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STRUCTURING TRANSACTIONS OUTSIDE ALL HOLDERS/BEST PRICE RULE

Mark Khmelnitskiy*

INTRODUCTION

Two-tier, front-loaded, all-cash, first-come, first-serve tender offer for 51% of stock, with a subsequent junk bonds squeeze-out of the second-step merger was a popular tactic for making a tender offer in the laissez-faire, caveat emptor era before the regulations of tender offers were introduced.1 This outrageously unfair, nevertheless lawful, method of coercing shareholders to tender their shares was finally prohibited by Congress in the Williams Act and by the subsequent rules of the Securities and Exchange Commission (SEC).2 However, the broad application of the established rules infringes on many lawful and frequently necessary transactions, exposing acquiring companies to liability and unexpected expenses.3

Such transactions, usually consummated at the time or around the time of the tender offer, include retaining the target company's

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management, securing non-competition promises from the target company’s departing employees, purchasing the target company’s patent and licensing rights and other similar agreements, necessary for successful operation of the acquired business. Those transactions create additional payments outside of the tender offer and may violate SEC Rule 14d-10, known as the All Holders/Best Price Rule. The Rule provides that a tender offer must be open to all holders of the security and that each holder must be paid the “highest consideration paid to any other security holder during such tender offer.” Under the broad application of Rule 14d-10, a side transaction would be included in the tender offer, which could increase the price offered to specific shareholders who are parties to the side agreement. This would constitute a violation of Rule 14d-10 and significantly increase the amount of the tender offer, causing additional expenses to the acquirer.

While the provisions of Rule 14d-10 addressed the original purpose of protecting security holders from coercive tender offers, within the past decade, Rule 14d-10 has been invoked as a sword to invalidate agreements made in conjunction with tender offers, or make the agreements a part of the tender offers. These agreements, although frequently conferring various benefits upon key employees and management, who are usually large security holders, nevertheless do not

4. See, e.g., Michael A. Hiltzik, Boardroom Battle Raged Over Times-Tribune Deal, L.A. TIMES, Mar. 22, 2000, at C1 (discussing the appropriateness of executive compensation to Times Mirror CEO Mark Willes in the context of a tender offer); Rita Ciolli & Pradnya Joshi, Deal's Silver Lining/ Times Mirror CEO to Get Going-Away Package, NEWSDAY, Mar. 22, 2000, at A57 (covering the same news story); Susan Chandler, Sears Not Alone in Pursuit of Lands' End; French Firm PPR the Likely Rival, CHI. TRIB., May 23, 2002, at 1 (confering the news of target executives compensation by the acquirer); Jonathan Berr, Litton Executives to Get $45.9 Mln Payment after Northrop Buy, BLOOMBERG NEWS, Feb. 1, 2001, at 6:56 PM EST (reporting that target executives will receive a large payment for stocks and options after the target is taken over).


7. See Walther, supra note 3, at 787.

8. Id.

9. See id. at 777 n.11.
constitute a greater consideration for the tendered securities. The courts, however, have entertained allegations that such agreements violate Rule 14d-10 and created controversy in interpreting payments and promises made near, or in relation to, tender offers.

The courts, when examining tender offers with side agreements that potentially violate Rule 14d-10 have come to varying conclusions, and use various methods to differentiate between the lawful and unlawful transactions. This legal uncertainty makes the option of a tender offer less attractive, eventually harms the security holders, acquirer and target companies and ultimately frustrates the concepts of efficient free market economy and rational allocation of resources. Clearly, in order to engage in tender offers in the future, companies will require precise guidelines as to what conduct and transactions made during a tender offer will not violate Rule 14d-10.

The first section of this paper will examine the range of transactions that acquirers enter with key employees, executives and other large security holders of target companies, the varying factual and legal circumstances surrounding these transactions and the treatment of such transactions before and around the time Rule 14d-10 was promulgated. The second part will focus on recent court decisions examining transactions made in connection with tender offers, illuminate the tests that courts established to interpret such agreements, distinguish the different approaches that the courts employed and discuss the effects of these decisions on the practice of tender offers. Finally, the last part of

10. See Kramer v. Time Warner, Inc., 937 F.2d 767 (2d Cir. 1991) (holding that the large payment to target’s executives was not made pursuant to a tender offer).


13. See Walther, supra note 3, at 804–05 (discussing some economic issues associated with tender offers).

14. See id. at 807 (proposing that a refinement of existing law will promote efficiency).
this paper will recommend some guidelines for companies to structure future transactions to avoid potential violations of Rule 14d-10.

I. BACKGROUND

A. Various Transactions in Relation to a Tender Offer

There are various reasons for an acquirer to make a tender offer, ranging from a takeover effort to a large investment interest.\(^\text{15}\) Furthermore, in a takeover bid, the acquirer can be interested in reorganizing the target company, dissolving it, selling or transferring some or all of its assets or merely modifying the way the company operates.\(^\text{16}\) In pursuit of these various interests, the acquirer might also have to enter into additional transactions and agreements with target’s key employees, management or business partners.\(^\text{17}\) These transactions could also be prompted by unique target company-specific long-term contracts, indentures for outstanding debt issued by the target, by-laws clauses and any other restrictions which might require payment of cancellation, break-up or satisfaction fees.\(^\text{18}\)

The most common transaction is when the acquirer retains incumbent directors, executive officers or key employees to run the target company even after the acquisition.\(^\text{19}\) The acquirer often provides incentives in the form of an increased salary, promise of a large sign-on (continuation) bonus, additional securities or stock options, promotion to higher management positions and other tangible and intangible benefits.\(^\text{20}\) Those benefits can come as an immediate lump sum or be

\(^{15}\) See generally id.

\(^{16}\) See id. at 805 (explaining various reasons for acquirer to enter into different transactions with target’s shareholders).

\(^{17}\) See William J. Altier, A Method for Unearthing Likely Post-Deal Snags, MERGERS & ACQUISITIONS, Jan./Feb. 1997, at 33 (examining the motives for entering into various employment agreements with target’s employees).

\(^{18}\) See Hiltzik, supra note 4 (describing restrictions imposed on the target’s largest shareholder by other obligations).

