SUNGLASSES: THE SECRET TO MAKING TENDER OFFERS FASHIONABLE

SIDE AGREEMENTS AND THE ALL-HOLDERS/BEST-PRICE RULE

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Tender offers often require bidders and targets to negotiate a number of complex issues that can potentially diminish the target company's value and may, in some cases, cause an entire deal to fall apart. Even for a friendly tender offer to succeed, bidders often need to make sure that influential directors will support the tender offer, persuade poor performing corporate officers to leave long-term employment contracts, convince key corporate officers to stay with the surviving entity, and neutralize poison pill holders. Perhaps the most effective tool a bidder has in these situations is the ability to offer employment contracts, consulting deals and non-compete agreements (collectively referred to as "side agreements") to different corporate players. Notwithstanding their effectiveness, side agreements have become taboo because they substantially increase the likelihood of shareholder litigation.

In the recent case of *Luxottica Group S.p.A Securities Litigation* (commonly referred to as "*Sunglass Hut*"), shareholders argued that the lucrative side agreement offered to a director of the target company increased the consideration paid "during the tender offer" for those director's shares, violating the all-holders and best price rules codified in Rules 14d-10(a)(1) and (2).[1] These arguments have had a chilling effect on the use of tender offers. As this article will discuss, the SEC origi-

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1. *Luxottica Group S.p.A Securities Litigation*, 293 F. Supp. 2d 224, 230 (E.D.N.Y. 2003) [*hereinafter* "Sunglass Hut"). *See also* 17 C.F.R. § 240.14d-10 (2004). Rule 14d-10(a)(1) codifies the All Holders Requirement, and Rule 14d-10(a)(2) codifies the Best Price Rule. The rule states: "No bidder shall make a tender offer unless: (1) [t]he tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) [t]he 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." *Id.*

nally enacted Rule 14d-10 with the basic purpose of ensuring that tender offers would be made available to all shareholders.[2] In recent years, however, plaintiffs' lawyers have managed to convince several courts that the rule should be expanded to include compensation received outside of the tender offer.[3] The outcome of *Sunglass Hut* and others like it have had a remarkable impact on Rule 14d-10 and on the popularity of tender offers in structuring business combinations.

Because key officers and directors often hold a strong equity position in the target company, and typically have the power to influence the outcome of the transaction, bidders often want to appease these individuals. Failure to obtain the board's endorsement, for example, can be a fatal and expensive mistake. Bidders can easily minimize the risk that a tender offer will fail by enticing these individuals through attractive consulting agreements, compensation packages, and non-compete agreements. Moreover, bidders may also have a legitimate interest in using side agreements to maximize the value of the newly created entity. If, for example, the target corporation is full of talented managers and knowledgeable senior executives, then healthy compensation packages, consulting contracts, and other side agreements will allow the bidder to create the incentives needed to keep management in place. Conversely, where poor management has allowed the target company to suffer or otherwise become undervalued, bidders who want to squeeze management out may need to rely on non-compete agreements or other arrangements to entice the target's management to relinquish long-term employment contracts, golden parachutes and other potentially poisonous devices that can kill a tender offer. In most cases, side agreements are the most effective means of securing these results.

Notwithstanding the virtues of these agreements, plaintiffs' attorneys have convinced several courts that they provide the opportunity for officers and directors to demand a premium for their own shares at the expense of other sharehold-

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2. Amendments to Tender Offer Rules; All-Holders and Best-Price, 51 Fed. Reg. 25873 (July 17, 1986).

3. Gerber v. Computer Assoc., 303 F.3d 126, 135 (2d Cir. 2002); Epstein v. MCA, Inc., 50 F.3d 644, 654-56 (9th Cir. 1995); Kramer v. Time Warner, Inc., 937 F.2d 767, 778-79 (2d Cir. 1991); Field v. Trump, 850 F.2d 938, 944 (2d Cir. 1988).

ers who will not receive the same consideration. These attorneys failed to realize that Rule 14d-10 is neither the only nor the best way to protect shareholders from overzealous corporate egos. By state law, officers and directors owe specified fiduciary duties to their shareholders, and clear cases of self-dealing can and should be prosecuted using the laws that have been expressly established for this purpose. Given the expansion of corporate governance controls and disclosure procedures that have been created by the Sarbanes-Oxley Act of 2002,[4] the new listing standards that have been promulgated pursuant to Section 301,[5] and the state law fiduciary protections provided shareholders, it is easy to conclude that other laws are better suited to deal with this problem.

There is a fine distinction between side agreements that are intended to pay a premium for a person's shares rather than their influence and corporate knowledge. The analysis can be very fact-specific and require a thorough, time consuming, and expensive investigation. The need for bidders to have a reliable "blueprint" that allows them to properly make use of side agreements in a tender offer has been frustrated by the approach to Rule 14d-10 that many jurisdictions have taken. In short, some believe that the promulgation of hard and fast rules regarding the timing and amount of consideration paid during a tender offer could very well serve as a "blueprint" for denying shareholders equal compensation.[6] This paper will discuss how this dilemma has challenged regulators and confused the courts into adopting two separate standards of evaluating these cases.

This article is divided into three parts, the first of which undertakes a thorough examination on the question of whether side agreements violate the All Holders and Best Price Rules by allowing certain key corporate directors to enjoy a better share price than what was offered to other shareholders for theirs. After identifying and discussing the issues related to side agreements, the article will then examine the competing

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4. 15 U.S.C. § 7201.

5. 15 U.S.C. § 78j-1; SEC Release Nos. 33-8220; 34-47654

6. Ben Walther, Note, *Employment Agreements and Tender Offers: Reforming the Problematic Treatment of Severance Plans Under Rule 14d-10*, 102 COLUM. L. REV. 774 (2002) (arguing that allowing 14d-10 to be applied to employment agreements invites frivolous lawsuits that harm the utility of tender offers).

interpretations of Rule 14d-10 used in various circuits. Next, the article will move on to identify a number of possible solutions that may cure the dilemmas that corporate entities and their advisors face when structuring a deal. Finally, the article will explore the fiduciary obligations of the parties involved in a tender offer and discuss how these duties can serve to protect shareholders. The issues presented herein remain largely unresolved by the circuits, unaddressed by the Securities and Exchange Commission and, therefore, ripe for consideration.

I.
HISTORY OF THE ALL HOLDERS & BEST PRICE RULES

The SEC issued Rule 14d-10 on July 17, 1986,[7] in response to *Unocal Corp. v. Pickens*.[8] In *Unocal*, the target corporation (Unocal) responded to a hostile tender offer by mounting a self-tender offer that expressly prohibited the hostile bidder (Mesa) from participating in the exchange.[9] Mesa responded by seeking a preliminary injunction to prevent Unocal from completing its self-tender offer until the condition excluding Mesa from the deal was removed.[10] The district court denied the injunction, holding that nothing in the text of either § 13(e) or § 14(e) of the Williams Act supported prohibition of discriminatory tender offers.[11] The court concluded that "[i]t is more reasonable to infer. . . that the SEC's failure to adopt such proposed rules (and its apparent failure to litigate the issue in court) is more likely based on either a view that such substantive rules are not authorized by the Act or that, if they are, as a matter of policy the SEC has chosen not to require such an 'open to all' condition."[12]

7. Amendments to Tender Offer Rules; All-Holders and Best-Price, 51 Fed. Reg. 25873 (July 17, 1986). *See* Field v. Trump, 850 F.2d 938, 942-43 (2d Cir. 1988); Michael D. Ebert, *"During the Tender Offer" (Or Some Other Time Near It): Insider Transactions Under the All Holders/ Best Price Rule*, 47 VILL. L. REV. 677, 677 (2002).

8. *Compare* Proposed Amendments to Tender Offer Rules, 50 Fed. Reg. 27976 (July 9, 1985) *with* Unocal Corp. v. Pickens, 608 F. Supp. 1081 (C.D. Cal. 1985).

9. *Unocal*, 608 F. Supp. at 1082.

10. *Id.*

11. *Id. See also* 15 U.S.C. § 78m(e), 78n(e) (relevant portions of the Williams Act).

12. *Unocal*, 608 F. Supp. at 1082.

Undoubtedly disturbed by the court's decision, the SEC issued Rule 14d-10. Authority for the rule was based on the Williams Act of 1968, in which Congress amended the Securities Exchange Act of 1934 ("Exchange Act") by adding new sections "designed: (1) to promote investor protection by requiring full and fair disclosure in connection with cash tender offers, and (2) to eliminate discriminatory treatment among security holders who may desire to tender their shares."[13] In explaining the need for Rule 14d-10, the SEC stated that:

> [w]ithout these provisions, discriminatory tender offers could be effected by extending the offers to some security holders but not others or by making offers to security holders at varying prices. The objective of the all-holders requirement and best-price provision is to make explicit the requirement that issuers and bidders alike must extend their tender offers to all holders of the class of securities being sought in the tender offer and must pay every tendering security holder the highest consideration paid to any other security holder.[14]

Rule 14d-10's rulemaking history makes limited references to the issue of side agreements. In discussing the best price portion of Rule 14d-10(a)(2), the SEC explained that the rule generally allows "both issuer and third-party bidders [to increase or] reduce the consideration offered to security holders during the tender offer [as long as] the highest price paid to any tendering security holder. . . [is] paid to any other tendering security holder."[15] In response, some commentators raised concerns about what they called "alternative consideration."[16] Specifically, these commentators were curious about whether the rule prohibited the bidder from offering shareholders a choice of cash or securities.[17] In addressing

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13. Amendments to Tender Offer Rules; All-Holders and Best-Price, 51 Fed. Reg. 25,873, 25,875 (July 17, 1986). *See also* 15 U.S.C. §§ 78m(d), n(f)) (which added sections 13(e), 14(d) and 14(e) to the Exchange Act).

