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SECURITIES ALERT

SEC AMENDS TENDER OFFER BEST-PRICE RULE

On October 18, 2006, the Securities and Exchange Commission adopted amendments to the best-price rule for issuer and third-party tender offers.[1] The best-price rule, which was adopted in 1986, requires that a tender offer be open to all holders of the class of securities and that the consideration paid to any holder be the highest consideration paid to any other holder.[2] The amendments are designed to remove uncertainty with respect to the application of the rule to payments made to shareholders, particularly within the scope of employment compensation, severance or other employee benefit arrangements, at or around the time of a tender offer. In some cases, plaintiffs have successfully argued that these payments constitute additional tender offer consideration that must be paid to all shareholders under the best-price rule. This litigation risk and the potential for enormous damage awards have significantly deterred the use of tender offers as an acquisition vehicle.

JUDICIAL ANALYSIS OF THE RULE

After enactment of the best-price rule, plaintiff-shareholders began pursuing damage claims by alleging that arrangements entered into at or around the time of the tender offer with employees, suppliers and other business partners of the company who owned securities subject to the tender offer constituted additional tender offer consideration paid in violation of the best-price rule. For example, executive officers of target companies often enter into new employment agreements as an incentive to remain with a company following its acquisition. If an executive officer held 1,000 shares in the subject company and received a $1,000,000 employment agreement to remain with the business entity, plaintiffs' counsel could allege that under the best-price rule all shareholders are due an additional $1,000 per share.

In litigation over the application of the best-price rule, courts have generally employed either a bright-line test or integral-part test to determine whether the particular arrangement violates the best-price rule. Courts employing the bright-line test only consider ancillary payments made after the announcement and before the closing of the tender offer. Courts applying the integral-part test focus on whether the transaction or payment at issue was an integral part of the tender

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[1] Amendments to the Tender Offer Best-Price Rules, Exchange Act Release No. 34-54684 (November 1, 2006).
[2] Exchange Act Rules 13e-4(f)(8) and 14d-10(a).

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offer regardless of the timing of the transaction or payment. If the court determines that such transaction or payment was integral to the tender offer — notwithstanding any public announcements framing the period of the offer — the tender offer is deemed extended to include the period in which the ancillary transaction or payment occurred, and thus other security holders are entitled to the same level of consideration under the best-price rule.[3]

The integral-part test involves a highly fact-intensive judicial determination of whether employment-related payments, supplier-related payments or other secondary payments are an integral part of a tender offer. This fact-intensive standard made it very difficult for defendants to prevail on motions to dismiss regarding these claims. Due to the uncertainty in the application of the integral-part test and the risk of enormous damage awards, potential bidders have shied away from the use of tender offers and instead have turned to statutory mergers to achieve their strategic goals since the best-price rule does not apply to mergers. Likewise, foreign private issuers entering into business combinations based outside of the United States, where statutory mergers are often unavailable due to different corporate statutory frameworks, have often excluded U.S. holders of their securities from tender offers. The amendments to the best-price rule reflect the SEC's desire to return tender offers to their former status as a viable mechanism for parties contemplating a business combination.

AMENDMENTS

The SEC's amendments to the best-price rule eliminate a significant amount of the uncertainty created by judicial interpretations of the best-price rule. The principal amendments are summarized below.

Best-price rule applies only to consideration paid "for securities tendered in the tender offer." Prior to the amendments, the best-price rule required a bidder to pay all tendering security holders the highest consideration paid to any security holder *during* the offer. The amended rule requires a bidder to pay all tendering security holders the highest consideration paid to any other security holder *for securities tendered in the tender offer*. Consequently, only consideration paid to security holders for their tendered securities will be evaluated when determining the highest consideration paid to a security holder in the tender offer. It also follows that payments made to employees, directors and other security holders who enter into arrangements with the bidder or the subject company and do not tender their securities in the tender offer will not be subject to the best-price rule.

The SEC declined to adopt the bright-line test for arrangements made *during* the tender offer, which would provide comfort that arrangements made before or after the specified tender offer period would not be subject to the best-price rule. Instead, the SEC believes that its amendments to the rule and the addition of the exemption and safe harbor discussed below provide sufficient certainty to parties desiring to engage in a tender offer as to whether other consideration paid or arrangements made at or around the time of the tender offer can be claimed to constitute part of the tender offer consideration.

