

### Highlights

- The SEC proposed amendments to the best price rule, which regulates prices paid in tender offers.
- Due to a series of court decisions that had created significant uncertainty in the application of the best price rule, acquirers have increasingly avoided tender offers to consummate friendly business combinations, in spite of the fact that tender offers can be completed more quickly and efficiently than statutory mergers.
- The proposed amendments clarify that the best price rule applies only with respect to the consideration paid for securities tendered in a tender offer and generally not to employment and severance arrangements.
- If these proposed amendments are adopted, the use of tender offers and exchange offer in friendly acquisitions and business combinations should increase significantly.

## SEC Proposes Amendments To The Best Price Rule

### Introduction

On December 16, 2005, the Securities and Exchange Commission proposed long-awaited amendments to Rule 14d-10(a)(2) under the Securities Exchange Act of 1934, the so-called "best price rule."<sup>(1)</sup> The best price rule prohibits an acquirer from making a tender offer unless the "consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer." Some courts have interpreted this rule broadly in recent years by refusing to grant summary judgment on shareholder claims that severance and other employment arrangements, as well as ancillary agreements with principal stockholders, represent hidden payment of additional consideration in tender offers. Judicial willingness to allow these claims to go to jury trial has substantially decreased the attractiveness of tender offers as a means of effecting acquisitions and business combinations.

The SEC's proposed amendments to the best price rule are intended to clarify that the rule applies only with respect to the consideration paid for securities tendered in a tender offer and generally not to employment and severance arrangements. If the proposed amendments are adopted, they should increase the use of tender offers in acquisitions and business combinations. Comments on the proposed amendments are due by February 21, 2006.<sup>(2)</sup>

### History of the Best Price Rule

The SEC adopted the best price rule in 1986 to assure equal treatment of tendering shareholders.<sup>(3)</sup> From the rule's inception until 1995, case law and available staff interpretations of the best price rule consistently applied the rule temporally so that

### The Proposed Amendments to the Best Price Rule

#### **Clarification of the Best Price Rule**

The SEC proposes to modify the language of the best price rule to read as follows:

it had effect only during the tender offer process as measured from the statutorily defined commencement of the tender offer through the expiration of the tender offer in accordance with its stated terms. <sup>(4)</sup> The importance of the temporal application of the best price rule was largely the planning certainty it afforded tender offer participants who for commercial and/or personnel reasons wanted to enter into contemporaneous arrangements with members of management or key shareholders, such as severance arrangements, new employment agreements or distribution arrangements. So long as those arrangements did not occur during the actual pendency of the tender offer, the participants could be sure that they had complied with the best price rule.

Since the Ninth Circuit's 1995 decision in *Epstein v. MCA, Inc.*, <sup>(5)</sup> a series of court decisions have created a significant level of uncertainty relating to the application and scope of the best price rule. In *Epstein*, the Ninth Circuit refused to strictly limit the operation of the best price rule to the time period beginning at the formal commencement of the tender offer and ending upon its formal termination. That case involved a negotiated tender offer by Matsushita for MCA. Immediately prior to the formal commencement of the tender offer, Matsushita entered into an agreement with Lew Wasserman, MCA's Chairman and CEO, under which Matsushita would acquire his MCA shares in exchange for preferred stock of a newly formed Matsushita subsidiary with a value intended to equal the cash price paid by Matsushita in the tender offer. <sup>(6)</sup> The closing under Wasserman's agreement was conditioned upon consummation of the tender offer and the exchange of his shares was to occur "immediately following" the expiration of the tender offer. <sup>(7)</sup> The Ninth Circuit noted that the best price rule did not contain explicit temporal limits and it declined to read such limits into the rule, opting instead for an interpretation that the rule applied to all transactions that are an "integral" part of the tender offer. The Ninth Circuit then held that the agreement with Wasserman was an "integral part" of the tender offer because, among other things, consummation was conditioned on the success of the tender offer and the redemption value of the preferred stock was determined by reference to the tender offer price.