14. *Id.* at 25,881.

15. Amendments to Tender Offer Rules; All-Holders and Best-Price, 51 Fed. Reg. 25,873, 25,875, 25,858 (July 17, 1986). *See also* 15 U.S.C. §§ 78m(d), n(f).

16. *Id.*

17. *Id.* ("A few commentators stated that it was unnecessary to require alternative forms of consideration to be substantially equivalent in value, so

this issue, neither the commentators nor the SEC regarded non-compete agreements, consulting contracts or other side agreements as falling within the purview of "alternative consideration."[18] Throughout the rulemaking history of Rule 14d-10, there is only one other context in which the issue of "alternative consideration" was raised. In an earlier release, the SEC addressed the situation where more than one class of securities is subject to a tender offer.[19] The SEC concluded that "the consideration under the offer is permitted to differ between the two classes."[20] In sum, there is no evidence that the SEC ever intended Rule 14d-10 to apply to the type of side agreements discussed above.

II.
THE JUDICIAL SPLIT

The critical question raised in *Sunglass Hut* is whether a side agreement "come[s] within the temporal limitations of the Best Price Rule [when] entered into prior to the commencement of the tender offer."[21] In other words, should side agreements be subject to the tender offer rules or are they best left subject to state fiduciary duty statutes? Generally speaking, most circuits have adopted one of two diametrically opposed views known as the "bright line" approach and the "integral part" approach, respectively.[22]

The facts of *Sunglass Hut* are not uncommon and provide a good snapshot of how tender offers are conducted. In this case, an Italian manufacturer and distributor of prescription

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long as security holders have the same choice among the forms of consideration offered.").

18. Here, the SEC stated that 'alternative consideration' is appropriate as long as the "security holders [are] afforded the right to elect among all types of consideration offered." *Id.* ("[T]he Commission anticipate[d] that any problems associated with valuation, encouraging litigation and deterring tender offers where more than one form of consideration is offered will be eliminated" by this interpretation.).

19. Proposed Amendments to Tender Offer Rules, 50 Fed. Reg. 27976, 27978 n. 14 (July 9, 1985).

20. *Id.*

21. *Sunglass Hut*, 293 F. Supp. 2d at 232.

22. The "bright-line" and "integral part" tests have been developed over time by a number of courts and legal scholars. *See generally* Mark Khmelnitskiy, *Structuring Transactions Outside All Holders/Best Price Rule*, 9 FORDHAM J. CORP. & FIN. L. 501 (2004).

glasses (Luxottica) developed an interest in owning Sunglass Hut, a Florida corporation.[23] Luxottica's founder, Chairman and majority shareholder, Leonardo Del Vecchio, used another Italian company he controlled—Le Leonardo Finanziaria S.r.l.—to purchase over 5% of Sunglass Hut's stock.[24] The purchases were made at an average price of $7.78 per share.[25] Almost immediately after acquiring the stock, Luxottica engaged an investment banker to approach Sunglass Hut about the possibility of a merger.[26] The companies thereafter entered into tender offer negotiations that culminated in an offer of $8.50 per share.[27] Apparently turned off by the small premium, Sunglass Hut rejected the offer and ceased negotiations only to resume them six months later, after its Chairman and 4% owner, James Hauslein, became the company's new Chief Executive Officer.[28] At Hauslein's direction, Sunglass Hut permitted Luxottica to conduct its due diligence, which resulted in an increased offer of $9.10 per share.[29] Nevertheless, Luxottica's offer was rejected again.[30]

After several more rounds of negotiation, it became apparent to Luxottica that a deal would not be reached unless it could somehow get the new CEO's willing participation and endorsement.[31] In a final attempt to strike a deal, Luxottica approached CEO Hauslein and offered to increase the offer if he entered into a non-competition and consulting agreement.[32] Hauslein's side agreement, which was conditioned on the successful completion of the merger, provided that he would receive $15,000,000 in monthly installments of $250,000 and specifically stated that while he was to make himself reasonably available to Luxottica, he was "not required to devote all his business time to services hereunder."[33] The agreement dwarfed Hauslein's current employment agreement with Sun-

23. *Id.* at 228.
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.* These additional rounds ultimately yielded an offer of $11.25 per share.
32. *Id.* at 229.
33. *Id.*

glass Hut, which provided for a mere $375,000 in annual salary, and required him to "devote substantially all his working time and attention to the business and affairs of [Sunglass Hut]."[34]

Confident that Hauslein would support a tender offer, Luxottica made a new offer at $11.50 per share.[35] That evening, Hauslein informed the Board that he supported Luxottica's offer.[36] Not surprisingly, the board approved the transaction by unanimous vote and recommended that the shareholders accept Luxottica's offer and tender their shares.[37] The side agreement was executed on the same day that the two companies executed the tender offer and merger agreement.[38] The court's findings of fact make it abundantly clear that the target's support for the tender offer was due, in no small part, to the board's reliance on the statements of the target's CEO.[39]

Almost immediately after the tender offer was completed, a number of shareholders filed suit against Sunglass Hut alleging fraud, breach of fiduciary duty and, most notably, violation of Rule 14d-10.[40] In its defense, Luxottica filed a motion for summary judgment urging the court to take a "bright-line" approach towards Rule 14d-10. Luxottica argued that "no agreement, regardless of its intent, entered into outside of the official commencement of a tender offer could implicate the Best Price Rule."[41] In denying the motion, the court suggested that such a strict interpretation of Rule 14d-10 would undermine the purposes underlying the Williams Act and, in so doing, forced the question of whether side agreements offered in connection with a tender offer violate the best price rule.[42]

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34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. Indeed, the court noted that Sunglass Hut's 14D-9 filing stated that "in making the determination and recommendations" for tender, the Board considered: the fact that James N. Hauslein, one of the Company's principal shareholders, indicated that he was prepared to endorse the [Tender Offer and] Merger Agreement and to tender all of his shares in response to the [Tender Offer]." *Id.* at 229.
40. *Id.* at 230.
41. *Id.* at 232.
42. *Id.*

The court's ruling was consistent with the approach established by the Second Circuit.[43]

Sunglass Hut highlights several issues that have been weighted differently by many courts. The timing, terms, and players in side agreements are among the many things that courts have analyzed when trying to decide if additional compensation was paid for the shares of key target officials in violation of Rule 14d-10.[44] An examination of the seminal cases in each circuit will help explain why there is such a split of opinion as to how these cases should be handled.

The Integral Part Test

Several circuits, including the Second[45] and Ninth,[46] have taken a more functional approach towards side agreements in the context of Rule 14d-10[47] that relies on an 'integral part' test.[48] Under this test, the court will consider the totality of the circumstances surrounding the challenged tender offer.[49] The reasoning behind this approach was best summarized by the Second Circuit in *Gerber v. Computer Associates*, where the court stated that the functional test requires "look[ing] past the labels parties place on their transactions" because to do otherwise would be unduly fixated on rigid timing requirements that "drain Rule 14d-10 of all its force."[50]

While the basis for the integral part test is theoretically sound, critics argue that the test is too subjective and provides no guidance as to what the parties to the agreement should consider when negotiating various terms. Some have ex-

43. *See* Gerber v. Computer Assoc., 303 F.3d 126, 135-36 (2d Cir. 2002); Kramer v. Time Warner, Inc., 937 F.2d 767, 778-79 (2d Cir. 1991); Field v. Trump, 850 F.2d 938, 944 (2d Cir. 1988).

44. *See id.*

45. *Gerber*, 303 F.3d at 135-36; *Kramer*, 937 F.2d at 778-79; *Field*, 850 F.2d at 944.

46. Epstein v. MCA, Inc., 50 F.3d 644, 655 (9th Cir. 1995).

47. Until very recently, the Third Circuit relied on a functional interpretation of Rule 14d-10. *See* Millionerrrors Investment Club v. General Electric, 2000 U.S. Dist. LEXIS 4778, at *5 (W.D. Pa. Mar. 21, 2000), overruled in part by *In re* Digital Island Secs. Litig., 357 F.3d 322, 335 (3d Cir. 2004).

48. *Gerber*, 303 F.3d at 135-36; *Epstein*, 50 F.3d at 655; *Kramer*, 937 F.2d at 778-79; *Field*, 850 F.2d at 944.

