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INTRODUCTION TO HOSTILE TAKEOVERS

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1. Scope

Hostile takeovers are the exception, not the rule. But the possibility that a bidder will be able to proceed on a hostile basis undoubtedly underlies many negotiated transactions. It has also become clear that the largest U.S. companies have been willing to make hostile offers, if they believe that tactic necessary to accomplish a strategically important acquisition. Examples include Omnicare for NeighborCare, Comcast for Disney, Oracle for PeopleSoft, ATT for NCR, GE Capital for Kemper, IBM for Lotus, Johnson & Johnson for Cordis, Norfolk & Southern for Conrail, Hilton for ITT, WorldCom for MCI, Alcoa for Reynolds Metals, Phelps Dodge for Asarco and Cyprus Amax, Warner Lambert for Pfizer, SunTrust Banks for Wachovia, Weyerhaeuser for Willamette, Northrop Grumman for TRW, and AIG for American General.

European and other non-U.S. companies also have engaged in large hostile offers. Recent examples include Sanofi-Synthelabo for Aventis, Philip Green's aborted bid for Marks & Spencer, Sumitomo Mitsui's proposed bid for UFJ Holdings, Steel Partners' bids for Yushiro Chemical and Sotoh Co., the CITIC bid for GF Securities, the French bank wars, the Olivetti bid for Telecom Italia, the Royal Bank of Scotland bid for National Westminster Bank, the TotalFina and Elf Aquitaine bids for each other, the bid by Assicurazioni Generali for Istituto Nazionale delle Assicurazione; the huge Vodafone bid for Mannesmann, the Kingfisher bid for Castorama, and the Alcan bid for Pechiney.

The economic downturn that began in 2001 resulted in a nearly 60% decrease in M&A activity in 2001 from the 2000 level, it also brought about a 135% increase in hostile activity, most notably in industries currently undergoing consolidation (*e.g.*, telecommunications, technology, financial services, banking, etc.). Depressed share prices and

weakened profits contributed to the increase in hostile acquisitions. In addition, the elimination of pooling accounting for business combinations in 2001 and the ability of even hostile acquirors to avoid the amortization of goodwill from an acquisition provided further incentives for companies to engage in hostile activity. Contrary to expectations, however, the 2001 pace of hostile activity did not continue in 2002, when only nine hostile tender offers were announced. This may have been in part because of weak U.S. financing markets, lack of confidence in the wake of Enron and similar scandals, and greater desire for thorough due diligence by bidders and their boards.

Although the overall M&A market improved somewhat in 2003, hostile bids remained rare, with only five U.S. bids announced. Hostile activity has increased in dollar volume in 2004 (though the number of hostile bids has not been large), with bids by Sanofi-Synthelabo for Aventis, Comcast for Disney, Jones Apparel Group for Maxwell Shoes, Omnicare for NeighborCare, Coeur d'Alene Mines for Wheaton River Minerals, and Constellation Brands for Robert Mondavi.

While the number of hostile deals has remained low in recent years, the ability to effect a hostile transaction remains important. In part, this is because bidders still choose to proceed on an overtly hostile basis in some circumstances, such as when:

-- The target won't talk to the bidder. Examples: Omnicare for NeighborCare, ArvinMeritor for Dana; Weyerhaeuser for Willamette; CyberGuard for Secure Computing.

-- The bidder sees two competitors combining, and feels compelled to make a hostile bid as a matter of strategic market positioning. Examples: Phelps Dodge's offers for Cyprus Amax and Asarco; Northrop Grumman bid for

Newport News after it agreed to be bought by General Dynamics; SunTrust for Wachovia after it had agreed to be bought by FirstUnion; Sumitomo Mitsui Financial Group's bid for UFJ Holdings after Mitsubishi Tokyo Financial Group agreed in principle to buy UFJ.

In part, this is because many transactions that ultimately are negotiated begin with an unsolicited approach by the bidder, and happen in part because of the recognition by both bidder and target that the bidder may be able to take its case directly to the target's shareholders if the target's board "just says no".

