MERGERS & ACQUISITIONS

MARCH 2007 ★ THE DEALMAKER'S JOURNAL

A Comeback For Tender Offers?

Strategic and private equity buyers are buoyed by the best-price rule changes


By Guest Writers David Grinberg and Gordon Bava

Acknowledging that a regulatory disincentive to executing acquisitions through tender offers was not in the best interests of security holders, the SEC adopted final amendments to its tender offer best-price rules last October. The best-price rules require that all shareholders be paid the same price for their shares in a tender offer. The amendments are intended to resolve confusion and alleviate the uncertainty generated by conflicting federal circuit court decisions on the treatment of compensatory, severance, and other employee benefit arrangements granted to a target's employees, directors, and other shareholders.

The cloud over the best-price rules resulted in hesitancy among acquirers to utilize tender offers, and they substantially declined over the last several years. The SEC's amendments are designed to reduce the uncertainty by clarifying that the rules apply only to the price paid for securities tendered in the offer. As a result, the rules absolutely do not apply to any money paid in employment compensation, severance, or other employee benefit arrangements. The amendments will likely restore the use of tender offers as a viable acquisition vehicle.

The changes could have a major impact on private equity acquisitions of public companies in which compensation agreements with incumbent managers who also own stock in their company are critical to mounting and completing the deals.

Tender Offers' Advantages

Generally, a tender offer is a publicized bid to purchase shares of common stock — usually at a premium over the market price — made directly by a bidder to all of the target's shareholders. As long as the acquisition does not have antitrust or other regulatory approval requirements, a tender can be completed in 20 business days. A complete appreciation of the amendments to the best-price rules is possible only through comparison of the relative advantages of the tender with its primary alternative: the statutory merger.

From a buyer's perspective, the tender offer has four main advantages:

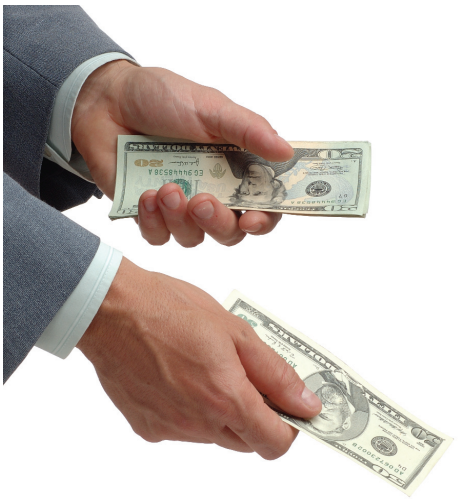
Speedy Process

Because the minimum number of business days that a tender offer must be kept open is only 20, the buyer can purchase a controlling stake in the target in a relatively short period of time, thereby reducing the probability of a competing bid by another potential buyer. If the bidder acquires enough shares to execute a short-form merger — usually 90% — the back-end merger can be consummated promptly without filing a proxy or information statement with the SEC or obtaining shareholder approval. A statutory merger subject to the SEC's proxy rules generally will take at least three to four months to complete.

Speedy completion of the acquisition decreases competition and execution risks and allows the buyer to begin integrating the target rather quickly. A quick closing also minimizes uncertainty and disruption for the target company's business, employees, customers, and business partners.

Direct Offer to Shareholders

Tender offers do not require the support of the target's management or its board of directors.



Buyers communicate directly with a target's shareholders by requesting them to tender their shares in exchange for cash, stock, or a combination of both.

Telescoping Control

A buyer can gain control of the target without purchasing 100% of the outstanding voting securities. This allows it to achieve its goals at a reduced cost.

Eliminating Appraisal Rights

Perhaps most important in today's environment of activist hedge funds, a tender offer eliminates the use of appraisal rights, which may be asserted in an attempt to increase the merger price, disrupt or even halt the proposed deal.

The tender offer has two main advantages for the target's shareholders:

1. They receive the acquisition currency faster than they would in a statutory merger;
2. There is a lower risk that intervening events, such as material adverse changes, will develop.

Significant intervening events could provide the buyer with a basis for terminating the deal or renegotiating the price. In addition, a tender offer usually reduces the time during which the target is operating under certain restrictions contained in a standard acquisition agreement.

Uncertainty Under the Old Rules

The SEC adopted the best-price rules in 1986 to mandate that all target shareholders must be treated equally during a tender offer. The best-price rules include Exchange Act Rule 14d-10, which applies to third-party tender offers, and Exchange Act Rule 13e-4(f)(8), which applies to self-tenders.