49. *Id.*

50. *Gerber*, 303 F.3d at 135 (citing *Field*, 850 F.2d at 944; *Epstein*, 50 F.3d at 655).

pressed concerns that the test "allow[s] specious allegations to reach trial where they carry huge settlement values, and ha[s] therefore hampered the utility of tender offers as acquisition vehicles."[51] An attorney may be powerless to convince an aggressive client who has been lured by an attractive side agreement to follow standards of good practice, when there is no formal legal obligation to do so. If the target's counsel in *Sunglass Hut,* for example, had been able to point to an established standard for handling side agreements in connection with a tender offer—perhaps one that provided guidelines for establishing independence, fairness, and timing—the outcome may have been different. Of course, an attorney who handles a deal in an integral part test jurisdiction may be well advised to review the relevant case law for an understanding of the types of things courts are inclined to consider. In *Sunglass Hut*'s application of the Second Circuit test, for example, a plaintiff must adequately demonstrate that the salient characteristics of the side agreement render it functionally inseparable from the tender offer.[52]

What are these salient characteristics? Integral part test jurisdictions generally consider two factors: whether the side agreement is conditioned on the tender offer, and the intent of the bidder. These factors are explained in greater detail below.

1. *Conditional Side Agreements*

Perhaps the best example of how the integral part test is applied comes from *Epstein v. MCA, Inc.*[53] In *Epstein,* the bidder secured a tender offer by entering into an agreement with the target company's CEO whereby the CEO's shares would be exchanged for preferred stock in a separate wholly-owned subsidiary of the target at a rate of 106% of the tender price multiplied by the number of shares the CEO held in the target.[54] No other shareholder was provided this alternative. In addition, the bidder also gave the target's Chief Operating Officer

51. Ben Walther, *Employment Agreements and Tender Offers: Reforming the Problematic Treatment of Severance Plans under Rule 14d-10,* 102 COLUM. L. REV. 774, 774 (2002).

52. *Sunglass Hut,* 293 F. Supp. 2d at 232.

53. *See* Epstein v. MCA, Inc., 50 F.3d 644 (9th Cir. 1995).

54. *Id.* at 648.

$21 million in cash in exchange for his unexercised stock options.[55] Both of these agreements were memorialized and executed immediately prior to commencement of the tender offer and payment was made days after all the tendered shares were accepted.[56]

In deciding whether and to what extent Rule 14d-10 should apply, the Ninth Circuit concluded that "an inquiry more in keeping with the language and purposes of [R]ule 14d-10 focuses not on when [a shareholder] is paid, but on whether the [challenged] transaction was an integral part of [the] tender offer."[57] The court then explained that a private agreement between a bidder and a select shareholder may be deemed integral to a tender offer if it is "conditioned on the tender offer's success," notwithstanding that consideration paid on the private transaction falls outside the tender offer period.[58] The court's focus on whether this side agreement was conditional has influenced the analysis used by other courts.[59]

2. *Intent of the Bidder*

Some integral part test jurisdictions have also undertaken an analysis of the bidder's intent.[60] In *Field v. Trump*, for example, a bidder commenced a tender offer at a price of $22.50 per share for the target's stock.[61] After it became clear that the target board would not provide its endorsement, the bidder withdrew the offer and proceeded to negotiate several options to purchase the shares of certain key directors at an increased price of $25.00 per share.[62] Once the options were secured, the bidder re-announced the tender offer to all other

55. *Id.*

56. *Id.* at 653.

57. *Id.* at 655. *See also* Perera v. Chiron Corp., U.S. Dist. LEXIS 22503, at *7 (N.D. Cal. 1996).

58. *Epstein*, 50 F.3d at 656.

59. Millionerrrors Investment Club v. General Electric, 2000 U.S. Dist. LEXIS 4778, at *4-5 (W.D. Pa. Mar. 21, 2000), overruled in part by, *In re* Digital Island Secs. Litig., 357 F.3d 322, 335 (3d Cir. 2004); *Perera*, U.S. Dist. LEXIS 22503 at *9.

60. Field v. Trump, 850 F.2d 938, 945 (2d Cir. 1988); Gerber v. Computer Assoc., 303 F.3d 126, 136 (2d Cir. 2002).

61. *Field*, 850 F.2d at 941.

62. The premium price was disaggregated into $23.50 per share plus a $900,000 payment for so-called "fees and expenses." *See id.* at 942.

shareholders at new price of $23.50 per share.[63] Understandably, the target shareholders sued the company alleging that the bidder violated Rule 14d-10 because these side agreements allowed the target directors to receive a $1.50 per share premium over what was offered to them.[64] The bidder countered by arguing that the side agreements were not executed during the tender offer, but rather after the original tender offer was withdrawn and before the second tender offer commenced.[65] The court rejected the defendants' highly technical arguments, stating, "[w]e refuse to give effect to the defendants' use of the labels "withdrawal" and "new" tender offer."[66] The court concluded that the second tender offer was really a continuation of the first because the totality of the circumstances suggested that the bidder had never abandoned its original intent of completing the tender offer.[67] Accordingly, the additional consideration paid to the target directors as part of the side agreements violated Rule 14d-10.[68] In other words, if the totality of the circumstances suggests that a bidder is acting to promote the ultimate goal of completing a tender offer, then the courts will consider a side agreement to be functionally inseparable and, therefore, require the bidder's actions to conform to the requirements of Rule 14d-10.

A. Timing as Indicia of Intent

Field v. Trump also teaches that some integral part test jurisdictions will look at other factors, such as the timing of the side agreement in relation to the tender offer, to determine the bidder's intent. Of course, *Field* is not the only case that has looked at the timing of the side agreement in relation to the tender offer. In *Gerber v. Computer Assoc. Int'l Inc. & LWB Merge, Inc.*,[69] for example, target shareholders filed suit complaining that several executives, including the target's Chairman and CEO, received additional compensation for their shares in violation of Rule 14d-10 when they accepted $5 mil-

63. *Id.*
64. *Id.*
65. *Id.* at 943.
66. *Id.* at 944.
67. *Id.*
68. *See id.*
69. 303 F.3d 126 (2d Cir. 2002).

lion for a five year non-compete agreement.[70] The Second Circuit was prompted once again to determine whether the side agreement violated the Williams Act and the regulations promulgated thereunder, specifically Rule 14d-10.[71] On review, the court found it "significant that [the target CEO] was paid before all other [target] shareholders."[72] The jury ultimately returned a special verdict in plaintiff's favor, finding that $2.34 million of the $5 million the bidder had paid to the target CEO was compensation in violation of Rule 14d-10, while the remainder was legitimate consideration for the non-compete agreement.[73]

The *Gerber* decision is also interesting from a practitioner's perspective because it highlights several evidentiary considerations that play an important role in litigation. The court made two rulings that had a substantial impact on the outcome. First, the court refused to allow the bidder to present evidence showing that it had entered into similar side agreements in the past.[74] That ruling is consistent with the general tendency of integral part test jurisdictions to ignore the title given to the side agreement and instead examine the substance of its provisions. Labeling a side agreement "non-compete," "consulting," or otherwise will not shield the bidder from liability. After examining the agreement's provisions, the court was able to conclude that the agreement was much more than a traditional non-compete agreement.[75] The court was specifically persuaded by a provision that allowed the bidder to purchase the target CEO's shares in the event of a competing offer.[76]

The second major ruling the court made was to give the jury specific instructions to "consider whether the payment of $5 million dollars under the [side] agreement was paid to [the target CEO] for his shares, or his agreement not to compete, or partly for the shares and partly for the agreement not to

70. Here, as many of the situations already discussed, the target CEO initially resisted entering into a non-compete agreement. *Id.* at 128-31.

71. *Id.* at 131-132.

72. *Id.* at 126.

73. *Id.* at 137-38.

74. *Id.* at 136.

75. *Id.*

76. *Id.*

compete."[77] In other words, the court allowed the jury to consider what portion of the total payment constituted additional consideration for the executive's shares. From a litigation standpoint, the implication that only part of a side agreement may contain unjustified compensation will almost always constitute a disputed material fact that will withstand a motion for summary judgment.[78]

Together, *Epstein*'s focus on whether the offer is conditional, *Gerber*'s emphasis on timing, and *Field*'s focus on the bidder's intent have influenced the way in which courts apply the 'integral part' test. By taking a general approach that focuses on substance rather than form, these jurisdictions have been able to honor the principles of equal treatment and investor protection that initially spawned the development of Rule 14d-10. The integral part test is a stark contrast from the approach taken by many "bright line" test jurisdictions, which are detailed below.

The Bright Line Test

Several circuits, including the Third,[79] Fourth,[80] and Seventh[81]— and at least one district court in the Eleventh Circuit[82]—have taken a "bright line" approach to side agreements and Rule 14d-10.[83] Under the bright line test, the court will "demark clearly the periods during which the special Williams Act rules apply" and then determine whether the side agreement at issue falls within these intervals.[84] In other words, the test does not require the court to look into the facts and cir-

77. *Id.* at 137.