\(^{19}\) See ARTHUR H. KROLL, COMPENSATING EXECUTIVES 214–16 (1998) (explaining the use of golden parachutes as incentives to retain employees).

\(^{20}\) See, e.g., Epstein v. MCA, Inc., 50 F.3d 644, 659 (9th Cir. 1993) (discussing the legality of the incentive payment); Katt v. Titan Acquisition Ltd., 133 F. Supp. 2d 632, 636 (M.D. Tenn. 2000) (providing incentives for employment termination); In re
spread over a long term of anticipated employment relationship. The challenge to such transaction stems from the allegation that in reality it is merely an inducement to tender shares in response to the general tender offer.

Another common transaction is a non-competition agreement with departing employees or management. These transactions become particularly relevant in technology and scientific industries, although potentially could apply even to a company making cereals. The scope and format of these agreements is standard in the business environment, and would involve a promise not to engage in any competing activity in return for some consideration. Such agreements are reviewed when the non-competition agreement accompanies a tender of a significant holding of securities, and the agreement is merely a vehicle to offer greater consideration for securities.

Similarly, patent-rights transfers, licensing agreements and contracts with existing business partners become potential violations of Rule 14d-10 when the parties to the agreement are also large security holders of target's securities. In this scenario, the acquirer would ask a distribution company, which is a target stockholder, to extend the contract with the target after consummation of the tender offer. This transaction would fall under review when there is an allegation that the extended contract is merely additional consideration to induce the


21. Compare Epstein, 50 F.3d at 659 (a large tax-free lump payment to a retiring executive) with Katt, 133 F. Supp. 2d at 636 (a bouquet of various short and long term employment incentives).

22. See Walther, supra note 3, at 802 (describing view of side employment contracts as additional compensation for a tender offer).


25. See Gerber, 303 F.3d at 136 (explaining that the court admitted evidence of the non-compete agreement after reviewing evidence of other similar agreements).

26. See id. (reviewing the legality of tender payments).

27. See Lerro v. Quaker Oats Co., 84 F.3d 239, 240 (7th Cir. 1996) (examining a transaction between the acquirer and target's major distributor, owned by target's shareholder).

28. See id.
participation in the tender offer. All of these transactions, and potentially many others, are triggered by conditions and events that take place at the time or around the time of a tender offer, and both the acquirer and the target must respond to these conditions or events by entering into various agreements, promises and payments.

The scenarios for such transactions are very diverse and fact intensive. Analysis requires an in-depth review of the facts surrounding each transaction, as well as extensive information about the target and acquirer companies, to understand the true motives behind each transaction. Only a close examination of the past and emerging rights and obligations, pre-offer compensation packages and operations of the companies will enable one to properly classify the transaction and distinguish it from other agreements, made in conjunction with pending tender offers and potentially violating Rule 14d-10.

**B. Treatment of Transactions Outside of Tender Offers Before Rule 14d-10**

Before Congress passed the Williams Act, tender offers were a popular method of corporate takeovers, because of little regulation and the coercive advantage that acquirers could exercise over target shareholders to obtain shares at a considerable discount. It was a common practice to make a tender offer for less than 100% of the outstanding stock and threaten with a subsequent squeeze-out at a lower price to cause shareholders to panic and tender their shares in response to the offer. Further, with an opportunity to incrementally increase the consideration offered for tendered shares, the acquirer could start with a low price and continue to gradually increase it until the entire offer

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29. *Id.*
30. *Id.*
32. *See id.* at 944 (articulating a test which “scrutinizes such [transactions] in the context of various salient characteristics of tender offers”).
33. *See id.*
35. *See id.* at 35 (emphasizing that the purpose of the Williams Act was to provide investors with adequate information necessary to respond to a tender offer).
would fill up.\textsuperscript{36} Considering that shareholders did not know the rate at which the offer was filling up at any price mark, and they had an imminent danger of losing any premium if the offer was closed, the average shareholders often tendered their shares at deflated prices.\textsuperscript{37} In the legal environment where tender offers were largely unregulated, acquirers could enter into any side transactions that would bring about a less expensive tender offer.\textsuperscript{38}

II. RULE 14D-10 AND RECENT COURT DECISIONS

\hspace{1.5em} \textit{A Rule 14d-10}

On this background of legal leniency and lack of supervision of side transactions, the Delaware Supreme Court was finally faced with a borderline transaction involving an offer that was not open to all shareholders.\textsuperscript{39} Following the established path, the court examined the transaction against the background of governing state law, and failed to consider the implications of Section 14(d)(7), of the Securities Exchange Act, as amended.\textsuperscript{40} The transaction involved a company’s selective offer to purchase its own outstanding shares at a premium price.\textsuperscript{41}

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\textsuperscript{36} See Jacobs v. G. Heilman Brewing Co., Inc., 551 F. Supp. 639 (Del. Dist. Ct. 1982) (stating that parties making competing tender offers may incrementally increase consideration while the tender offer remains open).

\textsuperscript{37} See Hanson Trust v. SCM Corp., 774 F.2d 47, 55 (2d Cir. 1983) (explaining that without proper information, investors could not make rational decisions).

\textsuperscript{38} See Walther, supra note 3, at 780–81 (explaining that bidders could enter into special agreements with certain shareholders to purchase shares at a premium without increasing the tender offer price to all shareholders).

\textsuperscript{39} See Unocal v. Mesa Petroleum Corp., 493 A.2d 946, 953 (Del. 1985) (examining appropriateness of an exchange offer discriminating against one shareholder under the “business judgment rule,” and not applying the Williams Act).

\textsuperscript{40} 15 U.S.C. § 78n(d)(7) (2002) provides:
Where any person varies the terms of a tender offer or request or invitation for tenders before the expiration thereof by increasing the consideration offered to holders of such securities, such person shall pay the increased consideration to each security holder whose securities are taken up and paid for pursuant to the tender offer or request or invitation for tenders whether or not such securities have been taken up by such person before the variation of the tender offer or request or invitation.