This outline reviews takeovers by reviewing the sequence of a takeover, looked at in stages:

- The acquiring company ("A") looks at the target ("T").
- T reviews its alternatives. Can T "just say no?" This involves both the applicable legal principles and the commercial reality of A's ability to take its case to T's shareholders.
- T considers defensive tactics other than a sale or merger.
- T explores a strategic merger.
- T seeks to sell itself to the highest bidder, whether A or a white knight.

2. What T Looks Like to A

The basic theme, both for A in reviewing T's vulnerability and for T in assessing its own alternatives, is how quickly can A take its case to T's shareholders, if A decides to go hostile, and what relief can A get by doing so?

It may also be prudent for A to assess its own vulnerability to a hostile takeover – both because of the possibility that T might consider a hostile acquisition of A – the so-called Pac-Man defense – and the possibility that a competitor in the market may seek to acquire A rather than having its competitive position undermined by completion of an A-T combination.

Here are the kinds of factors A (and T) looks at in assessing T's takeover defenses:

a. Law of the Jurisdiction of Incorporation

Where is T incorporated? Things to look for in the state law include:

- What percentage of the shares must vote in favor of a merger? For example, in New York, for corporations in existence on February 22, 1998, the required percentage is two-thirds, unless the charter otherwise provides,[1] while in Delaware the required percentage is a majority.[2] This is important in determining what it takes to block a deal.

- State takeover statutes.

  For example:

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[1] N.Y. Bus. Corp. L. § 903(a)(2).

[2] Del. Gen. Corp. L. § 251(c).

- A business combination statute, which restricts a company's ability to do a merger with a large shareholder. An example of this is Section 203 of the Delaware General Corporation Law, which bans a merger with a 15 percent holder for three years, with certain exceptions, unless, before the 15 percent threshold is crossed, the board of T approves either the merger or the crossing by A of the percentage threshold.

- A control share acquisition statute, under which someone who acquires more than X percent (usually 20 percent) does not get voting rights unless the shareholders approve the acquisition. Note that some control share statutes may have unexpected results, including giving A an opportunity to call a special meeting of shareholders of T to consider granting A voting rights above the threshold. As a result, many potential target companies, in states with control share acquisition statutes, have opted out from the applicability of the statutes.

- A statute that blesses a discriminatory poison pill. An example of this is Section 14-2-624 of the Georgia Business Corporation Code, looked to by the U.S. District Court in Atlanta in its July 1997 decision upholding the continuing director provisions of the pill Healthdyne used to resist Invacare's tender offer.[3] There is no comparable provision in the Delaware corporation statute, and the Delaware Supreme Court in *Quickturn Design Systems, Inc. v. Shapiro*[4] struck down continuing director provisions of a poison pill.

- A statute permitting (or in some rare cases requiring) directors to consider the interests of other constituencies (employees, customers, suppliers, the communities in which facilities are located) in

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[3] *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997). Section 14-2-624 of the Georgia Business Corporation Code was subsequently amended in 2000 to expressly provide that the terms and conditions of a rights plan may include provisions that "limit, restrict, or condition the power of a future director to vote for the redemption, modification, or termination of the rights [plan] ... for a period not to exceed 180 days from the initial election of the director ...." Ga. Bus. Corp. Code § 14-2-624(d)(2).

[4] 721 A.2d 1281 (Del. 1998).

reviewing a proposed acquisition of the company.

- A control bid statute requiring A to file detailed information with the state's securities regulators upon commencement of its bid and allowing the regulators to suspend the bid if the filing fails to provide the required information until A cures the defects.[5]

- Who can call a special meeting? Under some state laws (*e.g.*, Illinois, Ohio, Connecticut, Maryland), holders of a specified percentage of the stock have the right to call a special meeting.[6] In Delaware, special meetings can be called only by the persons authorized to do so in the charter or bylaws.[7]

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5 For example, the Ohio securities statute allows the Ohio Division of Securities to summarily suspend the continuation of any "control bid made pursuant to a tender offer" if the Division determines that T has failed to provide to the Division all of the information specified in the statute or that A's control bid materials do not provide full disclosure of all material information concerning the control bid. Ohio Ch. 1707 Securities § 1707.041(A).