78. *See* FED. R. CIV. P. 56.

79. *In re* Digital Island Secs. Litig., 357 F.3d 322, 334 (3d Cir. 2004).

80. Kahn v. Va. Ret. Sys.,13 F.3d 110 (4th Cir. 1993).

81. Lerro v. Quaker Oats Co., 84 F.3d 239, 243 (7th Cir. 1996).

82. Walker v. Shield Acquisition Corp., 145 F. Supp. 2d 1360, 1367 (N.D. Ga. 2001) (adopting *Lerro* and stating that "the court is not persuaded by *Epstein's* broad holding that in each case, transactions occurring prior to the beginning of the tender offer must be examined to determine if they should be deemed 'integral' to the tender offer.").

83. While the question has not been resolved by the Court of Appeals for the Sixth Circuit, at least one district court (M.D. Tenn.) has concluded that the bright line test offers the appropriate analysis. *See* Katt v. Titan Acquisitions, 133 F. Supp. 2d 632, 635 (M.D. Tenn. 2000).

84. *In re* Digital Island Secs. Litig., 357 F.3d 322, 334 (3d Cir. 2004) (citing *Lerro*, 84 F.3d at 243).

cumstances surrounding the side agreement, but instead to examine whether any part of the agreement falls during such tender offer as stated in the rule.[85]

While many practitioners argue that a bright line interpretation provides consistency and clarity, an examination of the case law in this area suggests that the opposite may be true. While most courts generally agree on how to compute a starting and ending time for tender offers, few agree on which parts of the side agreement need to fall within these temporal limits in order to violate the bright line test. For instance, some cases hold that a violation of the all holders/best price rule exists if *payment* on the contract is made "during the tender offer," while others suggest that the rule is violated if the agreement is *executed* "during the tender offer."[86] Some agree that that the bidder must be a party to the agreement,[87] while others recognize that additional compensation can sometimes come from the target company alone. This last point is particularly interesting in light of the failure of Rule 14d-10 to distinguish between bidders and targets. The rule simply states that every tendering investor must receive the "highest consideration paid to any other security holder during such tender offer."[88]

Surprisingly, even those courts that have taken a bright line approach to Rule 14d-10 recognize that the greatest opportunity for fraud exists when a strict interpretation of the tender offer rules is adopted. In *Digital Island*, for example, the Third Circuit "agree[d] with *Epstein* that [bidders] cannot be permitted to evade the requirements of the Williams Act simply by delaying the actual payment, or by agreeing on the extra payment beforehand."[89] The Seventh Circuit has also recognized that some payments made outside of the tender offer period can be so transparently fraudulent, that they must

85. Mark Khmelnitskiy, *Structuring Transactions Outside the All Holders Best Price Rule*, 9 FORDHAM J. CORP. & FIN. L. 501,516 (2004) (citing *Lerro*, 84 F.3d at 243).

86. *Compare* Kramer v. Time Warner, Inc., 937 F.2d 767 (2d Cir. 1991) (finding a violation of the all holders/best price rule if payment is made during tender offer) *with Lerro*, 84 F.3d at 246 (finding a similar violation if a side agreement is executed during tender offer).

87. *Kramer*, 937 F.2d at 779.

88. 17 C.F.R. § 240.14d-10.

89. *In re* Digital Island Secs. Litig., 357 F.3d 322, 334 (3d Cir. 2004).

be treated as if they had been made "during the tender offer."[90] Notwithstanding these comments, the court stopped short of explaining how these situations should be analyzed.

Despite its shortcomings, the bright line test does have some utility. For starters, it provides bidders with some assurances about how their side agreements will be treated by the courts. Additionally, the test makes it easier for a court to rule on summary judgment motions. If there is no material dispute as to when the tender offer began and when it terminated, courts will find it substantially easier to decide whether a particular side agreement violated the all holders/best price rule. Third, the rule also saves the court from having to decide close questions such as whether only part of an agreement should be considered additional consideration under Rule 14d-10.[91] Finally, the test arguably avoids the unintended consequence of causing a tender offer to start earlier than desired. In *Kahn*, for instance, the Fourth Circuit expressed concerns that a functional interpretation of Rule 14d-10 might create a situation where the execution of a side agreement followed by an otherwise proper public announcement causes a tender offer to have commenced, thereby "defeating the purpose of Rule 14d-2(c) by removing the certainty that it provides to bidders by allowing. . . [bidders and targets] to control the commencement of tender offers."[92] The court further acknowledged that "[t]he SEC included the specific requirements of Rule 14d-2(c) to provide certainty to bidders and to prevent the inadvertent commencement of a tender offer."[93]

The Lessons of Hanson Trust *and* Wellman

A common response from bidders faced with side agreement litigation is to urge the court to adopt specific starting

90. *Lerro*, 84 F.3d at 245 ("[d]oubtless there are limits to the use of a follow-up merger as a means to deliver extra compensation. Suppose [the bidder] had promised [a shareholder] $ 14 for each share he tendered during the offer, plus another $ 6 for each of these shares one month later. Just as tax law requires "boot" to be treated as a gain received from the sale of stock, securities law treats "boot" as a payment during the tender offer.").

91. This was precisely Judge Easterbrook's concern in *Lerro*. *See* 84 F.3d at 246.

92. *Id.*

93. Kahn v. Va. Ret. Sys.,13 F.3d 110, 116 (4th Cir. 1993) (citing SEC Release 16384).

and ending dates for the tender offer at issue.[94] The idea is that if the court is able to establish fixed dates for the beginning and end of the tender offer, then any side agreements reached either before or after these dates do not fall within the tender offer and are, therefore, not subject to Rule 14d-10. It is true that some SEC regulations suggest that tender offers do have specific starting points. Rule 14d-2(a), for instance, states that a bidder will have commenced its tender offer for purposes of Section 14(d) of the Securities Exchange Act of 1934 and the rules under that Section at 12:01 a.m. on the date when the bidder has first published, sent or given the means to tender to security holders.[95] Similarly, Rule 14e-1(a) states that all tender offers must be open at least until twenty days from the date on which the offer was made public to shareholders.[96] However, these arguments conflict with the traditional paradigm for applying the investor protection rules to tender offers.[97]

The use of a bright line test is fundamentally at odds with the precedents of *Hanson Trust*[98] and *Wellman*[99] because it relies on strict principles that ignore "the sole purpose of the Williams Act [which is] the protection of investors who are confronted with a tender offer."[100] In 1968, Congress adopted Section 14(d) "in response to the growing use of cash tender offers as a means of achieving corporate takeovers . . . which . . . removed a substantial number of corporate control contests from the reach of existing disclosure requirements of the federal securities laws."[101] In order to prevent bidders from evading investor protection regulation, the courts have fashioned a more functional definition of the term "tender offer," which requires the analysis of several factors.[102] Under no circumstances do the courts rely exclusively on the presence or

94. *See, e.g.*, Gerber, 303 F.3d at 135; *Epstein*, 50 F.3d at 654.

95. 17 C.F.R. § 240.14d-2(a).

96. 17 C.F.R. § 240.14e-1(a).

97. *See Epstein*, 50 F.3d at 654 ("[t]he term 'tender offer,' as used in the federal securities laws, has never been interpreted to denote a rigid period of time.").

98. Hanson Trust v. PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985).

99. Wellman v. Dickinson, 475 F. Supp 783 (S.D.N.Y. 1979).

100. *Id.* at 817 (citing Piper v. Chris-Craft Industries, 430 U.S. 1 at 35).

101. *Hanson Trust*, 774 F.2d at 54 (citing Piper v. Chris-Craft Industries, 430 U.S. 1 at 22).

102. *Id.*

absence of these factors to determine whether a tender offer has taken place. "Although many of [these] factors are relevant for purposes of determining whether a given solicitation amounts to a tender offer, the elevation of such a list to a mandatory litmus test appears to be both unwise and unnecessary."[103] Logic and reason suggest that it is similarly "unwise and unnecessary" to rely on a bright line test to Rule 14d-10 that would require the court's to ignore blatant investor abuses simply because a side agreement does not come within the temporal limits of a tender offer.[104]

The SEC's view of its investor protection responsibility under the Williams Act is functional and consistent with the approaches taken in *Hanson Trust* and *Wellman.*[105] The SEC's approach to tender offer regulation has never been one of hard and fast rules about whether a tender offer exists because it apparently recognizes that such an approach does not serve to promote the intent and purpose of the Williams Act.[106] Much like the Second Circuit, the SEC has generally relied on a functional approach towards tender offers that relies on a careful evaluation of all the attendant circumstances.[107]

Whenever a bidder begins a rapid accumulation of shares that results in a change in control, there must be guards against unfair treatment. Rule 14d-10 at least applies to shares

103. *Id.* at 57.