The expansive and contextual reading of the best price rule in *Epstein* was followed by numerous other plaintiffs' litigations. In addition, there were also a number of contradictory decisions which followed in its wake. As a result of the uncertainty arising out of these cases, acquirers have increasingly

"[t]he consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer."

The SEC's substitution of the clause "for securities tendered in the tender offer" to replace the current clauses "pursuant to the tender offer" and "during the tender offer" expressly clarifies that (a) the intent of the best price rule is to apply only to the consideration that is actually paid for securities tendered in the tender offer, and (b) the best price rule was not intended to apply to other payments made to individuals who happen to be shareholders of the target company, whether or not these payments are made during the formal tender offer period or are contingent on the success of the tender offer.

It is notable that the SEC did not, in its proposing release, opt for a narrowing of the best price rule to the temporal period of the formal tender offer process as many M&A practitioners had hoped. In fact, the SEC explicitly rejected the notion that best price rule should be subject to a strict temporal test. <sup>(8)</sup>

#### ***Specific Exemption for Compensatory Arrangements***

To minimize the most common deterrent to tender offers arising under the best price rule – claims attacking various compensation payments and arrangements as hidden tender offer consideration – and to acknowledge the commercial reality of most business combinations – that the key employees of the target company may represent a significant component of the company's inherent value – the SEC has proposed a specific exemption from the best price rule for employment and compensatory arrangements. The proposed exemption provides that the best price rule does not apply to the negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement made or to be made or benefits granted or to be granted according to such arrangements in connection with a third party tender offer where the amount payable under such arrangement:

avoided tender offers in favor of using conventional, one-step statutory mergers to consummate friendly transactions. This has occurred in spite of the fact that tender offers can be completed more quickly and efficiently than statutory mergers. Further, tender offers are viewed as structurally more advantageous to target shareholders because the shareholders are paid more quickly than in a one-step merger. Tender offers are also more advantageous to acquirers because their timing advantage (twenty trading days versus 3-4 months for a statutory merger) reduces the risk of intervening competing bids.

Despite the benefits of tender offers, the combination of the potential expense of litigating a best price rule claim, the significant risk inherent in a jury trial and the inevitable cost of settlement has come close to eliminating tender offers as a structure for friendly business combinations. This has resulted in particular from plaintiffs' attorneys claiming that severance and compensation arrangements for target executives are intended as payment for their shares, thereby justifying alleged damages literally in the billions or trillions of dollars. The "basis" for such measure of damages is that once the severance or other employee payments are properly characterized as part of the tender offer consideration, a recomputation of the "highest consideration paid" is required under the best price rule. For example, if an executive owning 10,000 shares receives a \$500,000 severance payment that is found by a judge or jury to constitute tender offer consideration, that executive would be deemed to receive an additional \$50 per share ( $\$500,000/10,000$ ) in the tender offer. Under this theory, the acquirer would owe an additional \$50 per share to all other target shareholders.

- relates solely to past services performed or future services to be performed or to be refrained from performing, and
- is not based on the number of securities that the employee or director owns or tenders.<sup>(9)</sup>

While the SEC's exemption does not extend to arrangements other than employment compensation, severance and employee benefit arrangements, such as commercial arrangements, a new instruction to the rule states that no inference should be drawn that payments made under any other arrangement (including commercial arrangements) constitute consideration paid for securities in a tender offer.<sup>(10)</sup>

#### ***Safe Harbor for Compensatory Arrangements Approved by Compensation Committees***

To provide greater certainty to acquirers, the SEC also has proposed a non-exclusive safe harbor (to which the exemption described above would be deemed to apply) for employment compensation, severance or other arrangements that are approved by a compensation committee (or a committee performing similar functions) of the acquiring company or the target company (whichever is the party to the arrangement) comprised solely of independent directors.<sup>(11)</sup> Independence of the directors would be determined by the same independence standards applicable to compensation committee members under the target's or acquirer's listing standards (if it is a listed company). If target or acquirer, as applicable, is not a listed issuer, the relevant company would be able to use any definition of independence of a national securities exchange or national securities association, so long as a consistent definition is applied to all members of the committee.