6 Conn. Bus. Corp. Act § 33-696(a) (10%); Ill. Bus. Corp. Act § 5/7.05 (one-fifth); Md. Gen. Corp. L. § 2-502(c)(1) (25%); Ohio Gen. Corp. L. § 1701(A)(3) (25%).

7 Del. Gen. Corp. L. § 211(d).

Many public Delaware companies have bylaws that do not authorize stockholders to call a special meeting.

- Can shareholders act by consent, rather than just at a meeting? Contrast Delaware, which permits shareholders to act by consent (unless the charter otherwise provides)[8] (for example, IBM-Lotus; Johnson & Johnson-Cordis; Kollmorgen-Pacific Scientific), with New York, which requires consents to be unanimous.[9]

b. *Charter and Bylaws*

For example:

- Is the board staggered, so that only part of the board comes up for election each year? Even if the board is staggered, is the staggered structure solidly protected? If the board is not staggered or if the staggered structure can be easily overturned, A can get complete control at the next annual meeting, if it can win a proxy fight. Examples include the 2000 decision by Shorewood to merge with International Paper, after Chesapeake

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[8] Del. Gen. Corp. L. § 211(b).

[9] N.Y. Bus. Corp. L. § 615(a).

launched a hostile bid for Shorewood and a proxy fight to amend Shorewood's bylaws to eliminate a staggered board,[10] and the 1997 decision by ITT to enter into a transaction with Starwood Lodging, after the federal district court in Nevada struck down ITT's plan to split itself into three pieces without a shareholder vote, and to have the largest piece (ITT Destinations) spun off with a charter that included a staggered board.[11]

- If state law permits action by consent, has the charter eliminated this right?

- Are there special supermajority voting requirements for mergers, at least with an A that owns more than a specified percentage of T's stock?

- Does the charter provide for "blank check preferred" – that is, preferred stock issuable in series, the terms of which may be fixed by the directors? The preferred could be used to underlie a poison pill, or to issue to a white knight or white squire.

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[10] *Chesapeake Corp. v. Shore*, No. 17626, 2000 Del. Ch. LEXIS 20 (Del. Ch. Feb. 7, 2000).

[11] *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342 (D. Nev. 1997), *aff'd*, 116 F.3d 1485 (9th Cir. 1997).

- Does the charter have ample authorized but unissued common stock that could be issued to a white squire or white knight?

- When is the annual meeting? How long can T put off holding an annual meeting, before A can go to court to compel the annual meeting to be held? (For example, in Hilton's 1997 bid for ITT, under Nevada law, ITT had to hold its annual meeting within 18 months of the last annual meeting; ITT in October 1997 entered into an agreement for a transaction with Starwood Lodging, in the face of a court order that the annual meeting be held not later than November 14, 1997.[12]) Are there provisions in the bylaws requiring a specified period of advance notice to T for any shareholder nomination or other action at a meeting?

- Can A call a special meeting of shareholders? How quickly? Even if the bylaws permit stockholders to call a special meeting, T's directors may be able to amend the bylaws to defer for a reasonable period the time within which such a meeting must be held.[13]

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[12] *Id.*

[13] Such a bylaw amendment, providing that if the requisite percentage of stockholders called a meeting, the board would fix the date for the meeting to be not less than 90 nor more than 100 days after the company had

- Is a supermajority required before the shareholders can amend the bylaws?

c. Poison Pill

A shareholder rights plan, commonly known as a poison pill, is a device that encourages a would-be acquiring company to talk to T's directors before seeking to acquire more than X percent of T's stock, because not doing so will result in substantial economic harm to A: the rights held by A will become void, and all the other shareholders will be able to buy shares of T at half price. A rights plan can be adopted without shareholder approval; the directors authorize the rights to be distributed as a dividend to T's shareholders.