\textsuperscript{41} See Unocal, 493 A.2d at 953 (stating that Delaware law allows a corporation to deal in its own stock).
was a defensive measure in response to a threat of a hostile takeover by one of the largest shareholders. The offer was structured in such a way that it excluded the hostile shareholder, while inviting all the other shareholders to tender their shares for a significant premium. The court examined the validity of the transaction under state corporation law and upheld the transaction as a proper and adequate exercise of the Business Judgment Rule.

The SEC immediately responded to that decision by issuing Rule 14d-10, which substantially redefined Section 14(d)(7), and specifically provided that: "(i) a tender offer must be extended to all holders of the class of securities which is the subject of the offer (the "all holders requirement"); and (ii) all such holders must be paid the highest consideration offered under the tender offer (the "best-price rule")."

In the ensuing release, the SEC provided a detailed explanation for the reasons and purposes of Rule 14d-10, as well as provided a preview of what the future application of the Rule would be. The SEC’s position was that the All Holders/Best Price "requirements further the purposes of the Williams Act by assuring fair and equal treatment of all holders...". In fact, the SEC explicitly stated that Rule 14d-10 is necessary to avoid the practice of discriminatory tender offers, and that Congress did not intend to "permit such selective protections of target company security holders."

The SEC’s basis for the All Holders portion of the rule is inferred from Congress’ “understanding that all security holders were to have the

42. See id. at 954.
43. See id. at 958 (holding that a corporation does not have to include the shareholder who is causing the threat in a beneficial repurchase offer).
44. Id. The court examined the offer against the state corporate laws and concluded that the transaction was an appropriate response to a correctly identified threat.
46. See Ebert, supra note 2, at 683 (quoting 17 C.F.R. § 240.14d-10 which provides Rule 14d-10).
47. See Amendments to Tender Offer Rules; supra note 45.
48. Id.
49. Id. at 25,875.
50. Id.
opportunity to participate in a tender offer.\textsuperscript{51} Further, the SEC concluded that while a tender offer could be for less than all the securities of a specified class, the offer must be available to all security holders.\textsuperscript{52} Coupled with Section 14(d)(7), which provided for the highest consideration to all tendering security holders, the SEC formulated the All Holders/Best Price Rule in its current format.\textsuperscript{53} It should be noted, though, that the SEC recognized the "statutory purpose of investor protection . . . in a neutral manner" and while drafting the Rule "avoided favoring either management or the takeover bidder."\textsuperscript{54} In light of this, the SEC explained that while the consideration offered for the securities may vary in type and does not have to be "equivalent in value," the security holders should be able to choose the consideration they prefer.\textsuperscript{55}

Rule 14d-10 was issued in response to a transaction that fell outside of the scope of Section 14(d)(7) and enabled the party making the tender offer to discriminate against a specific shareholder while favoring the others.\textsuperscript{56} It was evident that the SEC took a position that all transactions in connection with a tender offer must treat all target company security holders equally.\textsuperscript{57} Therefore, Rule 14d-10, effectively alleviated the threat of disparate and inequitable treatment of specific target security holders, which actually prompted the establishment of the Rule.\textsuperscript{58}

Rule 14d-10 was drafted very broadly specifically to reach the garden variety of discriminatory transactions and undermine the practice of such transactions.\textsuperscript{59} However, many legitimate and appropriate transactions in connection with tender offers also invoked application of Rule 14d-10 and exposed the parties to liability under Federal Securities

\textsuperscript{51} Id. (citing 15 U.S.C. section 78n(d)(1) and 15 U.S.C. section 78n(d)(6) which provide Sections 14(d)(1) and 14(d)(6) of the Williams Act).

\textsuperscript{52} Id. (citing 15 U.S.C. section 78n(d)(6) which provides Section 14(d)(6) of Williams Act).

\textsuperscript{53} It should be noted that Rule 14d-10 has never been amended. See 17 C.F.R. § 240.14d-10 (2002).

\textsuperscript{54} See Amendments to Tender Offer Rules, supra note 45.

\textsuperscript{55} See id.; cf. 17 C.F.R. § 240.14d-10 n.47

\textsuperscript{56} See Amendments to Tender Offer Rules, supra note 45; cf. 17 C.F.R. § 240.14d-10 n.75.

\textsuperscript{57} See 17 C.F.R. § 240.14d-10 (providing Rule 14d-10).

\textsuperscript{58} See Amendments to Tender Offer Rules, supra note 45; cf. 17 C.F.R. § 240.14d-10 n.3.

\textsuperscript{59} See Amendments to Tender Offer Rules, supra note 45.
laws. Under Rule's broad application, any side agreement that involved a shareholder and the party making a tender offer would constitute a payment of additional consideration. Employee-retaining contracts and non-competition agreements started to fall in the risk zone of violating Rule 14d-10 and increasing the overall price of the tender offer. The companies found themselves in the dire straits where a sound business decision would invalidate an equally sound tender offer and vice versa.

Promulgating Rule 14d-10, the SEC failed to recognize its overbearing drastic effect on legitimate transactions. However, as was said above, those transactions were not the focus of the SEC when the Rule was drafted, and the transactions did not come into focus until years later. Only starting in the early nineties, due to the rapid growth of economy and fast technological advances, the companies did begin to enter into non-competition and future-employment agreements with target's key employees and managers. Further, due to an increasingly popular practice to reward employees with company stock and stock options, key employees and managers also accumulated large holdings of company's shares. Therefore, regardless of its legitimacy, any side transaction between an acquirer and target's employees or managers potentially violates the All Holder/Best Price requirements of Rule 14d-10.

