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Recent Decisions Interpret "All Holders, Best Price" Rule

Negotiated acquisitions often involve various payments to the executives of the target company such as non-compete and severance payments for departing executives, and compensation packages, options and retention bonuses for those who will be retained. When the transaction is structured as a tender offer and the executive is a shareholder of the target, there are several lawsuits in which plaintiffs have argued that these payments constitute additional consideration paid to those insiders in violation of the "all holders/best price" provisions of Exchange Act Rule 14d-10. Three recent decisions illustrate how the courts have interpreted Rule14d-10.

Rule 14d-10 promulgated under the Exchange Act provides in relevant part that "no bidder shall make a tender offer unless...the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer." As these cases illustrate, the courts are divided on how to interpret the phrase "during the tender offer". Some courts read it literally so that any payments made before the commencement or after the expiration of the tender offer fall outside the scope of this rule. Other courts, finding that this literal reading of would make it too easy to circumvent the rule by scheduling discriminatory payments immediately before commencement or immediately following expiration of the offer, have adopted a more flexible analysis that looks at whether a payment to an insider was an "integral part" of the tender offer.

In *Harris v. Intel*, decided on July 8, 2002, the U.S. District Court for the Northern District of California applying the "integral part" test granted defendants' motion for summary judgment finding that plaintiffs had failed to introduce sufficient evidence to show that severance payments, bonuses and a $5 million non-compete agreement to three executives of DSP Communications, Inc. were intended as an inducement to the executives to support the tender offer and to tender their shares. The case arose out of the acquisition of DSP Communications Inc. by Intel through a cash tender offer. The agreement was entered into on October 3, 1999 and the tender offer commenced on October 20, 1999. The bonus plan in question was adopted by DSP's Compensation Committee on August 30, 1999 at a time when DSP was negotiating with several different prospective buyers. The purpose of the bonus plan was apparently to keep senior DSP management in place in the event of a change of control, which would facilitate the sale of DSP as a going concern. On October 13, 1999, one of the executives agreed with Intel to receive half of his bonus in the form of consideration for a two-year non-compete agreement with Intel. The severance payments were made pursuant to change in control clauses in existing employment agreements that had been amended at Intel's request to ensure that the executives would remain for four months following closing. The amendments had the effect of reducing the payments these executives were to receive and to reduce the number of hours they were to work from 30 to 10 hours per week.

The Court noted that (a) the bonus plan was a pre-existing obligation of DSP to its executives; (b) Intel did not learn about the bonus plan until October 9, 2002; (c) Intel played no role in choosing the recipients of the bonuses or their amount; and (d) the bonus plan was not specific to any acquiring company and did not require that a tender offer be the means of effecting the change in control. The Court then concluded that there was no evidence that the bonuses and the non-compete were intended as inducements by the executives to tender their shares. As to the severance payments, the Court noted that the executives would have been entitled to receive payment regardless of the amendments and that a reduction in the payment amounts could not have violated Rule 14d-10 and concluded that the reduction in the executives' hours of work was not sufficient evidence that the amendments were an inducement to tender.

In *Gerber v. Computer Associates International, Inc.,* decided on September 4, 2002, the Second Circuit affirmed a decision of the U.S. District Court for the Eastern District of New York, which applied the "bright-line timing" test and found that a $5 million payment made by a bidder to the CEO of the target while nominally consideration for the CEO's 5-year non-compete agreement was actually, in part, additional consideration paid to the CEO for his shares in violation of Rule 14d-10.

In August 1991, Computer Associates was negotiating to acquire On-Line Software. On August 16, in response to a New York Stock Exchange inquiry prompted by unusual trading volume in On-Line stock, the parties issued press releases announcing that they had reached an agreement in principle for the acquisition of On-Line, but that the agreement was still subject to approval of the boards of both parties. On August 21, the parties executed a merger agreement and Computer Associates and On-Line's CEO executed a non-compete and stock purchase agreement. The tender offer was disseminated the same day and was scheduled to expire on September 20, 1991. The CEO was not paid the $5 million until September 25. Defendants argued that the non-compete payment could not violate Rule 14d-10 as additional consideration paid "during the tender offer" because the non-compete was entered into before the commencement of the tender offer and payment was made after expiration of the tender offer. The Court rejected both arguments, finding that the August 16 press release met all the requirements of Rule 14d-2[1] and thus constituted "commencement" of the tender offer and that, although the non-compete payment was made after expiration of the tender offer, the CEO was paid before any other target shareholder.

In *In Re Digital Island Securities Litigation*, decided on September 10, 2002, the federal District Court for the District of Delaware applied the "bright-line timing" test and dismissed a class action alleging that executive compensation packages entered into between the target and certain of its officers constituted additional consideration for those officers' target stock because all agreements with the officers had been entered into before commencement of the tender offer. The alleged additional consideration at issue included payments under existing stock option plans and new employment agreements that were entered into with the bidder in connection with the transaction and were to become effective upon successful completion of the tender offer.

The plaintiffs urged the Court to follow the "integral part" line of cases and not to focus on whether the transaction challenged occurred during the time frame of the tender offer. The Court acknowledged that the circuits were split on this issue and that the Third Circuit (in which the Delaware District Court is included) had not yet ruled on the issue. The Court, citing legislative and administrative history of Rule 14d-10, found the "bright line" interpretation of the Rule more persuasive and, in view of the fact that the compensation arrangements at issue, including the new employment agreements, were entered into prior to the commencement of the tender offer, dismissed the plaintiffs' Rule 14d-10 claim.

These cases illustrate the split that currently exists among the courts as to the interpretation of the all holders/best price rule. The risk of costly litigation, particularly in courts that apply the "integral part" test may in some cases act as a deterrent to the use of tender offers in situations in which executives of the target are also shareholders.

The above is of course a simplification of a very complex issue which lately has received a lot of attention from the M&A bar and from commentators.[2] We understand that there are various bar associations efforts to seek SEC clarification on this issue. However, we note that this issue is probably not a top priority right now at the SEC.

Harris v. Intel Corp., , No. C00-1528 CW (N.D. Cal., July 8, 2002); *Gerber v. Computer Associates International, Inc.*, No.00-9557 (2nd Cir., September 4, 2002); *In re Digital Island Securities Litigation*, No. 02-57-GMS (D. Del., September 10, 2002)

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This memorandum constitutes only a general description of the three decisions it discusses. It is not intended to provide legal advice and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to the following members of our M&A Group:

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[1] Rule 14d-2 was amended subsequent to the events giving rise to this case but the Court applied the Rule as then in effect. Under Rule 14d-2 as it currently reads, commencement is deemed to occur "at 12:01 a.m. on the date when the bidder has first published, sent or given the means to tender to security holders."

[2] See Note, *Employment Agreements and Tender Offers: Reforming the Problematic Treatment of Severance Plans Under Rule 14d-10*, 102 Colum. L.Rev. 774 (2002). See also 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 (2002).