104. *Id.*

105. "The tender offer rules still may apply to activities that function as unconventional tender offers. We maintain our position that the term tender offer should be interpreted flexibly . . . A determination of whether a particular transaction . . . constitutes a tender offer will, of course, depend on the particular facts and circumstances and is not limited to 'conventional' tender offers." *See Regulation of Takeovers and Security Holder Communications,* Exchange Act Release No. 33-7760 (October 22, 1999).

106. "The substance of the federal securities laws must be broadly construed, and, since public investors are the intended beneficiaries of the Williams Act, [15 U.S.C. § 78a et seq.], accordingly, its provisions should be construed to facilitate their coverage." *Wellman,* 475 F. Supp. at 825.

107. In a more recent release dealing with mini-tender offers, the SEC expressly endorsed the functional approach of Hansen and Wellman, stating that "[w]hile the term 'tender offer' has never been defined in any statutory provision or rule, the courts generally have applied an eight-factor test in determining whether a particular acquisition program constitutes a tender offer. It is not necessary that all eight factors be present to conclude that the acquisition program is a tender offer." SEC Release 34-43069 (July 2000).

accumulated through a tender or in the open market,[108] but perhaps it should also apply to shares acquired through a side agreement that is functionally inseparable from a tender offer. Some courts, however, have resisted the *Hanson* and *Wellman* analogies by distinguishing between the test used for establishing "whether" a tender offer has begun and "when" a tender offer has begun.[109] The Seventh Circuit all but chastised the plaintiff in *Lerro v. Quaker Oats*[110] for arguing that, under the "totality of the circumstances" test of *Hanson Trust*[111] and the eight-factor test of *Wellman v. Dickinson*,[112] the tender offer began later than expected and, therefore, included the side agreement at issue.[113]

III.
RECOMMENDATIONS

Unless and until the SEC decides the question of how Rule 14d-10 applies to side agreements, tender offers will continue to be an undesirable form of conducting friendly business combinations. Considering the approach the SEC has generally taken towards investor protection regulations in relation to tender offers, it is unlikely that the SEC will adopt a bright line test. Bright line rules make it too easy for bidders to defraud shareholders. There are, however, a number of possible alternatives that the SEC may consider.

Limitations on Tendering Shareholders

First, the SEC could amend Rule 14d-10 so that the All Holders/Best Price Rules apply only to shares that are actually "tendered." Currently, Rule 14d-10 provides, in relevant part, that: "No bidder shall make a tender offer unless . . . [t]he consider-

108. SEC v. Carter Hawley Stores, Inc., 760 F.2d 945 (9th Cir. 1985).

109. *See* Lerro v. Quaker Oats Co., 84 F.3d 239, 246 (7th Cir. 1996) (noting that "our case is about 'when' rather than 'what'").

110. "As the District Court correctly found, however, *Hanson* and *Wellman* both involve the issue of whether a tender offer has occurred, not when a tender offer starts, and the parties here do not dispute that a tender offer occurred. Rather, the only question is when the tender offer commenced, a question which is answered by Rule 14d-2(c), not by *Hanson* or *Wellman.*" *Gerber v. Computer Assoc.*, 303 F.3d 126, 133 (2d Cir. 2002).

111. Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 57 (2d Cir. 1985).

112. Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979).

113. *Lerro,* 84 F.3d at 246.

ation paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.[114] By modifying the language of Rule 14d-10 in a way that conditions the rule on whether the shares are actually tendered, the SEC could assure bidders that they will not be deemed to have provided additional compensation by entering into a side agreement with a shareholder as long as he or she does not tender. This modification would effectively legitimize side agreements and make them a viable tool for facilitating tender offers. For instance, Rule 14d-10(a)(2) could instead read: "The consideration paid to any security holder for shares tendered in the tender offer is the highest consideration paid to any other security holder for shares tendered in the tender offer."

The rationale here is easy to understand. If key target officials do not tender, then any consideration they receive as part of a side agreement cannot be considered part of the tender offer. The modified rule would also give investors confidence that the executives who are promoting the tender offer are not doing so because of the increased value they will receive for their shares. This alternative is also consistent with the SEC's view when originally promulgating Rule 14d-10.[115] In its original proposal, the SEC declared that Rule 14d-10:

> would require a bidder in making a tender offer under Section 14(d) of the Exchange Act . . . [t]o pay every *tendering* security holder the highest consideration offered to any other security holder at any time during the tender offer and, if more than one type of consideration is offered, that the types be substantially equivalent in value and the highest consideration of any type offered to any security holder is paid to any other security holder *accepting* that type of consideration.[116]

The SEC inserted similar language in the final rule, explaining that "[t]he highest price paid to any *tendering* security holder,

114. 17 C.F.R. § 240.14d-10.

115. Proposed Amendments to Tender Offer Rules, 50 Fed. Reg. 27976, 27977 (July 9, 1985).

116. *Id.* (emphasis added).

however, would need to be paid to any other *tendering* security holder."[117]

This change might effectively convert the issue of side agreements from a Rule 14d-10 question into an executive compensation question. While bidders could still try to entice key target officials to promote the tender offer by offering large employment agreements or consulting contracts, these agreements may still need to survive scrutiny from the board's compensation committee.[118] In other words, this modification guarantees that the compensation these officials receive is not tied to the number of shares they hold. This proposed modification also gives shareholders confidence that the target officials will continue to act in the best interest of the shareholders because, when they do not tender, they retain a personal pecuniary interest in the target company.

While attractive, this solution does suffer from several pitfalls. First, the Williams Act arguably prohibits the new change because it treats tendering and non-tendering shareholders differently. The SEC seemed to have considered this issue when promulgating Rule 14d-10, stating that just because "the substantive provisions of the Williams Act are intended to assure equal treatment of *tendering* security holders does not detract from the fact that the Williams Act is designed to protect all security holders regardless of whether they tender their shares."[119] The fact that only tendering shareholders are sub-

117. *See* Amendments to Tender Offer Rules; All-Holders and Best-Price, 51 Fed. Reg. 25873, 25878 (July 17, 1986) (emphasis added).

118. SEC Release No. 34-48745. The new NYSE listing standards as amended pursuant to Section 301 of Sarbanes Oxley require listed companies to establish a compensation committee comprised solely of independent directors. These committees must establish a charter that, among other things, must give the committee responsibly for approving CEO and non-CEO compensation. *See* NYSE Listing Standards, at 8, *available at* www.nyse.com/pdfs/finalcorpgovrules.pdf. While the NASD listing standards do not mandate the establishment of a compensation committee, companies are encouraged to do so. *See* NASD Rule 4350(c)(3)(A), *available at* http://nasd.complinet.com/nasd/display/display_display.html?rbid=1189&record_id=1159003671.

119. *See Amendments to Tender Offer Rules; All-Holders and Best-Price,* 51 F.R. 25873 (July 17, 1986) (citing Hundahl v. United Benefit Life Ins. Co., 465 F. Supp. 1349, 1368 (N.D. Tex. 1979). *See also* Plaine v. McCabe [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,749 (9th Cir. 1986); Wellman v. Dickinson, 475 F. Supp. 783, 817 (S.D.N.Y. 1979), *aff'd on other grounds,* 682 F.2d 355 (2d Cir. 1982), *cert. denied,* 469 U.S. 1069 (1983); *In re* Com Oil/Tesoro Petroleum

ject to Rule 14d-10 does not conflict with the ultimate purpose and intent of the Williams Act, which is to protect all investors during a tender offer. Rather, when read together, "[t]he all-holders and best-price amendments implement the purpose of the Williams Act to protect all tendering and non-tendering security holders."[120]

Second, amending Rule 14d-10 in this fashion may make it difficult for bidders to get the number of shares they need to take control of the company. If, for example, those management officials who decide to enter into a side agreement and forgo tendering their shares collectively hold a majority of the target's outstanding shares, then the bidder will have a problem. Moreover, the rule could potentially increase the cost of doing business. Consider the situation where the bidder is able to purchase enough shares to take control of the company, but is unable to obtain the number of shares needed to take advantage of short-form merger provisions because corporate officials who are party to a side agreement hold a large number of shares.[121] This raises a serious concern for bidders who rely on the cost-advantages of short-form provisions. Instead, the bidder will need to absorb the cost of complying with additional regulations.

Establishing a "Bona Fide" Safe-Harbor Provision

As a practical matter, Rule 14d-10 should not apply to side agreements unless the facts suggest that the agreement was intended to provide additional compensation for a person's shares rather than for some other legitimate and non-discriminatory purpose such as corporate knowledge or influence. However, unless and until bidders have some assurance that

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Corp. Secs. Litig., 467 F. Supp. 227, 241-43 (W.D. Tex. 1979); A. Bromberg, SECURITIES LAW: FRAUD § 6.3 (1974).