**B. Judicial Interpretation of Side Transactions in Relation to Tender Offers**

Absent any specific language discussing the broad application of Rule 14d-10 or Section 14(d)(7), courts were called upon to interpret

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60. *See generally* Ebert, *supra* note 2; Walther, *supra* note 3.
63. *See* Walther, *supra* note 3, at 778 n.12 (“In fairness, the problem has only recently come to light . . . and only a handful of circuits (the Second, Seventh, and Ninth Circuits) have ruled on the precise issue.”).
64. *Id.* at 775–78 (discussing post merger employment issues that have arisen since the adoption of 14d-10).
65. *See* Berr, *supra* note 4 (describing such payments as common).
66. *See* Ebert, *supra* note 2, at 687 (asserting that “the securities laws should be interpreted liberally to reflect their remedial purposes”).
legitimacy of side transactions.\textsuperscript{67} Unable to come to a uniform conclusion, circuits developed two methods to apply Rule 14d-10 to side transactions.\textsuperscript{68} The first method focuses on the functionality and role of the transaction in the underlying tender offer.\textsuperscript{69} The other method promotes a formal approach of establishing specific guidelines for the timing of tender offers and examining side transactions with respect to this timeline.\textsuperscript{70}

While professionals are concerned about the legal uncertainty of interpreting legitimate side transactions in the context of tender offers, academics are not satisfied with any of the proposed methods.\textsuperscript{71} The “functional” approach invites courts to closely examine each transaction and scrutinize every fact.\textsuperscript{72} Clearly, this will enable many claims to survive the Summary Judgment stage and proceed to trials, potentially exposing acquiring companies to erroneous jury verdicts or large settlements.\textsuperscript{73} At the same time, the “formal” approach will provide explicit guidelines and enable companies to avoid the application of Rule 14d-10,

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{67} See Walther, \textit{supra} note 3, at 791 (discussing judicial application of the “integral part analysis and the legitimacy of various side transactions”).
\item \textsuperscript{68} There are actually three distinct methods, but two of them can be united under the term ‘functional.’ For more information about the difference between the ‘functional’ and ‘integral part’ tests, see Ebert, \textit{supra} note 2, at 687–95.
\item \textsuperscript{69} See Field v. Trump, 850 F.2d 938, 943–44 (2d Cir. 1988); Epstein v. MCA, Inc., 50 F.3d 644, 657 (9th Cir. 1993).
\item \textsuperscript{70} See Lerro v. Quaker Oats Co., 84 F.3d 239, 244 (discussing the need for bright line guidelines when large amounts of money are at stake).
\item \textsuperscript{71} Compare Ebert, \textit{supra} note 2, at 688–95 (debating the merits of different methods for analyzing tender offers) with Walther, \textit{supra} note 3, at 784 (discussing how the functionalist approach is over inclusive).
\item \textsuperscript{72} See Field, 850 F.2d at 944 (noting that transactions near the time of a tender offer may be of great importance to shareholders); \textit{Epstein}, 50 F.3d at 654 (discussing how determining if a transaction violates Rule 14(d)-10 depends on the consideration given, and whether the transactions constituting consideration occur within the tender offer period).
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even structuring illegal transactions.\textsuperscript{74} As was correctly summarized by one of the observers, "the underinclusiveness of the formalist approach mirrors the overinclusiveness of the functionalist approach."\textsuperscript{75}

\textbf{1. The "Functional" Method}

Initially, the functional method was established to determine the legality of a private stock purchase made in the time period between a withdrawn and a subsequently resubmitted tender offers.\textsuperscript{76} The trial court dismissed the complaint reasoning that Rule 14d-10 did not govern transactions not made pursuant to a tender offer.\textsuperscript{77} The Second Circuit determined that the Rule would be handicapped if acquirers could withdraw tender offers, negotiate private agreements with selected security holders, and announce subsequent, less valuable, tender offers.\textsuperscript{78} To determine the applicability of Rule 14d-10, the court closely examined the transaction and concluded that, in fact, the second tender offer constituted the continuation of the withdrawn offer, and therefore, the private agreement violated Rule 14d-10.\textsuperscript{79}

While the conclusion of the court was certainly warranted under the facts of the case, the court established a broad functional method, which invited courts to scrutinize every transaction on a case-by-case basis.\textsuperscript{80}


\textsuperscript{75} Id. at 779.

\textsuperscript{76} See Field, 850 F.2d at 942 (noting that the functional method scrutinizes various characteristics of tender offers, while also considering the purposes of the Williams Act).

\textsuperscript{77} See id. (explaining that the court dismissed for failure to state a claim under 14(d)(7)).

\textsuperscript{78} Id. at 944.

\textsuperscript{79} See id.

\textsuperscript{80} See, e.g., Epstein v. MCA, Inc., 50 F.3d 644, 655 (9th Cir. 1995) (discussing the importance of examining transactions near the tender offer to determine if there is a statutory violation); Gerber v. Computer Assocs. Int'l., Inc., 303 F.3d 126, 132 (2d Cir. 2002) (the court concluded that a press release constituted a tender offer, and conditions arising after the press release did not prevent the press release from marking the commencement of the tender offer period); Kramer v. Time Warner, Inc., 937 F.2d 767, 773 (noting that the court took notice of documents surrounding the complaint even though they were not exhibits to the complaint); Kahn v. Va. Ret. Sys., 13 F.3d 110 (4th Cir. 1993) (where the court examined a press release as a transaction surrounding a tender offer).
While the court failed to establish any specific guidelines or characteristics that would distinguish legitimate transactions from those violating Rule 14d-10, the only standard that the court articulated involved an analysis of the acquirer’s intentions in the “surrounding circumstances” and the function that the transaction achieves.\(^8\)

The subsequent application of the functional approach, absent a defined structure of factors to examine transactions under Rule 14d-10, led courts to even greater uncertainty.\(^8^2\) Unable to rely on or formulate a more a definite standard, courts struggled to distinguish between legitimate and improper transactions.\(^8^3\) In one instance, the Second Circuit determined that a transaction, in which the executives’ stock options were cashed out at a higher price immediately before the second step of the two-step merger was not a part of a tender offer and did not invoke application of the Best Price Rule.\(^8^4\) The court came to this conclusion after closely examining the transaction and finding that the payment of a higher premium for the options took place five months after the tender offer and was made by the target company and not by the acquirer.\(^8^5\) However, the court could have come to a diametrically opposite conclusion, if instead it focused on the fact that the premium payments were specified in the original merger agreement, which initiated the tender offer.\(^8^6\) Thus, the fluid functional approach, which required the courts to examine the intent and circumstances of each transaction in question, nonetheless failed to provide any definite factors or characteristics to determine the legitimacy of a side transaction.\(^8^7\)

The Second Circuit continued to struggle with the functional method interpreting a non-competition agreement between the acquirer