## Potential Impact on Business Combinations

While the SEC did not go as far as some M&A practitioners had hoped, the proposed amendments to the best price rule should eliminate the risk of lawsuits alleging violations of the best price rule in most situations, particularly those where the only uncertainties under the current regime arose from employment compensation and other employee benefit arrangements. As a result, the use of tender offers in friendly acquisitions and business combinations would likely increase significantly if the proposed amendments are adopted in their current form.<sup>(12)</sup>

### **Cash Tender Offers**

Due to the fact that a cash tender offer coupled with a back-end (almost always a short form) merger can be consummated more quickly and inexpensively than a conventional one-step cash merger, we expect that adoption of the proposed amendments would result in cash tender offers supplanting conventional mergers as the preferred method to structure friendly business combinations for cash.<sup>(13)</sup> The proposed amendments would eliminate any uncertainties with respect to employee compensation and related employee benefit arrangements that currently deter most acquirers from considering the use of a tender offer for a friendly business combination in the first place.<sup>(14)</sup>

### **Exchange Offers**

On October 19, 1999, the SEC adopted a broad package of amendments to the rules governing, among other things, tender and exchange offers, mergers and other business combinations.<sup>(15)</sup> Under these amendments, the SEC sought to harmonize the time frames for cash tender offers and equity exchange offers by permitting an acquirer to commence an exchange offer utilizing securities as part or all of the consideration immediately upon the filing of the registration statement, which is the analog to the filing requirement for commencement of cash tender offers.<sup>(16)</sup> If the proposed amendments to the best price rule are adopted, acquirers would no longer be deterred from using an exchange offer structure as a quicker and more efficient alternative to statutory mergers for friendly stock-for-stock business combinations.<sup>(17)</sup>

### **Cash and Securities Business Combinations**

For acquisitions that are being structured with a mix of cash and acquirer securities as consideration, two-step tender offer/merger structures also would once again be viable alternatives to conventional one-step mergers. Depending on the circumstances and the acquirer's financial ability to fund the cash tender offer, a two-step transaction structure with a cash tender offer followed by a second step merger for stock or other securities would be available without fear of the potential repercussions under the best price rule.

#### Endnotes:

- (1) Proposed Rule: Amendments to Tender Offer Best-Price Rule, Release No. 34-52968; IC-27193; File No. S7-11-05, available at <http://www.sec.gov/rules/proposed/34-52968.pdf>.
- (2) In addition, as part of the proposed amendments, the SEC has proposed similar amendments to the best price rule contained in Rule 13e-4(f)(8). That rule applies to tender offers by issuers and their affiliates. However, as described in footnote 10 below, the SEC did not extend the exemption for compensatory arrangements to the issuer best price rule.
- (3) See Amendments to Tender Offer Rules: All-Holders and Best-Price, Release No. 34-23421 (July 11, 1986).
- (4) See *Kramer v. Time Warner Inc.*, 937 F.2d 767 (2d Cir. 1991); *Kahn v. Virginia Retirement System*, 13 F.3d 110 (4<sup>th</sup> Cir. 1993). But see *Field v. Trump*, 850 F.2d 938 (2d Cir. 1988), where the court integrated two consecutive tender offers and treated them as a single tender offer for purposes of the best price rule.
- (5) 50 F.3d 644 (9<sup>th</sup> Cir. 1995), *rev'd on other grounds sub nom Matsushita Electric Industrial Co. v. Epstein*, 516 U.S. 367 (1996).
- (6) Matsushita's tender offer was for a combination of \$66 per MCA share in cash and stock in WWOR-TV worth \$5 per MCA share. Under his agreement, Wasserman would also receive stock in WWOR-TV.
- (7) In addition to the arrangements with Wasserman, two days after the consummation of the tender offer MCA cashed-out stock options held by Sidney Sheinberg, MCA's COO, that had been granted pursuant to an amended employment agreement entered into immediately prior to the formal commencement of the tender offer. This transaction was also challenged as violating the best price rule.
- (8) A strict temporal (or bright line) test was adopted by the Seventh Circuit in *Lerro v. Quaker Oats*