120. *Id.*

121. Many states allow a person owning a substantial majority of the corporation's shares to consummate what is known as a "short-form merger." In Delaware, for example, the short-form merger statute allows a parent company owning at least 90% of the stock of a subsidiary to merge with the subsidiary upon approval of the parent company's board of directors alone. Advance notice to or consent of the minority shareholders is not required. These provisions greatly reduce the amount of time and money spent consummating a merger. *See generally* Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (describing generally the steps taken in a short-form merger.)

these legitimate side agreements will not, as a matter of law, create a prima facie violation of Rule 14d-10, tender offers will continue to be avoided. Perhaps the best way to give bidders the confidence they need to use tender offers is to develop a safe-harbor provision within Rule 14d-10 that allows bidders to enter into "bona fide" employment, consulting or non-compete agreements without fear of violating Rule 14d-10. In so doing, the SEC would need to clearly define what a bona fide side agreement is. Failure to do so is bound to create a flood of litigation that bidders will have a tough time defending.

1. *Defining a "Bona Fide" Side Agreement*

Defining a truly bona fide side agreement is difficult. As a basic starting point, Rule 14d-10 should not apply to agreements that bear no relation whatsoever to a tender offer. So an agreement is not bona fide if, at the time of execution, neither party is subject to a Rule 13d-1 reporting requirement, or has the intent to commence a tender offer. The rationale behind this definition is simple and reflects the purpose of the tender offer rules generally. Just as minor accumulations of stock, without more, do not create the need for tender offer regulation,[122] neither should consulting contracts or employment agreements where neither party has a considerable stake in the target company or the intent to commence a tender offer.

2. *Additional Relief Under a Multi-Factor Test*

While the aforementioned exemption is simple and easy to understand, it fails to protect serious bidders who will undoubtedly trigger Rule 13d-1 or otherwise have the intent to conduct a tender offer. Therefore, the SEC should consider developing an alternative safe-harbor provision. For example, the SEC could create an alternative definition of a bona fide side agreement that relies on a preponderance of factors designed to ensure that the agreement at issue is not intended to

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122. *See generally* 17 C.F.R. § 240.13d-1. The preliminary reporting requirements of Rule 13d-1 are set so that the rule is not triggered unless a person has acquired beneficial ownership in excess of 2% of a class of equity securities registered under Section 12 of the Exchange Act within a twelve month period and who owns more than 5% of the outstanding shares of securities registered under Section 12 of the Securities Exchange Act of 1934.

provide additional compensation for a person's shares, but rather for some other legitimate and non-discriminatory purpose. In addition to providing some general guidance about how side agreements should be used, an SEC sanctioned multifactor test would also make it easier for courts to decide whether a plaintiff has alleged facts sufficient to establish a *prima facie* violation of Rule 14d-10. If the courts ultimately adopt such a test, then it may serve to revive the use of tender offers by providing some protection against unwarranted litigation.

Any multifactor test should take into account a number of considerations. The first factor the SEC should consider adopting is whether the consideration paid in the agreement is commensurate with the value of the services being received. If the consideration is substantially more than the value typically paid for the same services, it is possible that the agreement is meant to compensate the individual for his or her shares. If, as in *Sunglass Hut,* the target CEO receives the benefit of a compensation agreement that is several times his or her salary, it is difficult to say that the agreement is bona fide without a comparable increase in that person's duties and responsibilities. This approach is not new. Courts in both bright line and integral part test jurisdictions have allowed plaintiffs to overcome the temporal requirements of the tender offer rules by alleging specific facts that, if left uncontested, would render the side agreement at issue suspect. In both *Digital Island Securities* and *Epstein,* for instance, the courts examined whether the compensation package was excessive, or out of line with amounts that similarly situated executives were paid.[123]

A second factor to be considered is whether the agreement operated as an inducement. Some courts have also used this factor. In *Epstein,* for instance, a major factor that influenced the court's decision was whether the payments offered to the target shareholders were "given . . . as an *inducement* to

123. The *Digital Island* court suggested that this inquiry requires more than mere "conclusory allegations." Rather, the sufficient facts must be alleged so as to provide a basis on which to infer the payment of a share premium in violation of the Best Price Rule. *In re* Digital Island Secs. Litig., 357 F.3d 322, 336 (3d Cir. 2004). *See also* Epstein v. MCA, Inc., 50 F.3d 644, 657-59 (9th Cir. 1995).

support the tender offer and tender his shares."[124] The same consideration was raised in *Perera*, where the court found that option enhancements were given to shareholders as a means of encouraging them to tender their shares and to support the tender offer.[125] Finally, in *Millionerrrors Investment Club v. General Electric*, the court found that a claim for additional consideration under Rule 14d-10 existed when there were enough facts to show that the options granted to certain shareholders were provided in order "to *induce* them to support the Tender Offer and to tender their own shares."[126]

If the target CEO or any other beneficiary to a side agreement provides his or her endorsement only after being offered a lucrative non-compete agreement or employment contract, then it is much easier to conclude that the agreement operated as an inducement and is, therefore, not bona fide. A critical consideration here is whether there was actually a change in the beneficiary's position regarding the tender offer. In many of the cases already discussed, the execution of the side agreement triggered a total shift in the beneficiary's view of the tender offer.[127] In *Maxick v. Cadence Design Systems*, for example, the court rejected defendants' bright line argument that the focus should be exclusively on the timing of retention bonuses.[128] The court reasoned that "the actual timing of the offer and the payment is irrelevant if plaintiff can show that the purpose of the 'retention bonuses' was to compensate. . .[i]nsiders for parting with their shares in the tender offer and/or for endorsing the tender offer to the other shareholders."[129] Clearly these fiduciaries must objectively evaluate

124. *Epstein*, 50 F.3d at 659.

125. Perera v. Chiron Corp., U.S. Dist. LEXIS 22503, at *4 (N.D. Cal. 1996).

126. Millionerrrors Investment Club v. General Electric, 2000 U.S. Dist. LEXIS 4778 (W.D. Pa. Mar. 21, 2000) (superceded by *In re* Digital Island Secs. Litig., 357 F.3d 322, 335 (3d Cir. 2004) (emphasis added).

127. Whereas the CEOs in *Sunglass Hut* and *Gerber* were initially opposed to the idea of a tender offer, the non-compete and consulting agreements they received appeared to cause a sudden change in their opinion of the tender offer that is unexplained but for the additional compensation they received. *Sunglass Hut*, 293 F. Supp. 2d 224 (E.D.N.Y. 2003); *Gerber*, 303 F.3d at 126.

128. Maxick v. Cadence Design Systems, 2000 U.S. Dist. LEXIS 14099, at *2-3 (N.D. Cal. 2000).

129. *Id.* at *3.

tender offers and refrain from engaging in self-dealing. In order to avoid fiduciary liability in these instances, it would seem reasonable for beneficiaries to articulate some other legitimate reason for endorsing the tender offer. As was the case in *Sunglass Hut,* it may be sufficient for the beneficiary to demonstrate that his or her endorsement was predicated on other considerations such as an increased offering price.[130]

The final consideration that should be taken into account is whether the agreement is contingent on successful completion of the tender offer. In nearly all of the cases discussed earlier, the targeted shareholder would not receive the benefits of the side agreement if the tender offer did not succeed. As discussed, this condition has been a significant factor for many courts. In *Perera,* for example, the district court concluded that enhancements granted to certain employee shareholders amounted to a premium in violation of Rule 14d-10 even though the options were granted prior to the tender offer.[131] The court was particularly concerned with the fact that the enhancements were conditioned on the acceptance of the offer, stating that "[g]iven these circumstances, it is difficult to see how the Court could find as a matter of law that the enhancements are separate from the Tender Offer."[132]

The factors described above are not problem-free and can pose a real challenge for defendants in presenting a motion to dismiss under Rule 56.[133] The most critical defect is that they carry a degree of subjectivity so great that questions of material fact will almost always be in dispute. Even though the courts do not presently rely on an established group of factors, they have overwhelmingly recognized that Rule 14d-10 requires a facts-intense analysis. In *Cummings v. Koninklijke Philips Electronics,* for instance, the court decisively stated that whether additional consideration was integral to a tender offer is a factual question unsuited to disposition in a motion to dismiss.[134]

130. *Sunglass Hut,* 293 F. Supp. 2d at 232.

131. *Perera,* U.S. Dist. LEXIS 22503, at *10.

132. *Id.* at *9-10 (citing *Epstein,* 50 F.3d at 656 ("Rule 14d-10 does not prohibit 'transactions entered into or effected before, or after, a tender offer— provided that all material terms of the transaction stand *independent* of the tender offer.'")) (emphasis added).

133. FED. R. CIV. P. 56.

134. Cummings v. Koninklijke Philips Electronics, 2002 U.S. Dist. LEXIS 23383, (N.D. Cal. 2002).

Similarly, in *Padilla*, the court rejected the defendants' argument that the additional compensation paid to target executives was not sufficiently alleged by plaintiffs to be part of the tender offer.[135] The court held that "[a]ll of Defendants' arguments fail because they rely on particular factual findings which the Court cannot make in determining a motion to dismiss."[136] As it stands, there are no guidelines or any key facts that must be provided in order to establish a prima facie case for violating Rule 14d-10. At a minimum, these factors provide an outline of what plaintiffs must plead and prove.