Key terms include:

- The percentage of T's stock that triggers a right to buy stock at half price (a so-called "flip-in"). This threshold percentage now is usually in the range of 10 percent to 20 percent.

- The exercise price. Since the essence of the pill is to inflict harm to A by giving every other shareholder the right, on payment of the exercise price, to receive T's shares worth twice the exercise price, the harm to A will be greater, the higher the exercise price.

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received and determined the validity of the requests, was upheld in *Mentor Graphics Corp. v. Quickturn Systems, Inc*, 728 A.2d 25 (Del. Ch. 1998).

- Whether the pill is "chewable," by including such features as the shareholders' ability to force a redemption of the pill by a referendum within a specified period of time, if the tender offer is an all-cash offer for all of T's shares.

- Whether the pill provides a period of time (a "window of redemption") following the crossing of the threshold, within which the directors can still redeem the pill. (If there is a window, aren't T's directors more likely to blink?)

- Are there obstacles to the shareholders' ability to elect new directors who can redeem the pill? Some pills provide that once A threatens to acquire T, the only directors who can redeem the pill are the "continuing directors" – that is, the existing T directors and their hand-picked successors. Alternatively, a pill may provide that directors who are elected in a proxy fight after A has surfaced cannot redeem the pill for a specified period of time (for example, 180 days). Are such provisions legal? Contrast the *Quickturn v. Shapiro* decision of the Delaware Supreme Court in 1998 [14] and the *Bank of New York* decision of the New York

[14] *Quickturn Design Systems, Inc. v. Shapiro,* 721 A.2d 1281 (Del. 1998).

Supreme Court in 1988,[15] holding that such a provision improperly restricts the ability of the directors to act, with the 1997 *Invacare* decision,[16] rejecting a challenge to a continuing director provision, under Georgia law, and the 1998 decision in *AMP-AlliedSignal,*[17] upholding under Pennsylvania law a pill that became nonredeemable and nonamendable if after receipt of an unsolicited acquisition proposal a majority of the board consisted of persons nominated by the unsolicited bidder.

d. Antitrust

Are there any antitrust obstacles to a combination of A and T? Examples include the Justice Department suit to block the First Data-Concord EFS merger, which led First Data to divest its interest in NYCE and agree to new financial terms in order to complete the merger, and the demise of the Staples-Office Depot, MCI Worldcom-Sprint, Time Warner-EMI, General Dynamics-Newport News Shipbuilding, and General Electric-Honeywell transactions. Although the Justice Department did not prevail in its suit to block Oracle's bid for PeopleSoft, it did lead Oracle to withdraw its

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15 *Bank of New York Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988).

16 *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997).

17 *AMP Inc. v. AlliedSignal Inc.*, Civ. Action No. 98-4405 (E.D. Pa. Oct. 8, 1998).

proposed slate of directors and other shareholder proposals for consideration at PeopleSoft's 2004 annual meeting.

e. *Regulatory Issues*

For example:

- Is T an insurance company or an insurance holding company? If so, is state regulatory approval required? Under most state insurance holding company laws, control is presumed to exist at 10 percent, although the presumption is rebuttable. (Contrast Michigan's determination that Kerkorian could increase its holdings in Chrysler – and indirectly its insurance subsidiaries – to up to 15 percent). Moreover, some initially hostile offers for insurance companies have led to negotiated acquisitions – for instance, Nationwide Mutual for ALLIED Group and AIG for American General.

- Is A foreign-controlled? If so, does the acquisition raise any national security issues under Exon-Florio?

f. *T's Shareholder Profile*

- How much is owned by management and its allies? How much by institutions? It may be easier for A to mount a hostile bid at a premium for a T that is institutionally owned, than for a T (for example, a utility) that is

owned largely by retail shareholders, or that has a large shareholder that is allied with management. Contrast, for example, LVMH's accumulation of shares of Gucci, after Investcorp sold its holdings of Gucci stock, with the termination by Simon Property Group of its hostile tender offer for Taubman Centers in the face of opposition by the Taubman family.

