KIRKLAND & ELLIS LLP

M&A NOTES

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Amendment of the Tender Offer Best-price Rule

The U.S. Securities and Exchange Commission (the "SEC") has amended Rules 13e-4(f)(8)(ii) and 14d-10(a)(2) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"), which are generally referred to collectively as the "best-price rule." The best-price rule requires that all shareholders of a company that is subject to a tender offer receive the same price for shares tendered in the offer. The rule had been subject to conflicting court interpretations regarding whether compensation, severance and other benefits paid to employees of the target company - in addition to the price for shares tendered by the employees - are counted for purposes of the rule. The amendments clarify that compensation, severance and other benefits paid to employees of the target who tender their shares do not count as part of the price paid for the shares. These amendments eliminate a major legal uncertainty regarding tender offers and should result in increased use of tender offers as a means of acquiring public companies. The primary effects of the amendments are to:

- *Revise the rule to clarify that it applies only to payments for tendered shares;*
- *Create an exemption for consideration paid pursuant to compensatory arrangements; and*
- *Create a safe harbor for employee benefit arrangements that are approved by an independent compensation committee.*

Background

The tender offer best-price rule originally provided that no acquirer shall make a tender offer unless "[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." Litigation brought under the rule frequently focused on whether consideration paid to shareholders of the target company pursuant to employment, severance or other employee benefit arrangements was consideration paid in the tender offer for purposes of the best-price rule. In considering these claims, federal circuit courts interpreted the rule pursuant to either (i) the integral part test or (ii) the bright-line test.

The Integral Part Test.

In *Epstein v. MCA, Inc.*[1], the United States Court of Appeals for the Ninth Circuit considered whether arrangements made by the acquirer with the chief executive officer (CEO) and chief operating officer (COO) of a target company, which were agreed prior to but performed after the offer period, were subject to the best-price rule. Specifically, the CEO agreed to a stock-for-stock exchange with the acquirer and the COO (who tendered his shares in the tender offer) agreed to an amendment to his employment agreement in

exchange for an additional cash payment of $21 million. Relying in part on the fact that the value of the total consideration received by each executive was determined by reference to the tender offer price[2] and that the arrangements were conditioned on the success of the tender offer, the court held that the arrangements formed an "integral part" of the tender offer and thus were subject to the best-price rule.

The Bright-Line Test.

In *Lerro v. Quaker Oats Co.*,[3] the United States Court of Appeals for the Seventh Circuit considered whether a distributorship agreement between a subsidiary of the acquirer and an entity affiliated with the target company's chief executive officer, executed prior to the tender offer and to be performed indefinitely thereafter, were subject to the best-price rule. The court held that "[b]efore the offer is not 'during' the offer"[4] and, observing that the Williams Act "depends on making the times start from a public announcement,"[5] concluded that the agreement was not subject to the best-price rule.

As a result of the uncertain application of the best-price rule due to the federal courts' varying interpretations of the rule, and the potentially significant costs to an acquirer should employee compensation be deemed to be tender offer consideration (i.e., all the other shareholders of the target company would arguably be entitled to the same consideration per share), acquirers and their legal advisors have for several years favored structuring deals as mergers, rather than tender offers.

Amendments

On October 18, 2006, the SEC adopted several amendments to the tender offer best-price rule. These amendments were published by the SEC on November 1, 2006, and will become effective on December 1, 2006.

The amendments to the tender offer best-price rule:

- *Revise the language of the best-price rule to clarify that it applies only to the consideration offered and paid for securities tendered in the offer.* The best-price rule previously provided that no acquirer shall make a tender offer unless "[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*." The SEC has amended the rule to replace the phrases that are italicized above with the phrase "for securities tendered in the tender offer," such that the revised rule now reads "[t]he consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer." These changes are intended to clarify that the best-price rule is limited solely to payments made for securities tendered in the tender offer, thereby resolving any ambiguity as to whether payments for other purposes (i.e., compensation) should be considered for purposes of the rule.

- *Create an exemption from the best-price rule for consideration offered and paid to shareholders pursuant to employment compensation, severance and other benefit arrangements entered into with employees and directors of the target company, so long as certain requirements are satisfied.* Specifically, under the amendments, consideration offered and paid to shareholders of the target pursuant to employment compensation, severance and other benefit arrangements is exempt from the best-price rule so long as such amounts (i) are paid or granted to the individual as compensation for the performance of past services, the performance of services in the future or the agreement to refrain from providing certain services in the future by the shareholder (and matters incidental thereto) and (ii) are not calculated based on the number of securities tendered (or to be tendered) in the tender offer by the shareholder. The SEC noted that any arrangement that is contingent on a shareholder's tendering shares into an offer "would most likely violate one or both of the requirements of the exemption." This exemption should permit acquirers to negotiate and enter into new employment, severance and other benefit arrangements, or amend existing arrangements, with employees of a target who tender (or may tender) their shares into a tender offer.

- *Create a safe harbor for employee compensation, severance and other benefit arrangements that are approved by an independent compensation committee.* Specifically, the SEC adopted a safe harbor from the best-price rule for consideration offered and paid pursuant to an employment compensation, severance or other employee benefit arrangement entered into with an employee or director of the target company that is approved by the compensation committee or committee performing similar functions of the target (without regard to whether the target is party to the arrangement) or, in third party tender offers, by the compensation committee or committee performing similar functions of the acquirer (if the acquirer is

party to the arrangement). All members of the committee approving the arrangements must be independent as defined under applicable listing standards or, with respect to foreign private issuers, under home country regulations. A determination by the board of directors that directors serving on the applicable committee are independent in accordance with the provisions of the safe harbor will satisfy these independence requirements. To be eligible for the safe harbor, the arrangements must be approved prior to the payment of the tender offer consideration.

Conclusion

The amendments clarify that a target company or an acquirer can enter into new or amend existing compensation, severance and other benefit arrangements with employees and directors of the target who are also shareholders of the target without having to worry about whether the consideration received by those employees or directors as part of these arrangements will be considered for purposes of the tender offer best-price rule. By eliminating a major legal uncertainty regarding tender offers, the amendments should result in increased use of tender offers to acquire public companies. Acquirers and their counsel should keep in mind, however, that certain requirements must still be satisfied to come within the new exemption to the best-price rule and/or to fall within the new safe harbor to the rule. We recommend that acquirers using the tender offer method to acquire a public company have all compensation, severance and other benefit arrangements with employees or directors of the target company approved by a compensation or other committee that meets the requirements of the new safe harbor.

1 50 F.3d 644 (9th Cir. 1995), *rev'd on other grounds sub nom. Matsushita Electrical Industrial Co. v. Epstein*, 516 U.S. 367 (1996).

2 With respect to the stock-for-stock exchange, the agreement between the acquirer and CEO valued the target company securities exchanged by the CEO at the tender offer price. With respect to the COO, the $21 million payment was determined based on the value of 1,000,000 options (each "in-the-money" by $21) that the target intended to grant, but had not at the time of the tender offer granted, to the COO.

3 84 F.3d 239 (7th Cir., 1996).

4 *Id*. at 243.

5 *Id*. at 246.

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