Payments made pursuant to compensation arrangements exempted from the best-price rule. The SEC expressly exempted from the best-price rule the negotiation, execution and amendment of employment compensation, severance and other employee benefit arrangements, and payments and other benefits pursuant to such arrangements, where the amount payable—

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

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- is compensation for services performed or future services to be performed or to be refrained from performing and
- is not calculated based on the number of securities tendered or to be tendered by the security holder.

In the final rules, the SEC expanded the persons covered by this exemption to include all security holders of the subject company, not just employees and directors. In the adopting release, the SEC also explained that the grant of equity-based awards or the modification of previously granted equity-based awards typically will not be subject to the best-price rule because such grants or modifications are not generally calculated based on the number of securities tendered in the tender offer by the security holder.

Although the SEC specifically exempted from the best-price rule compensation arrangements meeting the requirements set forth above, it declined to expressly exempt commercial arrangements, stating that it was unable to craft a specific exemption that would be functional and not subject to potential abuse. The SEC did, however, include a specific instruction clarifying that its exemption for compensation arrangements should not create a negative inference with respect to any other type of arrangement.

Safe harbor provided for compensation arrangements approved by independent directors. The amendments provide a safe harbor with respect to employment compensation, severance and other employee benefit arrangements that are approved solely by directors who are independent within the meaning of the company's applicable listing standards. If the company does not have securities listed on a national securities exchange or quoted on an inter-dealer quotation system of a national securities association, then the company may use the independence requirements of any such exchange or system, but it must apply the requirements that it selects consistently to all directors approving the arrangement.

For third-party tender offers, the approval by independent directors can be obtained in any of the following ways:

- the compensation committee or a committee performing similar functions of the subject company's board of directors can approve the arrangement, regardless of whether the subject company is a party to the arrangement, or
- if the bidder is a party to the arrangement, the compensation committee or a committee performing similar functions of the bidder's board can approve the arrangement.

In the case of issuer tender offers, the compensatory arrangement can be approved by—

- a compensation committee of the issuer's board or a committee performing similar functions, regardless of whether the issuer is a party to the arrangement, or
- if an affiliate is a party to the arrangement, by the compensation committee or a committee performing similar functions of the affiliate's board.

With respect to both third-party and issuer tender offers, if the approving entity's board does not have a compensation committee or other committee performing similar functions or if none of the members of any such committee is independent, the arrangement can be approved by a special committee of the board formed to consider and approve the arrangement.

In the adopting release, the SEC explains that all members of the committee used to approve a compensatory arrangement must be independent. Consequently, a compensation committee that does not consist entirely of independent directors may need to create a subcommittee composed solely of independent directors to approve the arrangement.

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To eliminate challenges as to whether the approving directors satisfy the independence requirements, the SEC also added an instruction that a determination by the company's board of directors that the members of the committee are independent under the applicable listing standards is sufficient to conclusively establish that such committee members meet the applicable independence requirements.

In approving a compensatory arrangement, the committee need not specifically determine that the amount to be paid satisfies the rule's exemption requirements. The directors must, however, approve the arrangement as an employment compensation, severance or other employee benefit arrangement.

Many commenters had requested that the SEC clarify the ability of committees to reapprove or ratify arrangements approved before the consideration of a specific transaction or the effectiveness of the rule amendments. The SEC did not believe that additional clarification was necessary, noting that the provisions of the safe harbor, which do not preclude approval by means of ratification, would simply need to be satisfied before the consideration is paid in the tender offer.

Safe harbor extended to foreign private issuers. In response to comments, the SEC extended the safe harbor for compensatory arrangements to foreign private issuers. Foreign private issuers may have the arrangement approved by any members of the board of directors or any committee of the board authorized to approve the arrangement under the laws or regulations of their home country. In addition, the board or committee members will be independent if they satisfy either the applicable U.S. listing standards or the independence requirements of the laws, regulations, codes or standards of their home country.

CONCLUSION

The amended rules, which will take effect 30 days after publication in the Federal Register, should remove much of the uncertainty that has chilled the use of tender offers in negotiated transactions. The safe harbor for compensatory arrangements approved by independent directors will eliminate the most frequently alleged claims of violation of the best-price rule. The certainty provided by the amended rules will help restore the use of tender offers as a viable acquisition vehicle and will allow parties structuring a transaction to once again take advantage of the speed and efficiency of a tender offer.

CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

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