusivity: A New Strategy for Effecting Corporate Change in Chapter 11*, 4 J. Bankr. L & Prac. 621, 628-29 (Sept./Oct. 1995) (contending that “[t]he commencement of a Chapter 11 case should not preclude the application of the *Revlon* standard to the debtor”) (hereafter “A New Strategy”).

Should Revlon Justify a Termination of Exclusivity?

There are no reported cases where exclusivity was terminated on the basis of *Revlon* duties. Most of the time, the request is denied. *E.g.*, *In re Adelphia Communications Corp.*, 336 B.R. 610, 675 (Bankr. S.D.N.Y. 2006) (denying request to terminate exclusivity in the face of an offer to purchase the company, and stating that “in the face of significant challenges, the Debtors have used the exclusive periods to develop a plan that will result in the sale of the company that will bring in $17.6 billion in value); *In re UDC Homes,* Case No. 95-441 (Bankr. D. Del. 1996) (unpublished) (denying equity committee’s motion to terminate exclusivity on grounds that company was “in play” under *Revlon* and holding that “Delaware law does not require [the debtor] to give up its right to exclusivity”).

There appears to be only one instance in which *Revlon* provided a basis for terminating exclusivity, which is discussed in the Klyman article cited above – in *In re Petroleum Recycling Corp.*, No. LA 93-19446 (Bankr. D.D. Cal. 1993), the court found that a proposed sale of effective control of the debtor triggered *Revlon* duties and terminated exclusivity to allow another bidder to file a competing plan. *See generally*, Klyman and Lurey, *A New Strategy,* 4 J. Bankr. L. & Prac. at 636-39.

IMPACT OF DERIVATIVES ON THE RESTRUCTURING PROCESS

(IN PARTICULAR, DECOUPLING AND EMPTY VOTING)

"Decoupling" and "empty voting" are terms coined, and then expanded upon, by Henry T.C. Hu ("Hu") and Bernard Black ("Black") in a series of related articles and presentations, including:

- Hu and Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811 (2006);
- Hu and Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications and Reforms*, 61 Bus. Law. 1011 (2006);
- Hu, *Shareholder and Creditor Decoupling: Separating "Embedded Rights" and Contractual Rights from Economic Interests* (10th Singapore Conference on International Business Law, Aug. 22-23, 2007);
- Hu and Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625 (2008) ("*Decoupling II*").
- *See also* Hu and Jay L. Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321 (2007); Gregory Gennady Plotko, *The Impact of Credit Default Swaps on the Chapter 11 Process*, 18 Norton J. Bankr. L. Prac. 1 (2009) ("*Impact of Credit Default Swaps*").

What is decoupling and why does it matter?

At its most basic, decoupling is a separation and spreading of the economic risks of a security or credit from its ownership/beneficial interest. Traditionally, owning debt (or a security) conveyed a package of rights: economic (receipt of payments of principal and interest), control (enforcement or waiver of terms of the contract) and more (including rights in a bankruptcy proceeding (such as voting) and to sue Ds and Os under applicable law).

Derivatives, however (including credit default swaps, recovery swaps and loan participations) effectively separate the creditor's risks from the other elements of ownership. "Empty voting" is thus a situation where an investor holds a voting interest that exceeds (perhaps far exceeds) its economic interest. This cuts against the "traditional notion" that creditors are incentivized to work towards a reorganization and maximize the value of the debtor. Instead, creditors may take positions that are destructive to the company and overall value, but that maximizes value to the creditor individually to the detriment of all other constituents.

Credit default swaps are one example of decoupling and empty voting

Credit Default Swap

•Protection Buyer (“PB”) pays fee to Protection Seller (“PS”)

•In exchange, PS agrees to compensate PB in the event of a default by Reference Entity (“Entity”)

•PB thus gives up risks associated with default by Entity and takes on risk of default by BOTH the credit and PS

•PS takes on risk of default by Entity, just as if PS was a lender to Entity

•Entity is not a party to the CDS

•PB does not necessarily own Entity’s debt

Recovery Swap

A bet on the expected percentage recovery for bond holders in the event of a default by Entity.

E.g., in a recovery swap of 40% of par, Buyer agrees to buy bonds at 40% if there is a default. Upon default, Buyer benefits if actual recovery rate is higher than 40%. Seller benefits if recovery rate is lower than 40%

Potential Effects of Decoupling/Empty Voting With Credit Default Swaps

At its most basic, the holder of a CDS (the PB) winds up having no effective economic interest in the Entity and, in fact, may have an economic interest directly adverse to Entity:

•If PB holds Entity's debt and a CDS, then PB's exposure on Entity's debt is hedged, minimizing or perhaps completely eliminating any economic interest.