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81. See Field, 850 F.2d at 943.
82. See Epstein, 50 F.3d at 654–56.
83. Id. at 658.
84. See Kramer, 937 F.2d at 776 (where the court determined an action did not invoke application of the best price rule based on an examination of related documents bearing on the adequacy of disclosure and documents alleged to contain misleading statements).
85. Id.
86. Id. at 779.
87. See Epstein, 50 F.3d at 656 (holding that the court understood the necessity of examining factors beyond whether or not the transaction was a private placement, and the court still failed to determine illegality).
and the target’s CEO.\(^8\) The court, again, closely examined the transaction and upheld the jury’s verdict in favor of the plaintiff shareholder, finding that the non-competition agreement in part constituted additional consideration paid to the target CEO in connection with a tender offer.\(^8\) The panel aggregated the additional payment with the tender offer largely on technical grounds of the timing of the offer and non-competition agreement.\(^9\) Nonetheless, while the court cited witness testimony when finding that the compensation under the non-competition agreement was derived “by “intuition” without any “mathematic analysis,”\(^9\) there is a possibility that a properly structured and accounted non-competition agreement would withstand the court’s scrutiny.\(^9\)

A more specific form of a functional approach was established by the Ninth Circuit, which determined that a transaction must play an integral part in the tender offer to invoke the all-holders, best-price Rule.\(^9\) While professing to use a more precise functional test, the court examined the role that the transaction was given by the acquirer and whether that role was integral to the making of, or contingent on the success of the offer.\(^9\) Yet, in search of definite factors, the court singled out the very factors that usually become the terms in any side agreement, where the acquirer wants to secure shareholder’s future employment.\(^9\) Similarly, in a subsequent case involving a promise to grant additional

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8. See Gerber v. Computer Assocs. Int’l, Inc., 303 F.3d 126, 131 (2d Cir. 2002) (describing that the court had to decide whether the payment to the CEO was for company shares, for an agreement not to compete, or a combination of both).
9. Id. at 137.
10. Id. at 133.
11. Id. at 138.
12. See id. at 137–38. Because the court based its decision on the imprecise manner in which the amount of compensation had been determined, the case leaves open the possibility that compensation clearly tied to a valid goal will not violate the all-holders, best-price Rule.
13. See Epstein v. MCA, Inc., 50 F.3d 644, 656 (9th Cir. 1995), rev’d on other grounds, 516 U.S. 367 (1996) (determining that the transaction was indeed integral in that the subsequent loans were conditioned on terms of the public tender offer).
14. See id. at 656 (showing that the loan agreement and the tender offer differed only in the type of consideration, making the transaction in violation of Rule 14d-10(e)(1)).
15. See id.; see also Shearman & Sterling, supra note 73 (discussing the difficulty of distinguishing the arrangements made for legitimate business reasons from illegal additional compensation).
stock options to target's employees, the court refused to dismiss the
claim that the promise constituted a larger consideration for tendering
target's stock.\(^\text{96}\) In the more recent cases, two district courts followed
the same method, and concluded that transactions involving payments or
promises made to target's key employees were made in connection with
tender offers and violated Rule 14d-10.\(^\text{97}\) In the first case, the court
decided that the agreements were integral to the tender offer because
they explicitly relied on the success of the offer, despite the fact that the
agreements were made a few months before the tender offer was
announced.\(^\text{98}\) In the second, the stock options to target executives were
granted by the target more than a month in advance of the acquisition,
but were nonetheless considered an integral part of the tender offer and
violated the all-holders, best-price Rule.\(^\text{99}\)

Overall, the functional approach was established to provide a
substantive basis to application of Rule 14d-10 to side transactions in
connection with tender offers.\(^\text{100}\) However, while inviting courts to
examine transactions on a case-by-case basis, both the Second and the
Ninth Circuits failed to articulate any definite factors that would distinguish
legitimate transactions from mere efforts to escape Rule 14d-10.\(^\text{101}\)

\(\text{96. See Perera v. Chiron Corp., 1996 U.S. Dist. LEXIS 22503 (N.D. Cal. May 8,}
\text{1996) (holding that Rule 14d-10 prohibits unequal treatment of shareholders in}
\text{connection with a tender offer).}

\(\text{97. See Katt v. Titan Acquisition Ltd., 133 F. Supp. 2d 632, 644 (M.D. Tenn. 2000)
(showing that the court prohibits making a deal more appealing to certain investors at}
the possible expense of others); Millionerrors Inv. Club v. GE, P.L.C., 2000 U.S. Dist.
LEXIS 4778, at *5 (W.D. Pa. Feb. 8, 2000) (examining the fact that shareholder value
was diminished in the form of cashed-out options going to the directors that was
rightfully theirs).}

\(\text{98. See Katt, 133 F. Supp. 2d at 644–45 (holding that the rule would not have been}
violated provided that the terms were not contingent on one another).}

\(\text{99. See Millionerrors Inv. Club, 2000 U.S. Dist. LEXIS 4778, at *5 (describing the}
inequity associated with the fact that the options received by executives caused them to
receive a better price than the shareholders, which is violation of the rule).}

\(\text{100. Epstein v. MCA, Inc., 50 F.3d 644, 652–53 (9th Cir. 1995), rev'd on other}
grounds, 516 U.S. 367 (1996) (describing that Rule 14d-10 was created to forbid}
discrimination among shareholders).}

\(\text{101. See Shearman & Sterling, supra note 73, at 3 (criticizing the Katt court for}
failure to articulate any definite guidance and implication that any employment}
agreement will violate Rule 14d-10).\)
2. The "Formal" (Bright-Line) Method.

The formal method of interpreting Rule 14d-10 is dramatically different from the functional method, in that it does not examine the facts surrounding the transaction in question and the tender offer, but merely looks at the plain language of Rule 14d-10. Consequently, transactions that do not fall under direct application of Rule 14d-10, namely transactions not made "during or pursuant" to a tender offer, are deemed appropriate. This standard was devised to validate a private stock purchase transaction, which was commenced before the tender offer was made. This standard has been followed to validate private stock purchase transactions that were commenced before the tender offer was made. The Fourth Circuit reasoned that integrating the transaction with the tender offer would substantially destroy any definite notion of when the tender offer commences. Concluding that the purposes of Rule 14d-2(c) would be frustrated if notions of "during or pursuant" to a tender offer were interpreted loosely, the court found the transaction to be outside of the scope of the rule. While the court’s reasoning clearly warranted the decision in this case, the court followed a test that practically endorsed discriminatory transactions, so long as they fell outside of formal tender offers.