- Are the shareholders happy or unhappy with management? How has the stock performed? One place to look for this kind of information is the graph in T's proxy statement that compares T's cumulative total return on its shares with a market index and a peer group index. What do the broker research reports say about T? Have there been shareholder economic proposals? If so, with what voting result?

g. *"Social Issues"*

- Who is the CEO of T? How old is he or she? What experience has the CEO had in making or defending against takeovers? Is there an internal successor?

- Who is on the board? Cronies of the CEO, or distinguished businesspeople with reputations and fortunes to protect?

- What employment or severance agreements are in place? What equity plans? How rich will the senior management be if there is a change of control?

- How can A reduce the risk that those of T's employees who are valuable assets to the continued success of the business (e.g., in high technology or professional services companies) do not walk out the door in response to the tender offer?

h. Financing and Change of Control Issues

- How would A finance the acquisition of T? Would additional A leverage necessary to finance the acquisition have a negative impact on A's credit rating after the deal is announced and closed?

- Would any of T's borrowings have to be refinanced as a result of a change of control – either because of change of control provisions in the loan agreements, or because of the impact of the acquisition on T's balance sheet and on its ability to meet financial covenants?

- What other agreements does T have that might be adversely affected by a change of control (*e.g.*, license agreements, joint ventures, governmental permits)?

i. Potential Acquirors; Synergies

- Who are the other potential acquirors of T? How much could they pay for T before the acquisition would be dilutive for them? Might they be willing to undertake a hostile bid for A or for T rather than to permit the A-T transaction to proceed?

- What are the potential synergies, to A and to other potential acquirors? For example, how much of T's expenses could A cut without hurting the business?

j. Basic Due Diligence

A should not neglect basic due diligence questions, to the extent that they can be pursued from the outside looking in, based on T's public filings. These questions may include, among other things, litigation, environmental concerns, major contracts, indemnification obligations with respect to businesses that have been sold by T, pension funding, and retiree medical obligations.

k. How Best to Approach T

A will also consider how best to approach T. Possibilities include a private letter, a publicly disclosed proposal (a "bear hug"), or a tender offer, perhaps coupled with a proxy solicitation seeking a change in T's board. Often, unless there is some reason for immediate hostile action (for example, T is about to complete a competing transaction), A will wish to start first with less hostile approaches, and escalate if T proves unwilling to talk.

3. T Reviews Its Alternatives

Suppose A has sought a friendly acquisition of T, and has been politely but firmly rebuffed. Suppose A – with or without first taking the intervening step of a public "bear hug" letter – then takes its case to T's shareholders, by commencing a tender offer for all T shares, either for cash or for A shares. A might also begin to take its case to shareholders by soliciting consents to remove directors and elect new ones; by seeking to call a special meeting; by proposing at the annual meeting a new slate of directors and perhaps a shareholder proposal (*e.g.*, a bylaw that no pill can continue in effect if not approved by the shareholders). Is such a bylaw proper? Contrast the *Fleming Companies* case,[18] holding that shareholders can always amend the bylaws with respect to the company's pill, with the *Invacare* case,[19] holding improper a proposed bylaw on the ground that it conflicted with the broad discretion given to directors under Georgia law, and the *AMP-AlliedSignal* case, to the effect that a bidder's proposal to amend a target's bylaws to entrust control of pill decisions not to the full board but to a three-person committee was improper as an attempted amendment to the target's charter, which, under

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18 *International Brotherhood of Teamsters General Fund v. Fleming Cos.*, 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan. 24, 1997). The federal appeals court certified to the Oklahoma Supreme Court the question whether under Oklahoma law only the board of directors could create and implement shareholder rights plans, or whether shareholders may propose resolutions requiring that the plans be submitted to shareholders for a vote. The Oklahoma Supreme Court held that under Oklahoma law nothing precludes shareholders from proposing resolutions or bylaw amendments regarding shareholder rights plans, and that shareholders may propose bylaws which restrict board implementation of shareholder rights plans unless the certificate of incorporation provides otherwise. *International Brotherhood of Teamsters General Fund v. Fleming Cos.*, 975 P.2d 907, 908 (Okla. 1999).

