HUNTON & WILLIAMS

Client Alert

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SEC Charges Public Company for Violations of Going-Private Rules

On June 13, 2013, the Securities and Exchange Commission brought a settled administrative proceeding against Revlon, Inc., for disclosure violations relating to a 2009 exchange offer subject to the going-private rules under Rule 13e-3 of the Securities Exchange Act of 1934.[1] As described below, the SEC alleges that Revlon engaged in various acts described as "ring fencing" in an effort to conceal negative information about the transaction from minority stockholders. Without admitting or denying culpability, Revlon settled the matter by agreeing to cease and desist from future violations of the SEC's going-private regulations and by paying an $850,000 civil monetary penalty.

The SEC's Findings

The SEC's case revolves around Revlon's conduct in connection with a 2009 restructuring. Saddled with a significant debt to its controlling stockholder, Revlon first explored in April 2009 a merger transaction that would have resulted in a recapitalization of the company. To evaluate the proposal, Revlon formed a special committee of independent directors that, in turn, retained a financial adviser. When the special committee's financial adviser determined that the proposed merger was not fair from a financial point of review to Revlon's stockholders, the company abandoned consideration of it.

In June 2009, with Revlon still facing the impending maturity of a term loan, the company's controlling stockholder proposed that the company consider a voluntary exchange offer in which minority stockholders could exchange their common stock for preferred stock with an attractive coupon rate and liquidation premium. Unlike the merger proposal, however, the exchange offer was not a mandatory transaction.

A subset of minority stockholders held their Revlon common stock through a 401(k) plan. Under applicable ERISA fiduciary law, the trustee to the 401(k) plan determined that it would allow investors in the plan to tender their shares in the exchange offer only if the transaction provided for "adequate consideration." Because that consideration was neither cash nor a publicly-traded security, the trustee sought the fairness opinion of an independent financial adviser. The trustee's financial adviser ultimately concluded that the consideration offered in the transaction was inadequate for tendering 401(k) stockholders.

The SEC alleged that, in an effort to avoid making negative public disclosures, Revlon engaged in what one employee termed "ring fencing" to avoid receiving the adequate consideration determination from the trustee's financial adviser. Specifically, the SEC alleged that:

- Revlon amended the 401(k) trust documents to ensure that the trustee would not share the adequate consideration determination with Revlon.

[1] The SEC's order is available at http://www.sec.gov/litigation/admin/2013/34-69750.pdf. Our description of the factual background to the SEC's investigation is derived solely from the narrative in this order.

- Revlon ensured that it was not a party to any engagement letter concerning the adequate consideration determination.
- Revlon directed the trustee to inform Revlon of its decision regarding whether to allow 401(k) members to tender their shares without any reference to the adequate consideration determination.
- In a notice sent to the 401(k) investors and publicly filed with the exchange offer documents, Revlon removed the explicit term "adequate consideration" and replaced it with generic references to ERISA regulations.

As a result of this alleged conduct, the SEC claimed that neither Revlon's minority stockholders nor its independent board members were aware of the ring-fencing conduct and the trustee's adequate consideration determination. Additionally, the SEC alleged that Revlon took steps to omit and obscure the adequate consideration analysis in the company's public exchange offer documents. For example, the SEC order found that representations in the offering documents that the board's process for considering the transaction was "full, fair and complete" were misleading because the board was unaware of the ring-fencing activities. Thus, the board was denied the ability to weigh this important set of facts.

The exchange offer was subject to the SEC's going-private rules under Section 13(e) of the Securities Exchange Act of 1934, including Rule 13e-3(b)(1)(iii) thereunder, which prohibits issuers and their affiliates in going-private transactions from directly or indirectly engaging in "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." The SEC's order finds that Revlon's conduct violated Section 13(e) and Rule 13e-3(b)(1)(iii) because:

- Revlon knew or should have known that, through its ring-fencing activities, it was engaging in an act, practice or course of business that operated as a fraud or deceit upon Revlon's minority shareholders; and
- Revlon's ring-fencing acts caused various disclosures in Revlon's SEC filings to be materially misleading.

In addition to payment of the monetary penalty, the SEC's order also requires Revlon to cease and desist from committing or causing these violations and any future violations of Section 13(e) and Rule 13e-3(b)(1)(iii).

State Law Considerations

While the SEC's action against Revlon was brought under the federal securities laws, it bears noting that many of the SEC's allegations are relevant to state law considerations. For example, a board of directors' fiduciary duties under Delaware law require disclosure of all material information reasonably available when seeking stockholder action. Delaware courts have adopted the materiality standard applied under the federal securities laws, albeit in a more contextualized manner that is tailored to the particular matter. Delaware also requires that all communications with stockholders be truthful, regardless of whether the directors are seeking stockholder action.

Delaware also places heightened scrutiny on interested transactions with controlling stockholders, directors and officers. In fact, Revlon's proposed merger and exchange offer were subject to stockholder litigation in Delaware. Moreover, Vice Chancellor J. Travis Laster replaced the lead counsel for the plaintiffs in that case after finding that the original lead counsel had failed to provide adequate representation to the class of Revlon stockholders in agreeing to a settlement.[2] Among other things, Vice Chancellor Laster found that the original lead counsel had failed to conduct a meaningful assessment of the stockholders' claims before agreeing to a settlement.

[2] *See In re Revlon, Inc. S'holders Litig.*, C.A. No. 4578-VCL, mem. op. (Del. Ch. Mar. 16, 2010).

Conclusion

Here, the SEC took a substance-over-form approach in analyzing each of the incremental steps that Revlon took to conceal the ring-fencing conduct. Although this case was brought under the Section 13(e) regime, the SEC could have pursued similar charges under other antifraud provisions of the federal securities laws had the transaction been structured as a tender offer, merger or other form of business combination. The case underscores that the SEC will look, with the benefit of hindsight, at the totality of the circumstances surrounding transactional disclosures in the M&A context.

As noted above, the same facts giving rise to the SEC's action also have relevance to potential state law claims. In recent years, transaction parties and their counsel have focused primarily on defending against anticipated claims from stockholders. According to recent studies, almost all public company M&A transactions are subject to stockholder litigation. As such, a company considering a significant transaction must do so with the expectation that plaintiffs' counsel will scrutinize the board of directors' process and the company's disclosures. Additional considerations, including potential procedural safeguards, must be considered when evaluating a transaction with a controlling stockholder or other fiduciary. Still, the SEC's action against Revlon is an important reminder of the SEC's authority to regulate public-company M&A transactions.

Contacts

Steven M. Haas
shaas@hunton.com

Scott H. Kimpel
skimpel@hunton.com