This approach was later followed by the Seventh Circuit, which ruled that a transaction between an acquirer and target’s largest distributor, which incidentally was controlled by a large target shareholder, also did not fall within Rule 14d-10, because it did not constitute additional consideration for tendered shares. In deciding this case, the court applied a very narrow formal interpretation of Rule

102. See Lerro v. Quaker Oats Co., 84 F.3d 239, 246 (7th Cir. 1996).
103. Id.
104. See Kahn v. Va. Ret. Sys., 13 F.3d 110, 115 (4th Cir. 1993) (dismissing a case because transactions in question occurred before the date of commencement of the tender offer).
105. See id. at 116 (stating that holding a press release of a proposed transaction not strictly conforming to 17 C.F.R. § 240.14d-2(c) would remove certainty of when a tender offer commences).
106. Id. at 114–15.
108. See Lerro v. Quaker Oats Co., 84 F.3d 239, 243 (7th Cir. 1996).
14d-10, and found that there was no additional payment made to the target's shareholder pursuant to the tender offer. This case involved an unusual transaction, where the acquirer extended target's contract with one of the target's largest distributors. The claim was founded on the fact that the distributor was controlled by target's shareholder, who implicitly received increased consideration for tendering target's shares. The court concluded that the transaction was made prior to the tender offer, but the method that the court applied enables acquirers to structure discriminatory transactions in a way that evades the application of Rule 14d-10, which was specifically designed to reach such transactions.

Failing to recognize the drawbacks of the formal approach, another court dismissed a complaint alleging additional consideration paid in connection with a tender offer. Refusing to examine the transaction itself, the court reviewed the timing of the transaction, the timing of the payment and the time when the tender offer was announced, and concluded that Rule 14d-10 did not apply to the transaction, because the offer was made 20 days after the agreement to grant "Retention and Transition Awards" to certain targets' employees, who also tendered stock.

The formal method followed in a case where the court correctly concluded not to "thin" out the application of Rule 14d to any transactions broadly around a tender offer. However, the subsequent blind application of that method focused on the irrelevant factors of the timing of the offer and left the subject of review, the actual transactions, outside of the examination. While the functional method fails to

109. Id.
110. Id. at 240.
111. Id. at 241–42.
112. See Kahn v. Va. Ret. Sys., 13 F.3d 110, 113 (4th Cir. 1993) (discussing the Williams Act, which added § 14(d) to the Exchange Act; the court stated that the purpose of the Act was to curb the use of cash tender offers to effectuate corporate takeovers).
116. See id.
communicate any factors that would exclude proper and legitimate transactions from application of Rule 14d-10, the formal method provides too much leeway for abusive and discriminatory agreements to escape the review under the rule. "Neither approach carries much hope of tailoring the liability narrowly to the behavior the rule intends to discourage." 117

C. Effects of “Functional” and “Formal” Methods

While the Circuits are entertaining themselves with various methods to interpret Rule 14d-10 and apply the rule to side transactions, the real participants of these transactions are suffering from the legal uncertainty. The varying treatment of outside transactions leads acquirers to select favorable jurisdictions to proceed with the desired transactions, while avoiding the jurisdictions applying the functional method. In fact, despite the commitment of some Circuits to the formal method, there always remains the risk that the court will revisit the issue and decide to adhere to the functional method, articulated by other Circuits.

The effect of the split, therefore, revolves around the functional method and the underlying risks it carries to acquirers entering into side transactions. As the latest decision in the Second Circuit indicated, there are no definite factors that the court will consider in examining the independent validity of a side transaction. 118 Therefore, the court offered no guidance for acquirers on how to structure transactions or which factors to stress to be able to dismiss a complaint before proceeding to discovery. 119 One can certainly understand the reasoning of the court, refusing to provide any specific guidelines, and therefore, enabling a crafty acquirer to bypass them. 120 At the same time, the court is willing to enable meritless claims to proceed through discovery and

117. Walther, supra note 3, at 801 (stating that the formalistic courts are too stringent and dismiss viable claims, while the functionalist courts are too permissive and allow speculative claims to reach discovery).


119. See id. at 134 (unwilling to formulate definite limitations of Rule 14d-10 to avoid potential circumvention).

120. See id. (holding that the court would not create definitive limits of Rule 14d-10).
potentially go to trial. While a reasonably objective jury may find that the majority of claims are meritless, the threat of losing at trial and the fear of enormous liability pressure acquirers to settle the claims for high prices, relative to the merits of the claims.

In addition to the threat of being found in violation of Rule 14d-10, acquirers must also fear the monetary liability that springs from the violation. Under the rule, if a side transaction is found to constitute additional consideration in connection with a tender offer, such consideration must be paid to each tendering security holder. Consider a legitimate non-competition agreement with the target’s founder, CEO and holder of patent rights for $2 million for 5 years. Assume that the tender offer is for $50 per share, and the target’s CEO tenders 5000 shares, which constitute 5% of the outstanding stock. If the non-competition agreement is deemed a part of the tender offer, the CEO receives a premium of $400 for each share over the price of the tender offer. Under Rule 14d-10, the acquirer would have to raise the entire tender offer by this amount, incurring additional expense of $40 million.