19 *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997).

Pennsylvania law, could only be done with prior board approval.[20]

Under the federal tender offer rules, once A formally commences a tender offer for T, T must announce its position within 10 business days and file with the SEC a statement (a Schedule 14D-9) with respect to its position. What do T's directors and T's financial and legal advisers think about during this period of time?

Typically, issues thought about include:

a. Alternatives

- *Stand-alone.* Does T have a credible strategy for building shareholder value as a stand-alone company – by business-as-usual, or by divesting some components, or by undertaking a major recapitalization? Is now the right time to sell, or would shareholders do better, even on a discounted basis, by selling some years from now? (Examples include NBO-Quality Dining; Weyerhaeuser-Willamette Industries.)

- *Other buyers.* If T were to decide to sell, who else is out there as potential buyers? Would they buy the whole

[20] *AMP Inc. v. AlliedSignal Inc.*, Civ. Action No. 98-4405 (E.D. Pa. Oct. 8, 1998). For a thorough discussion of the legal issues relating to mandatory pill redemption bylaws under Delaware law, *see* R. Matthew Garms, "Shareholder By-Law Amendments and the Poison Pill: the Market for Corporate Control and Economic Efficiency," 24 Iowa J. Corp. L. 433 (1999); L.A. Hamermesh, "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?," 73 *Tulane L. Rev.* 409 (Dec. 1998).

company, or only components? How quickly could they move? How much could they afford to pay, without suffering dilution to reported or cash earnings per share?

- *Merger v. outright sale.* Would shareholders do better in a stock merger (which would not give rise to a duty to obtain the best price reasonably available, under *Paramount-Time*, so long as the transaction does not result in a change of control) or in an outright sale?

- *Negotiations with A.* Is A likely to be the highest bidder? Does A have the financial capability and strategic need? If so, when is the best time to talk to A? Right away, even before T files its Schedule 14D-9? (For example, American Home Products-American Cyanamid; IBM-Lotus Development.) Or later, if T can convince A that it has credible alternatives and the time to look for them? (For example, Northrop Grumman-TRW.)

b. *A's Bid*

- Is it preemptive? Fully financed?

- Are there any legal issues? If so, are they curable by disclosure? Or are there any "show-stoppers" (*e.g.*, a major antitrust roadblock, not curable by divestiture?)

c. Timetable

Under the federal tender offer rules, a tender offer must remain open for 20 business days. Typically, however, T's board can buy more time by taking advantage of its control over key defenses, such as a poison pill or a state business combination statute. If T's board is classified or A cannot act promptly by consent or by calling a special meeting of shareholders to remove the board, T's board can buy a lot of time. For example:

- In June 1997, Union Pacific Resources started a bid for Pennzoil. The bid was dropped in November 1997 when Pennzoil continued to "just say no."

- In August 1998, Mentor Graphics began a bid for Quickturn Design. The bid was dropped in January 1999 after the target agreed to be acquired by another company.

- In March 2000, North Fork Bancorp launched a hostile exchange offer for Dime Bancorp. In September 2000, North Fork dropped the bid, while reaffirming its commitment to a proxy contest to elect directors to Dime's board.

- In November 2000, Weyerhaeuser launched a hostile tender offer for Willamette. Willamette resisted, even after the shareholders elected Weyerhaeuser nominees as one class of Willamette's staggered board. In

January 2002, Willamette agreed to be acquired by Weyerhaeuser.