*Company*, 84 F.3d 239 (7<sup>th</sup> Cir. 1996). The Seventh Circuit disagreed with the Ninth Circuit's expansive reading of the best price rule and held that the best price rule applies only to transactions occurring between the formal commencement of the tender offer through its expiration. The court noted that "[b]efore the offer is not 'during' the offer".

- (9) The language of this requirement of the proposed amendment is ambiguous and could be construed to deny applicability of the specific exemption and related non-exclusive safe harbor to stock-based incentive programs. We expect this ambiguity will be eliminated through the comment process, so that stock-based incentive plans would be treated like all other compensation and benefit plans under the amended rule.
- (10) It is important to note that the SEC did not propose an analogous exemption to the issuer best price rule contained in Rule 13e-4(f)(8). While the SEC noted that issuers do not have the same need to execute or amend compensatory arrangements when they structure and commence tender offers, the SEC did request comment on whether a similar exemption to the issuer best price rule is necessary or practicable.
- (11) Under NYSE and NASDAQ rules, controlled companies are not required to have compensation committees comprised solely of independent directors. Therefore, the provisions of the safe harbor (as currently proposed) would prevent a controlled company that does not have a compensation committee comprised solely of independent directors from availing itself of the safe harbor. Since this is a non-exclusive safe harbor, this fact alone should not affect a controlled company's ability to qualify for the compensatory arrangement exemption to the third party best price rule so long as the employment compensation, severance or other employee benefit arrangement in question complies with provisions of the exemption.
- (12) However, due to the fact that SEC specifically rejected a bright line test to the best price rule, acquisition transactions involving other commercial arrangements between acquirers and targets and their affiliates may continue to be an avenue by which violations of the best price rule could be alleged in the future and, accordingly, would continue to need to be carefully analyzed as to whether to use a tender offer rather than a conventional merger structure.
- (13) The utility of a cash tender offer structure for LBOs will also depend upon the ability of private equity buyers and selling companies to create financing structures that comply with the Margin Rules. A number of Margin Rule compliant structures have historically been used for leveraged tender offers, but these structures may not be available in all situations.
- (14) If the transaction is likely to involve a significant regulatory delay (e.g., because of antitrust concerns), the acquirer may prefer a one-step merger to a tender offer followed by a back-end merger. This is because the acquirer cannot acquire the shares in the tender offer prior to obtaining regulatory approval, while the shareholder vote for a one-step merger (which can be held prior to receipt of regulatory approval) would typically cut off the target's ability to receive competing bids or to negotiate with other bidders.
- (15) See Final Rule: Regulation of Takeovers and Security Holder Communications, Release Nos. 33-7760, 34-42055; IC-24107; File No. S7-28-98 (October 22, 1999), available at <http://www.sec.gov/rules/final/33-7760.htm>.
- (16) Under the prior rules, an exchange offer could not begin until the registration statement had gone through the SEC review process and become effective, thereby making it unlikely that an exchange offer could be consummated on an appreciably faster timetable than a one-step statutory merger.
- (17) It is important to note that under NYSE and Nasdaq rules, acquirers are required to obtain the approval of their stockholders in connection with any issuance of shares if such shares represent more than 20% of the acquirer's outstanding voting shares. Accordingly, one-step statutory mergers will continue to be the preferred method for structuring stock-for-stock business combinations where acquirer stockholder approval is required.

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