Mere exposure to large liability should not protect acquirers from the application of Rule 14d-10. However, the Circuits applying functional method should fashion some guidelines how to approach and review transactions. It could be argued, however, that the courts implicitly communicated some guidelines. For instance, in a variety of cases, the courts applying functional method considered it significant that the outside transaction was conditioned upon success of the tender offer. Also, some courts paid attention to circumstances when the side

121. See Walther, supra note 3, at 795.
122. See id. at 779 (indicating that high damages will force a defendant to settle).
124. See Walther, supra note 3, at 779 (arguing that high damages or the under-inclusiveness of a mechanical test should be disposed of in evaluating a 14d-10 claim).
125. See id. at 785 (indicating that the use of surrounding circumstances and bidder intent is “difficult to apply in a consistent fashion”).
126. See id. at 784 (noting that the formalist and functionalist paradigms allowed judges to come to equitable solutions in disparate factual situations).
agreements were mentioned in the tender offers or merger agreements, or were actually made part of those agreements. At the same time, merely including the outside transaction in the merger agreement was not sufficient to put the transaction within the scope of Rule 14d-10. Interestingly, the very factors that the courts considered indicative of the connection between the transactions in question and tender offers, are the factors usually associated with an employment agreement. Conditioning the agreement on success of the tender offer, disclosing the agreement together with other information about tender offer, and even pegging the future compensation to the price of the offer are all factors in a valid employment agreement. Indeed, the agreement should go into effect only if: 1) the tender offer is successful, 2) the information about this transaction could be considered material and should be disclosed, and 3) employee compensation relates to the well-being of the company, or its stock price. Courts applying functional method frequently paid little attention to the actual intent of the transacting parties, leaving this conclusion to the jury or inviting the parties to settle the claim. Courts refused to recognize that certain agreements clearly provided no other benefit to the acquirer other than retaining the key target's employees and managers, that a "private purchase of stock and a public tender offer" do not make one tender offer according to Rule 14d-10, if all terms of the tender offer are independent).

128. See Epstein v. MCA, Inc., 50 F.3d 644, 656 (9th Cir. 1995), rev'd on other grounds, 516 U.S. 367 (1996) (indicating that the agreement was "conditioned on the terms of the public tender offer... "); Perera, 1996 U.S. Dist. LEXIS 22503, at *9 ("[T]he Tender Offer provision and option enhancements were contained in the same Investment Agreement...").

129. See Kramer v. Time Warner, Inc., 937 F.2d 767, 775 (2d Cir. 1991) (holding that the trading value of the Securities Package did not make the Offer to Purchase a misrepresentation).

130. See, e.g., Perera, 1996 U.S. Dist. LEXIS 22503 at *11 (discussing incentive bonuses to executives); Millionerrors Inv. Club, 2000 U.S. Dist. LEXIS 4778, at *5 (discussing the more than $26 million paid to GE executives); Katt, 133 F. Supp. 2d at 644–45 (stating that Titan officers were paid $30 million).

131. See Walther, supra note 3, at 794.

132. See id. (naming factors necessary to the implementation of a merger agreement).

133. See id. at 786–87 (discussing the Gerber and Kramer courts' refusals to evaluate a formal business purpose for a payment and rather only look to the origin of the payment to determine propriety).
because the tender offers were obviously oversubscribed or because there was no requirement for the employees to tender their shares.134

At the same time, intent was also never examined when courts applied formal method.135 While the formal approach promises that a transaction will not be deemed a part of tender offer if it was consummated outside of the time of the offer, as defined by SEC Rule 14d-2, courts might soon catch on to the obvious flaw of this method and abandon it. Indeed, under strict interpretation of the terms "during or pursuant" to a tender offer, a "boot" transaction would not violate Rule 14d-10.136 A "boot" transaction provides that specific tendering security holders will receive additional consideration after the completion of the tender offer, and is precisely the kind of transaction that Rule 14d-10 was designed to prevent.137

While the Circuits are split over which method is more appropriate to interpret Rule 14d-10, and to promote the goals articulated by Congress and the SEC, neither the functional nor the formal methods offer a satisfactory solution.138 Whereas the formal method clearly does not reach the very transactions that the SEC tried to prohibit, the functional method has no viable mechanism to limit meritless claims or dismiss them at the pleadings stage.139 However, there has been speculation that the SEC will begin to look into what are legitimate employment or severance agreements.

134. See, e.g., Perera, 1996 U.S. Dist. LEXIS 22503, at *11 (indicating that incentive bonuses "were not consideration because they were not offered in a quid pro quo exchange for the tender of Chiron employee option holder's stock"); Millionerrors Inv. Club, 2000 U.S. Dist. LEXIS 4778, at *5 (discussing the more than $26 million paid to GE executives); Katt, 133 F. Supp. 2d at 644–45 (stating that Titan officers were paid $30 million to induce support for a tender offer, but no part of the agreement included a requirement that the holders tendered their shares). See also Walther, supra note 3, at 790 (noting that the Katt court did not invalidate an agreement because of payment to Titan executives).

135. See Lerro v. Quaker Oats Co., 84 F.3d 239, 244 (7th Cir. 1996) (examining transaction, not intent); Walker v. Shield Acquisition Corp. 145 F. Supp. 2d, 1360, 1367 (N.D. Ga. 2001) (indicating that courts look at transactions, not at the parties' intent).

136. See Walther, supra note 3, at 799 (noting that "boot" transactions, in which some of the promised cash is delivered at a later date, would be payment pursuant to a tender offer).

137. See id.

138. See id. at 778–79.

139. Id. at 778.
III. AVOIDING LIABILITY UNDER RULE 14D-10

When making a tender offer, the acquirer may pursue different business plans for future operations of the target company. The acquirer may wish to offer future employment to current management and key employees of the target, retain contacts with major business partners or clients of the target or structure a non-competition agreement with the target’s departing personnel and management. All of these transactions, often vital to the business plan of the acquisition, may be unavailable to the acquirer.140

Some courts’ functional interpretation of Rule 14d-10 led to integration of outside transactions into tender offers, thus invalidating the outside transactions and exposing acquirers to liability for violation of Rule 14d-10.141 While unwilling to articulate a definite standard, courts assumed a functional method of examining each transaction on a case-by-case basis, and have come to distinguish various factors in arriving at conclusions.142

Acquiring companies, interested in structuring a side transaction with the target’s employees, managers or business partners face difficult choices.143 While such transactions certainly serve sound business purposes, they expose acquiring companies to enormous liability of violating Rule 14d-10.144 So far, the courts have been unable to

140. See Shearman & Sterling, supra note 73, at 2.
141. See Walther, supra note 3, at 784–85.
143. See Perera, 1996 U.S. Dist. LEXIS 22503, at *6–*7; Katt, 133 F. Supp. 2d at 634.
144. See Walther, supra note 3, at 806–10.
communicate a definite standard, leaving acquiring companies in the dark.\textsuperscript{145}