- In July 2003, ArvinMeritor launched a hostile tender offer for Dana. Dana's Board consistently recommended shareholders to reject the bid, even after ArvinMeritor raised its offer. After extending the tender offer period three times, ArvinMeritor terminated its bid in November 2003.

- Omnicare launched a hostile tender offer for NeighborCare in May 2004. NeighborCare has resisted all attempts by Omnicare to discuss the offer. Omnicare has extended the tender offer period four times.

Exchange offers take longer than cash tender offers because of the need to register the shares being offered by A under the Securities Act. Until January 2000, an exchange offer could not be commenced until the SEC had declared the registration statement effective. Moreover, because an exchange offer involves securities of the bidder, a much more detailed description of A and its business is required than would be the case in a cash tender offer.

Part of this disadvantage disappeared when the SEC changed its M&A rules in January 2000. Under Securities Act Rule 162, an offeror may solicit tenders of securities in an exchange offer before a registration statement is effective, so long as no securities are purchased until the registration statement is effective. Thus, even under the new rules, the registration must be declared effective

before the bidder is permitted to accept shares tendered in the exchange offer.

However, despite these regulatory obstacles, a hostile exchange offer could well be competitive, even under the rules in effect before January 2000. (Examples include Wells Fargo-First Interstate; Western Resources-KCP&L; WorldCom-MCI; Northrop Grumman-Newport News Shipbuilding.) An unsolicited exchange offer may also be an effective way for a competing bidder to put its offer before T's shareholders in competition with a negotiated but less valuable merger that must be approved by T's shareholders (for example, the Phelps Dodge offers in 1999 for Cyprus Amax and for Asarco, after Cyprus Amax and Asarco had announced a no-premium stock merger). And the exchange offer may permit the transaction to be tax-free. An example of a successful high-profile hostile exchange offer under the tender offer rules as amended in 2000 is Northrop Grumman for TRW.

How much time does T's management have before A can take its case to the shareholders, to obtain varying kinds of results – for example, to replace T's board or to have a competing friendly merger transaction voted down by T's shareholders?

What are the odds that A will win (*i.e.*, will be able to remove the incumbent board, or will have a competing negotiated merger agreement rejected by T's shareholders?) If T has decided to sell itself to the highest bidder, will T be successful in convincing shareholders that impartial T directors should run the sale process rather than A's directors, who are interested in buying T at the lowest possible price?

d. Can T's Board "Just Say No?"

Language in such cases as *Paramount-Time,*[21] *Paramount-QVC,*[22] *Amanda-Universal Foods,*[23] *WLR-Tyson*[24] and *Moore-Wallace*[25] suggests so, depending on the circumstances, although the question may not have been definitively resolved under Delaware law.[26] But the law yields to the strength of A's ability to take its case to shareholders – and defensive measures that disenfranchise T's shareholders may be struck down by the courts (for example, ITT-Hilton, Quickturn-Shapiro).

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21 *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

22 *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993).

23 *Amanda Acquisition Corp. v. Universal Foods Corp.*, 708 F. Supp. 984 (E.D. Wis. 1989), *aff'd*, 877 F.2d 496 (7th Cir. 1989), *cert. denied*, 493 U.S. 955 (1989).

24 *WLR Foods, Inc. v. Tyson Foods, Inc.*, 65 F.3d 1172 (4th Cir. 1995), *cert. denied*, 516 U.S. 1117 (1996).

25 *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995).

26 In his decision in *In re Pure Resources Shareholders Litig.*, 808 A.2d 421 (Del. Ch. 2002), Delaware Chancellor Strine noted that some commentators believe that "directors cannot deny their shareholders access to a tender offer solely because of price inadequacy, once they have had an adequate opportunity to develop a higher-value alternative [and] to provide the stockholders with sufficient information to make an informed decision whether to tender." *Id.* slip. op. at 41. *See also Next Level Communications, Inc. v. Motorola, Inc.*, 834 A.2d 828, 846 (Del. Ch. 2003) ("Where an offer is found to be both structurally noncoercive and fully disclosed, the Court [will leave] the decision whether to tender or not up to the stockholders."). In citing *Pure Resources*, the *Next Level* court noted that "a person making a tender offer is not ordinarily required to disclose its 'reserve price.'" Id. at 851 n.89.

e. Defensive Tactics Available to T, Other Than Looking for a Sale or Merger

See next section.

f. The Opinion of T's Financial Adviser

Note the difference between an opinion that a deal price is fair from a financial point of view and an opinion that a price is inadequate.