To accomplish the SEC's objective, the best-price rules required the buyer to pay all target shareholders the same price per share. On the surface, the best-price rules seemed to be straightforward, but in reality, complying with the rules and their application became anything but simple.

After adoption of the best-price rules, target shareholders, seeking to reallocate acquisition proceeds, brought lawsuits alleging that employees, directors, and other shareholders had been paid additional amounts during the tender offer in violation of the rules. Typically, the complainants claimed that additional consideration was paid because the buyer entered into new compensation agreements with employees, directors, or other shareholders or adopted the target's existing compensation agreements. Shareholders specifically attacked severance or change-in-control payments to officers, cash retention bonuses, payments for non-competition agreements, and compensation paid in consulting agreements.

Unfortunately for M&A practitioners, federal courts differed in interpreting whether these monetary agreements constituted additional tender offer consideration in violation of the best-price rules. The conflict was between the "integral-part" test and the "bright-line" test.

Courts employing the integral-part test focused on whether the compensation agreement was an integral part of the offer, even if it was executed and performed outside of the formal tender offer period i.e., before the offer began or expired, and if the agreement had any commercial significance of its own outside of the offer. These judges usually concluded that the agreement did, in fact, constitute an integral part of the tender offer in violation of tender offer rules.

The result of incorporating compensation into the tender price would entitle all other target shareholders to the same level of consideration which was often a rather expensive undertaking. For example, suppose the chief executive officer of a target also owned 5,000 shares. In connection with the offer, the buyer agreed to pay the CEO a $500,000 retention bonus to stay on the job for a year after closing.

Under the integral-part test, each target shareholder would be entitled to an additional $100 per share. As a result, legitimate and customary agreements with a target's officers and directors, designed to ensure a smooth closing or an efficient transition, could not be part of a tender offer because of fears that courts would find the compensation in violation of the best-price rules. Because statutory mergers do not have a requirement similar to the best-price rules, the acquisition frequently was structured as a merger. The payments would be disclosed in proxy materials but not precluded.

Courts applying the "bright-line" test, such as the Seventh Circuit Court of Appeals, concentrated on the exact timing of the compensation payments or arrangements. The question was whether they were made during the tender offer — after it was announced and before it closed.

Under the bright-line approach, a disputed deal with a shareholder that

was completed before the tender offer began or after it was completed usually was found not to be subject to the best-price rules. Courts following that standard typically held that the compensation agreements and payments did not violate the best-price rules if they had not been made during the formal tender offer period. While affirming the objective of paying all shareholders the highest prices, these courts said that the best-price rules were not intended to capture the amounts paid in compensation under employment or similar agreements.

For several reasons, the split between the federal courts resulted in a drastic reduction in the use of tender offers, even in situations where the speed of a tender offer would have made it the most attractive and preferred acquisition structure.

Fact-Intensive Cases

Litigation involving the integral-part test was exceptionally fact-intensive because courts had to determine whether the challenged payments or agreements were actually integral parts of the tender offer. As a result, defendants were usually not able to dismiss a case early in its life cycle, regardless of whether the plaintiff's claim actually had merit.

Raising the Price

If a court determined that the payments or agreements were part of the tender offer, the per-share price paid to all target shareholders would be recalculated to include the cost of these payments or agreements. The fear of having to pay an increased per-share cost for all tendered securities created a financial risk that buyers were simply not willing to take.

Plaintiff-Friendly Venues

Complainants might choose to bring a claim in a jurisdiction that applied the integral-part test rather than the more buyer-friendly bright-line test. In other words, the potential liability was heightened by the possibility that claimants could bring a claim in a jurisdiction that recognized an interpretation of the best-price rule that best suited their case. As a result, friendly transactions were often not structured as tender offers because litigation, settlement risks, and costs outweighed the advantages of the tender.

Because the amendments will level the playing field between tender offers and statutory mergers in most cases, they may spur a resurgence of tender offers.

Best-Price Rule Amendments

Faced with competing tests regarding the application of the best-price rules and the resulting uncertainty and unintended consequences, the SEC issued amendments through a three-pronged approach that:

- Clarified that best-price rules apply only to the price paid for securities tendered and not to funds paid to shareholders for other aspects of the acquisition, such as compensatory, severance, or other employee benefit arrangements, as long as these arrangements were not related to purchasing the securities;

- Exempted from the best-price rules any money paid under employment compensation, severance, or other benefit arrangements to shareholders of the target, such as employees and directors, if the money was strictly for performance of service or under non-compete agreements and was not based on the number of securities the shareholder tenders; and

- Provided a safe harbor so that arrangements approved by independent directors of either the acquirer or target will not be prohibited by the rules.