3. *Establishing A Pure Safe-Harbor*

Finally, the SEC could address this issue by establishing a "pure safe-harbor" provision. In short, the SEC could declare any side agreement entered into with a shareholder who tenders less than two percent (2%) of the target's outstanding shares to be bona fide *per se*. Such a rule would allow bidders to secure the benefits of compensation agreements, non-compete agreements and consulting agreements without having to worry about whether these agreements will jeopardize the tender offer. From a practical perspective, such a rule would also protect investors by ensuring that side agreements are only going to individuals who will not, by virtue of their shareholder power, influence the outcome of the tender offer.

IV. RIGHT PROBLEM/WRONG RULE—ALTERNATIVE SHAREHOLDER REMEDIES

Certainly, the danger that overzealous corporate egos will engage in self-dealing and demand a premium for their shares concerns regulators and shareholders alike. Notwithstanding the seriousness of this problem, one has to wonder whether Rule 14d-10 should apply to side agreements at all. Perhaps the reason why the issue presented in this discussion is so complex is because Rule 14d-10 was never intended to deal with side agreements.[137] Other securities laws and regulations can

135. Padilla v. MedPartners, Inc., U.S. Dist. LEXIS 22839 at *8 (C.D. Cal. 1998).

136. *Id.*

137. Both the initial and final rules are silent on this issue. *See* Proposed Amendments to Tender Offer Rules, 50 Fed. Reg. 27976 (July 9, 1985);

be used to protect shareholders from discriminatory treatment in a tender offer. This last part of the paper examines some of these alternatives, including the early warning provisions of Rule 13d-1, applicable state fiduciary protection statutes, and the general fraud provisions of the federal securities laws. This final section describes how these alternative remedies can be used to deal with the issue of fraudulent side agreements.

The Protections of 13(d)

The early warning provisions of Rule 13d-1 already impose an obligation on potential bidders to provide shareholders with certain information prior to the commencement of a tender offer.[138] Item 6 on the Schedule 13D disclosure form, for example, requires the bidder to "describe any contracts, arrangements, understandings or relationships (legal or otherwise) . . . naming the persons with whom such contracts, arrangements, understandings or relationships have been entered into."[139] These provisions are better equipped to give shareholders the information they need to make an informed judgment about whether to participate in the tender offer given any special agreement that may exist. Moreover, Rule 13d-1 gives aggrieved shareholders standing to pursue a number of remedies if a potential bidder fails to make the proper disclosures.[140] At a minimum, shareholders can attempt to temporarily enjoin the tender offer until the bidder makes or corrects the required disclosures.[141]

Relying on State Fiduciary Protection Statutes

Aside from pre-acquisition disclosures, there are a number of other tools that are designed to protect shareholders throughout the tender offer process. Perhaps the most important of these are the fiduciary duties owed by directors, officers

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Amendments to Tender Offer Rules; All-Holders and Best-Price, 51 Fed. Reg. 25873 (July 17, 1986).

138. 17 C.F.R. § 240.13d-1.

139. *See* Instructions to Item 6 of Schedule 13D.

140. Kamerman v. Steinberg, 891 F.2d 424 (2d Cir. 1989); Sanders v. Thrall Car Mfg. Co., 582 F. Supp. 945 (S.D.N.Y. 1983), *aff'd*, 730 F.2d 910 (2d Cir. 1984).

141. Gearhart Industries, Inc. v. Smith Int'l, Inc., 741 F.2d 707, 714-16 (5th Cir. 1984); Florida Commercial Banks v. Culverhouse, 772 F.2d 1513, 1519 (11th Cir. 1985).

and, in some cases, controlling shareholders of the target corporation.[142] It is well established that state law controls issues of corporate governance such as breaches of fiduciary.[143] Therefore, the relevant question here is whether a fiduciary's decision to participate in a side agreement constitutes a *prima facie* breach of the fiduciary duties of care, loyalty and candor.

The decisions a board makes when faced with a tender offer will not receive the benefit of the business judgment rule if there is evidence that a director suffered from a conflict of interest, or failed to honor his or her fiduciary duties.[144] While most of the cases in this area deal specifically with defensive actions taken by the board to ward-off potential bidders,[145] such actions could apply to the board's decision to approve the tender offer as well. Side agreements can undoubtedly create an issue about whether the board suffered from such a conflict. For example, if certain key board members are beneficiaries of a lucrative employment agreement or consulting contract that is conditioned on the success of the tender offer and, at the same time, those members are actively engaged in getting the board's approval, it may be difficult for the board to rebuff charges that a conflict of interest exists. Under these circumstances, the court will have no choice but to ignore the business judgment rule and review the board's decision under the "enhanced judicial scrutiny" standard.[146]

Any officer or director who uses a side agreement to obtain a premium for his or her shares also likely commits self-

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142. *See* Pepper v. Litton, 308 U.S. 295, 306, 310-11 (1939) (holding that a controlling shareholder must not use his control to obtain a special advantage, or to cause the corporation to taken an action that unfairly prejudices the minority shareholders).

143. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 309 cmt. c. (1971).

144. Unocal Corp. v. Mesa Petroleum Co., 492 A.2d 946 (Del. 1985).

145. *Unocal*, 492 A.2d 946 (Del. 1985); Unitrin, Inc. v. American General Corp., A.2d 1361 (Del. 1995); Paramount Communs. Inc. v. Time, Inc., 571 A. 2d 1140 (Del. 1989); Paramount v. QVC Network, 637 A.2d 34 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A. 2d 173 (Del. 1986).

146. *See id.* The key features of "enhanced scrutiny" include: (1) a judicial determination regarding the adequacy of the decision-making process employed by the directors including the information upon which they based their decision; and (2) the reasonableness of the director's action in light of the circumstances then existing. *See generally* Paramount v. QVC Network, 637 A.2d 34 (Del. 1994).

dealing. "Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally."[147] The terms of a side agreement can easily become so favorable to a target director that a presumption of self-dealing sufficient to violate to duty of loyalty may be impossible to avoid. Similarly, a director's failure to fully disclose the extent of his or her personal interest in the tender offer could also be seen as a violation of the duty of candor. Finally, the board's decision to accept the conclusions of an interested director (e.g. one who is a party to a lucrative side agreement) without adequately exploring the extent to which the side agreement has influenced that director's statements provides evidence that the directors failed to act on an informed basis in violation of their duty of care.

If the SEC gives certain side agreements bona fide status, it will be much harder for plaintiffs to establish that a director has violated his or her duty of care and loyalty by entering into a bona fide side agreement with the bidder. Similarly, it would also become more difficult for shareholders to argue that the board's decision in approving or disapproving an offer was tainted by a conflict of interest. If instead the SEC would modify Rule 14d-10 to focus on whether the shareholder has tendered his or her shares, then the SEC could avoid having to answer the question of whether a particular side agreement is bona fide or permissible *per se*, making it easier for plaintiffs' attorneys to argue that the directors violated their fiduciary duties. A modified Rule 14d-10 would give plaintiffs a chance to satisfy the burden of proof needed to overcome the business judgment rule and may ultimately force the directors to prove that transaction was entirely fair.[148]

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147. Cede & Co. v. Technicolor, 634 A.2d 345, 362 (Del. 1993).

148. The phrase "entirely fair" is a term of art used to describe the entire fairness standard developed by many courts over the years. When this phase of the litigation is reached, the directors must prove both fair dealing and fair price. Generally the court will consider evidence related to the timing of the transaction, how it was initiated, structured and negotiated and the manner in which director and shareholder approval was obtained. Weinberger v. UOP Inc., 457 A.2d 701, 711 (Del. 1983).

1. *Personal Liability of Directors*

Plaintiffs can also use evidence of a breach of fiduciary duty to seek damages from a director.[149] While some states—notably Delaware—have allowed corporations to limit the liability of directors in their certificates of incorporation, these limitations do not apply to claims alleging breach of the duty of loyalty.[150] This very question was considered in the seminal case of *Cede & Co. v. Technicolor, Inc.*, ("Cede II") wherein certain shareholders sought to impose personal liability on the directors of Technicolor for breaching their duties of care and loyalty when they accepted a tender offer.[151]

In *Cede II*, the bidder (Perelman) approached a director of the target company (Technicolor) to discuss the possibility of a tender offer.[152] During the ensuing negotiations, the parties deliberated over a number of items including: the effect the tender offer would have on the chairman/CEO's employment contract with the target; whether the chairman/CEO and the director would continue with the new company; the importance of obtaining options from the target's two largest stockholders and their spouses; and whether a director should receive a finder's fee for the transaction.[153] Ultimately, the bidder offered the Chairman/CEO a lucrative employment contract[154] and the director a finder's fee of $150,000.[155]

149. In Cede & Co. v. Technicolor, Inc., the Delaware Supreme Court ruled that, as a matter of law, plaintiffs are not required to make an election of remedies before trial and may, therefore, concurrently pursue an appraisal action and a personal liability action. 542 A.2d 1182, 1192 (1988) [*hereinafter* "Cede I"].