However, although there are no set guidelines for structuring side transactions, the courts have focused on various factors and assigned different roles to those factors.\textsuperscript{146} The acquirers, therefore, can attempt to avoid triggering those factors.\textsuperscript{147} A careful examination of all the factors reviewed by courts applying functional method can yield a more definite answer as to what conduct and what transactions will trigger the application of Rule 14d-10.\textsuperscript{148} It should be noted, however, that the functional method is followed only in some jurisdictions, whereas the others apply the formal approach.\textsuperscript{149} The formal method, itself consisting of a rigid definition of Rule 14d-10, is much easier to define and bypass.\textsuperscript{150} The formal method dictates that as long as the agreement in question was not made "during or pursuant" to a tender offer, the agreement does not become a part of the tender offer and does not alert application of Rule 14d-10.\textsuperscript{151}

Contrary to the formal approach, the implication of the functional analysis is very difficult to bypass or satisfy.\textsuperscript{152} When contemplating an outside transaction in connection with a tender offer in the functional method jurisdiction, acquirers are advised to follow these guidelines:

\begin{itemize}
\item When making an employment agreement with the target’s director, executive or employee, the acquirer should offer intangible incentives; spread payments over time instead of giving one lump sum; structure incentives to induce the recipient to stay with the company and not cash out and leave.\textsuperscript{153}
\end{itemize}

\textsuperscript{145} Id. at 801.
\textsuperscript{146} See Field v. Trump, 850 F.2d 938, 943–47 (2d Cir. 1998); Epstein, 50 F.3d at 654.
\textsuperscript{147} See Epstein, 50 F.3d at 649–58.
\textsuperscript{148} See id. at 654; Field, 850 F.2d at 943–47.
\textsuperscript{149} See Walther, supra note 3, at 801.
\textsuperscript{150} See Lerro v. Quaker Oats Co., 84 F.3d 239, 240–42 (7th Cir. 1996).
\textsuperscript{151} See id. at 244 (finding distribution agreement, signed prior to tender offer, not in violation of Rule 14d-10); Walker v. Shield Acquisition Corp., 145 F. Supp. 2d 1360, 1371–72 (N.D. Ga. 2001) (holding that consideration agreements, signed before the offer began, did not occur during the tender offer and was not subject to Rule 14d-10).
\textsuperscript{152} See Walther, supra note 3, at 778.
\textsuperscript{153} See Shearman & Sterling, supra note 73, at 2.
Employment agreement should be offered by the target instead of the acquirer.154

Employment agreement should not be conditioned on success of the tender offer.155

Employment agreement should not be related to the price of the tender offer or the shares held by the recipient.156

Employment agreement should be consistent with the fair market value for such services.157

Employment agreement should be properly disclosed in pertinent disclosures.158

Employment agreement should explicitly disclaim any effort to induce tender of shares.

Structure a long-form merger transaction instead of a tender offer, since mergers are not regulated by Rule 14d-10.159

Non-competition agreements should have detailed calculations based on market value and expert opinions.

Business-continuation agreements, licenses and patent rights should be consistent with fair market value.

A proper paper trail of every discussion that led to a decision must be kept to show genuine intent.160

These are the minimal guidelines that acquirers should follow to avoid liability under Rule 14d-10 in functional method jurisdictions.161

It should be noted that the above guidelines only have the potential of

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154. See id. (indicating that the target and its executives should make employment agreements, not the acquirer).

155. Id.; see also Jacobs, supra note 73, at 3; Stacey A. Terral, Securities: Incentives Agreements at Time of Acquisition Held in Violation of the 1934 Act, 3 TRANSACTIONS 40 (2001) (summarizing the Katt decision and suggesting methods to bypass the application of Rule 14d-10).

156. See Jacobs, supra note 73, at 3; see also Ebert, supra note 2, at 705.

157. See Shearman & Sterling, supra note 73, at 2 (proposing that employment arrangement be made on customary market terms).

158. See id.

159. See id. at 3.

160. Because courts may use a test of "intent and circumstances," keeping a paper trail is important for a showing of legitimate intent. See Walther, supra note 3, at 785, for a discussion of the test in Field v. Trump, 850 F.2d 938 (2d Cir. 1988).

161. See Shearman & Sterling, supra note 73, at 3 ("[U]ntil the case law develops further, acquirers should consider carefully any employment arrangements proposed in connection with a tender offer.").
shielding the acquirer and should not be applied literally. The integral part of the functional method is that the courts examine each transaction on case-by-case basis, and therefore, the guidelines above should merely provide an initial framework for crafting a side transaction.\textsuperscript{162}

CONCLUSION

Congress and the SEC promulgated laws and regulations governing tender offers and treatment of a target company's security holders.\textsuperscript{163} The All Holders/Best Price Rule was crafted to ensure that an acquiring company cannot selectively favor some security holders in connection with a tender offer.\textsuperscript{164} Applied broadly, the rule invalidated legitimate transactions between the acquirer and target security holders, in which the acquirer tried to encourage continued employment, renew a business contract or secure a non-competition promise.

Faced with this dilemma, Circuits split and crafted functional and formal methods of reviewing such transactions. The former examines each transaction on a case-by-case basis and determines whether the outside agreement played an integral part in the tender offer.\textsuperscript{165} The latter applies a bright-line test to separate all transactions made during or pursuant to tender offers.\textsuperscript{166}

Absent formal guidance from Congress, the SEC or the courts and fearing enormous liability of Rule 14d-10, companies begin to abandon tender offer plans, frustrating the purposes of free-market economy. Some guidelines can be derived from the functionalist courts, thereby providing some basic framework for structuring transactions in connection with tender offers.\textsuperscript{167} However, the SEC indicated that the dilemma is being reviewed and probably will provide more certain guidelines shortly.

\textsuperscript{162} See Walther, supra note 3, at 785.
\textsuperscript{163} See Ebert, supra note 2, at 680-85.
\textsuperscript{164} See Walther, supra note 3, at 781.
\textsuperscript{165} See id. at 785.
\textsuperscript{166} See Ebert, supra note 2, at 693.
\textsuperscript{167} See id. at 702.