Compliance with the safe harbor ensures that the arrangements fall within the compensation exemption from the best-price rules. Nevertheless, compliance with the exemption alone is also sufficient to fall outside of the purview of the best-price rules.

Down the Middle

The amendments are notable for several additional reasons. They did not follow the approach of either the integral-part test or the bright-line test. The SEC reasoned that adopting a strict temporal test such as the bright-line test could lead to abuse and evasion of the rules.

Acknowledging Differences

The SEC acknowledged that critical personnel decisions often must be made concurrently with the decision to pursue a deal. Thus, the agency acknowledged that personnel decisions are made independently from the price paid for securities.

Expanded Exemption

The exemption includes all shareholders of the target, as opposed to only directors and employees. As originally proposed, the exemption to the best-price rules would have applied to compensatory, severance, or other employee benefit arrangements solely with employees and directors of the target company. Responding to suggestions from commentators that the exemption should be expanded, the SEC included any shareholder of the target.

The agency recognized that challenges to the best-price rules have focused on directors and employees, but nevertheless expanded the scope of the exemption because it believes that

the role and nature of the person is irrelevant. As a result, target shareholders that are also consultants and independent contractors are eligible for protection from the exemption.

The exemption was extended to include not only third-party tender offers but also self-tenders. Finally, the exemption includes agreements under which an individual agrees not to perform services, such as in non-competition agreements.

Excluded Recommendations

Although the SEC did respond favorably to many commentators' suggestions, it did reject some recommendations proposed in comment letters.

The agency declined to expand the exemption and safe harbor to encompass commercial agreements. Because of the wide variety of potential commercial arrangements that could be negotiated at the time of a tender offer, the SEC concluded that a specific exemption for commercial arrangements could not be drafted while still assuring security holders of the intended benefits of the best-price rules. For example, large shareholders who own companies that do business with the target received no relief. Thus, a special "price increase" paid to a shareholder-owned supplier or a special "price decrease" granted to a shareholder-owned customer would appear to be proscribed.

In addition, the SEC refused to adopt a de minimis exception to the best-price rules whereby holders of a certain percentage of the target's securities would be exempt from the best-price rules. The belief is that such an exception potentially would undermine the protections of the best-price rules.

Amendments' Lasting Impact

M&A professionals generally welcome the amendments to the best-price rules because they will reduce disincentives to the structuring of acquisitions as tender offers. By acknowledging that compensation arrangements are frequently important parts of mergers and acquisitions, the amendments ensure that employment and other similar compensation arrangements will be eligible for payment and will alleviate concerns about violating best-price rules.

Potential costs associated with conducting tender offers will be significantly reduced because of a decreased risk of litigation. The structure of a particular transaction will not be dictated by fear of violating the rules and artificial obstacles created by divergent interpretations of the rules. Most influential will be the merits of the structure itself and what is deemed to be in the best interests of the target's shareholders. The SEC stated in its announcement last October that it believes "the interests of security holders are better served when all acquisition structures are viable options."

An interesting aspect of the amendments will be their effect on deals involving private equity sponsors. Over the last several years, as PE funds increasingly have become buyers of public companies, the competitive nature of buying high-quality targets has also increased. In an auction scenario, PE bidders without antitrust or other regulatory issues could use the tender offer deal structure as an advantage over strategic buyers by employing this quicker and less risky path to deal closing.

Prior to establishment of the amendments to the best-price rules, PE buyouts were structured as statutory mergers because the deals often involved a variety of new employment and compensation arrangements with the target's executives who were also target shareholders. Even a deal fee paid to a large shareholder, such as a PE fund, for originating, structuring, and negotiating an acquisition now appears permissible, especially if approved by a committee of independent directors.

PE bidders without antitrust or other regulatory issues could use the tender offer deal structure as an advantage over strategic buyers by employing this quicker and less risky path to deal closing.

One of the comment letters to the SEC's proposed amendments noted that the number of tender offers declined from a high of 468 in 2000 to 264 in 2005, and 169 through August of 2006. Because the amendments will level the playing field between tender offers and statutory mergers in most cases, they may spur a resurgence of tender offers.

David Grinberg is a Partner and Chairman of the M&A Practice Group at Manatt, Phelps & Phillips. **Gordon Bava** is a Partner and Co-Chairman of the firm. Both are based in Los Angeles.

Manatt, Phelps & Phillips, LLP
11355 W. Olympic Boulevard
Los Angeles, CA 90064
www.manatt.com