150. *See generally* 8 DEL. C. § 102; *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 286 (2003) ("a charter provision pursuant to subsection (b)(7) can eliminate or limit personal liability of a corporate director for breaches of the duty of care; however, liability for duty of loyalty breaches cannot be eliminated or limited".).

151. Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) [*hereinafter* "Cede II"]. *Cede II* is the second appeal to the Supreme Court of Delaware regarding claims by a shareholder against Technicolor, Inc. and others. After the second remand, the parties stipulated to submit the remanded issues to the trial court without presenting additional evidence. Thus, the facts relevant to subsequent appeals are recited in *Cede II.*

152. *Id.* at 353-55.

153. *Id.* at 353-54.

154. Under the terms of the Chairman/CEO's new contract, his base contract was unchanged, but a consulting agreement granted him an additional $50,000 per year for five years upon the termination of his employment. The

Even after learning these facts, the board unanimously approved the tender offer, stock option agreement offered to the largest shareholders on the board, the director's finder's fee and, the Chairman/CEO's new employment contract.[156]

In analyzing the case, the Supreme Court of Delaware identified the factors that are to be considered when determining director liability and remanded for further consideration of this question.[157] In *Cede III*, the Supreme Court of Delaware again reviewed the Chancery court's analysis and agreed with its determination that even though a Plaintiff has successfully rebutted the presumption afforded to management by the business judgment rule, personal liability is not established *per se*.[158] Rather, these circumstances require the court to conduct a separate analysis of whether the director breached his or her fiduciary duties. Under this separate analysis, the relevant question becomes whether the director in question was actually affected by the financial interest he held in the outcome of the tender offer.[159] The two-part test designed to answer this question focused on the materiality of a director's self-interest to the given director's independence,[160] and the impact of any such self-interest on the collective independence of the board.[161]

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new contract also guaranteed his salary for the full term of the contract even if he later decided to leave the company. *Id.* at 355 n.14.

155. *Id.* at 355.

156. *Id.* at 357.

157. *Id.* at 361-73. The Supreme Court of Delaware determined that it was necessary for the trial court to examine the impact of certain factors on this question such as: (1) the impact of Del. Code § 144(a); and (2) the supermajority provision of Technicolor's charter. *Id.* at 366.

158. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 [*hereinafter* "Cede III"] (*citing Cede II*, 634 A.2d at 367, 371).

159. *Id.* at 1167.

160. *Id.* (citing *Cede II*, 634 A. 2d at 363). The Supreme Court stated, "[t]he Court of Chancery reasoned that the logical alternative was a subjective 'actual person' standard. We agree."

161. *Id.* at 1168. Now satisfied that the Chancery Court had properly considered the relevant factors, the Supreme Court agreed with it's determination "that a material interest of 'one or more directors less than a majority of those voting' would rebut the application of the business judgment rule if the plaintiff proved that 'the interested director *controls* or *dominates* the board as a whole or [that] the interested director *fail*[ed] to disclose his interest in the transaction to the board *and* a reasonable board member

The Supreme Court agreed with the Chancery Court's analysis on the question of whether the side agreement was material enough to impair the conflicted director's judgment, rather than the judgment of a fictitious "reasonable person."[162] Among other things, the Chancery Court examined whether the conflicted director had "some special characteristic that [made] him . . . especially susceptible to or immune to opportunities for self-enrichment or . . . evidence that [any of such directors] in fact behaved differently in this instance than one would expect a reasonable person in the same or similar circumstances to act."[163] While the court ultimately found that some directors did, in fact, have their judgment impaired, it was not enough to taint the entire board.[164] In short, the court validated the tender offer and merger on the grounds that a majority of the directors were motivated to promote the best interests of the stockholders.

In addition to providing an outline of how fiduciary duty claims will be analyzed in the face of a side agreement, the *Cede* cases demonstrate that the transgressions of an interested director may, under more serious circumstances, be enough to taint the entire board. Finally, the *Cede* cases demonstrate the benefits of using a functional standard of review in the tender offer context. After clarifying the two-part liability test in *Cede II*, which was endorsed in *Cede III*, the Delaware Supreme Court stated "that the question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case."[165] The court further reasoned that "a trial court must have flexibility in determining whether an officer's or director's interest in a challenged board-approved transaction is sufficiently material to find the director to have breached his duty of loyalty and to have infected the board's decision."[166]

would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.'" *Id.*

162. *Id.* at 1167.

163. *Id.* (citing *Cede III*, 663 A.2d at 1151-52) (emphasis in original).

164. *Id.* at 1167-68.

165. *Cede II*, 364 A.2d 345 at 364.

166. *Id.*

2. *The Duty to Disclose*

Another fiduciary protection given to shareholders is the duty of full and fair disclosure. Under Delaware law, for example, directors have a fiduciary obligation to disclose fully and fairly all material information within their control.[167] According to the Supreme Court, a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[168] Under this definition, there is no doubt that investors will consider exorbitant side agreements to be "material." Therefore, even if the SEC decides not to adopt any of the recommendations listed above, directors should make sure that shareholders thoroughly understand any personal interest they have in relation to a tender offer.

Violations of the duty to disclose material facts are serious and can result in liability without the plaintiff having to show reliance, causation or actual monetary damages. Generally, the directors have the initial burden of proving that they provided "complete disclosure."'[169] In *Smith v. Van Gorkom*,[170] the Supreme Court of Delaware found certain target directors liable for damages after concluding that they violated their duty of disclosure by hastily endorsing a tender offer without making an effort to secure and provide shareholders with material information. Among other things, the court focused on the "adequacy" and "completeness" of the information the board received.[171] The court found that the board's failure to disclose certain facts, including a description of what facts they did not have, was material.[172] As a practical matter, directors may not always be forthcoming about the interest they hold in a given transaction. If a director refuses to disclose the terms of a side agreement or if the board has failed to thoroughly

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167. *Cede III*, 663 A.2d at 1163 n.10; Smith v. Van Gorkom, 488 A.2d 858, 889-90 (Del. 1985).

168. TSC Industries Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (proxy-solicitation context). *See also* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (adopting *TSC Industries* standard for the § 10(b) and Rule 10b-5 context).

169. Stroud v. Grace, 606 A.2d 75, 89 (Del. 1992).

170. *Van Gorkom*, 488 A.2d 858 (Del. 1985).

171. *Id.*

172. *Id.* at 890-93.

investigate a director's interest in a tender offer, then it should disclose that information. In other words, shareholders find it "material" to have facts that reveal what a board does and does not know.

Fraud Protection

Finally, aggrieved shareholders also have standing to sue for both damages and injunctive relief if they have tendered their shares on the basis of false and misleading information.[173] Shareholders can pursue these suits under Section 14(e)[174] or Rule 10b-5.[175] Under Rule 10b-5, a breach of fiduciary duty under state law, by itself, is not enough to establish liability.[176] Rather, plaintiffs must also show that some type of material misrepresentation or omission accompanied the breach of fiduciary duty.[177] Above that, plaintiffs will also need to demonstrate that the directors' actions were conducted with scienter (e.g. that the directors had the intent to deceive the shareholders when the act or omission occurred), that the shareholders relied on these representations in deciding whether to tender their shares, and that the decision was a substantial factor in causing their loss.[178]

V. CONCLUSION

There is a lot of work that must be done before tender offers will one again become popular acquisition vehicles. While the integral part test fits best with the investor protec-

173. *See* Piper v. Chris-Craft Industries, 430 U.S. 1 (1977).

174. Section 14(e) of the Securities Exchange Act prohibits material misstatements, misleading omissions, and fraudulent or manipulative actions in connection with a tender offer or any solicitation for or against it. 15 U.S.C. § 78n(e) (2002). Section 14(e) mirrors Rule 10b-5 with the exception of the requirement that the fraud be perpetrated "in connection with the purchase or sale of a security." 17 C.F.R. § 240.10b-5 (2005).

175. Section 10(b) of the 1934 Act makes it unlawful "to use or employ . . . and manipulative or deceptive device" in contravention of SEC rule, in connection with the purchase or sale of any security. The rule most commonly used in conjunction with Section 10(b) is Rule 10b-5.

176. Santa Fe Industries v. Green, 430 U.S. 462 (1977).

177. *Compare* Biesenbach v. Guenther, 588 F.2d 400 (3d Cir. 1978) (citing Santa Fe Industries v. Green, 430 U.S. 462 (1977)).

178. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

tion purpose of the Williams Act, steps must be taken to give bidders the comfort and certainty they need to conduct tender offers without fear of expensive and time consuming litigation. In short, Rule 14d-10 requires a delicate balance between shareholder protection and shareholder value. If the SEC continues to remain silent on this issue, the judicial conflict will continue to discourage bidders from using tender offers altogether. The recommendations provided above are intended to demonstrate the wide range of possibilities that are available to the SEC for consideration. Regardless of which approach the SEC ultimately takes, shareholders will continue to be protected against directors and officers who abdicate their fiduciary duties and rely on side agreements as a mechanism for obtaining a premium for their shares.