- ✓ PB may thus abstain from participating in an out-of-court workout as it has no economic risk or incentive. If there are many people in PB's position, the chances of an out-of-court workout are reduced and the chances of a bankruptcy filing are increased.

•If PB does not hold Entity's debt, then PB has zero economic interest in Entity and instead, PB's economic interest is recovering on the CDS (which by implication is adverse to Entity's economic health).

- ✓ PB may thus be incentivized not only to ***avoid*** an out-of-court workout (by refusing to negotiate with Entity or making untenable demands), but perhaps even to file an involuntary petition against Entity to trigger payment to PB under the CDS

Case Studies

•*Multi-Fineline Electronix, Inc. v. WBL Corp.*, No. 2482-N, 2006 WL 4781677 (Del. Ch. Oct. 17, 2006) – discussed in Hu and Black, *Decoupling II*. M-Flex offered to buy MFS. WBL owned a majority stake in both the buyer and the target. M-Flex set up a special committee to consider whether the acquisition was favorable for the minority shareholders. Committee decided "no" and recommended minority shareholders vote against the transaction. M-Flex sued WBL to force WBL to vote no based on its fiduciary duty as a controlling shareholder. Apparently hedge fund Stark held 48% of M-Flex's minority shares and was incentivized to vote ***for*** the transaction because Stark also owned a large stake in target-MFS, thus hedging its interest in M-Flex and being happy if M-Flex would have overpaid for MFS. Stark had voting ownership of M-Flex shares but no economic ownership. Stark is an empty voter: its M-Flex shares have voting rights but economic ownership had been depleted.

•*High River Ltd. P'ship v. Mylan Labs., Inc.*, Case No. 04-CV-2677 (M.D. Pa. 2004) – discussed in Plotko, *Impact of Credit Default Swaps*. Mylan offered to merge with King Pharmaceuticals. Perry Capital, a King shareholder, engaged in a hedging transaction pursuant to which Perry Capital obtained a 9.9% voting stake in Mylan without any accompanying economic exposure – Perry also held 7 million King shares and if the merger occurred, the value of such shares would increase by as much as $28 million. (the deal ultimately collapsed)

Case Studies Cont'd

•Some have contended the Enron's collapse was in part, due to the lack of oversight by Enron's lenders as a result of hedging. Banks held approx. $8 billion of credit derivatives. Discussed in Plotko, *Impact of Credit Defaults*.

•Tower Automotive: As Tower's financial condition deteriorated after borrowing approx. $600mm in 2004, Tower tried to find an additional loan which would have required existing lenders to fee up a portion of collateral and adjust interest payment terms. Hedge fund participants would not agree and, as the facility required unanimous consent, no out-of-court restructuring was possible. One rumor was that some hedge funds had shorted Tower's stock and, thus, the bankruptcy filing increased the value of the short positions. *See id.*

•*CSX v. Children's Inv. Fund Management (UK) LLP*, 562 F. Supp2d 511 (S.D.N.Y. 2008), *aff'd*, 2008 WL 4222848 (2d Cir. 2008). CSX accused two hedge funds of accumulating big economic stakes in CSX in order to cause CSX to act in a manner that would increase the value of their respective holdings. Court found that the funds had violated the SEC's anti-evasion rule (Exchange Act Rule 13d-3(b), 17 CFR § 240.13d-3(b)) – provides that anyone who creates or uses a "contract, arrangement, or device with the purpose or effect of divesting" such person of beneficial ownership [as part of a plan to evade the reporting requirements of the Williams Act] "shall be deemed . . . the beneficial owner of such security." *See* Plotko, *Impact of Credit Derivatives*.

Other Potential Effects of Empty Voting and Decoupling

•Decreasing incentives for empty unsecured creditors to act in Chapter 11; potential alteration/minimization of Bankruptcy Code's established checks and balances.

•Decreasing incentives for empty secured creditors to be concerned with value of collateral and possibility for potential different decision making than other secured creditors.

•Creditor voting power may be disproportionate to economic stake, potentially resulting in confirmation of riskier chapter 11 plans (because the risk that decoupled creditors face are lower than the amount of their claims).

•Disclosure obligations: no requirement to disclose derivative holdings could result in a creditor sitting on a committee making decisions that may be inconsistent with a committee member's fiduciary obligations. Lack of disclosure requirements could also result in creditors getting onto committees where, if the derivative holdings had been known, they would not have been appointed (*e.g.*, Blue River's appointment to the WorldCom Committee).

•Decoupling as a valid basis for designating a vote on a chapter 11 plan or equitable subordination of a claim?