4. T Considers Defensive Tactics Other Than a Merger or Sale

a. The Legal Standards

(i) The General Business Judgment Rule

State corporation statutes typically provide that the business of the company is to be "managed by or under the direction of the board of directors." A corollary is that courts will not substitute their judgment for the business judgment of the directors, so long as the directors act consistently with their duties of care and of loyalty.

The prerequisites for applying the business judgment rule (to protect the directors from liability and to prevent their acts from being set aside or enjoined) are as follows:

- A *decision* by the directors.
- *Good faith* and *disinterestedness*. A decision that is disinterested might still

fail scrutiny if it is so careless as would amount to bad faith.

- *Being informed.* Under the Delaware cases, the directors should be informed of "all material information reasonably available to them."

- A decision that is *not irrational.*

(ii) Additional Prerequisites for Takeover Defenses

If the matter being considered relates to a takeover defense, then, because of the interest the directors may have in retaining their jobs, Delaware courts, under *Unocal Corp. v. Mesa Petroleum Co.*,[27] require two other prerequisites to be satisfied before the action will be entitled to the presumption of validity under the business judgment rule:

- *Threat.* The directors must show the existence of a threat to corporate policy or effectiveness. The Delaware Supreme Court in *Unitrin, Inc. v. American Gen. Corp.*[28] noted three kinds of threats that might be posed by a hostile offer: opportunity loss (risk of

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[27] 493 A.2d 946 (Del. 1985).

[28] 651 A.2d 1361 (Del. 1995).

depriving T's shareholders of the chance to get a better alternative); structural coercion (the risk that disparate treatment of non-tendering holders might distort shareholders' decisions on whether to tender); and substantive coercion (the risk that shareholders will mistakenly accept an underpriced offer because they do not believe management's representation of intrinsic value).

- *Reasonable response*. The response must be reasonable in response to the threat posed.

In *Unitrin*, the Delaware Supreme Court said that in reviewing defensive measures, a court should examine whether the defensive measures are "preclusive or coercive" and, if they are not, should then examine whether the defensive measures fall within a "range of reasonableness." "[I]f the board of directors' defensive response is not draconian (preclusive or coercive) and is within a 'range of reasonableness, a court must not substitute its judgment for the board's."[29] One of the key elements in assessing whether a defensive measure is preclusive is whether it prevents T's

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[29] *Id.* at 1388.

shareholders from acting on the proposed acquisition – for example, to remove the existing directors and to replace them with directors who are able to remove the obstacles to the takeover. An example of this is offered by *Hilton Hotels Corp. v. ITT Corp.*[30] In enjoining ITT from implementing without a shareholder vote its shareholder plan, which included spinning off most of ITT's assets into a company with a staggered board, the court noted that "interference with the shareholder franchise is especially serious. It is not to be left to the board's business judgment, precisely because it undercuts a primary justification for allowing directors to rely on their business judgment in almost every other context."[31]

b. Specific Defensive Techniques

Targets recently have used a wide array of defensive techniques, both singly and in combination, with varying degrees of success.

(i) Litigation

- *Antitrust.* While the target may not have standing to bring suit itself on antitrust grounds, it may point out antitrust problems to the regulators – federal and state. See, e.g., the failed antitrust action brought

30 978 F. Supp. 1342 (D. Nev. 1997), *aff'd*, 116 F.3d 1485 (9th Cir. 1997).

31 *Id.* at 1351.

by ten states and DOJ to bar Oracle's acquisition of PeopleSoft[32]; Loewen's raising of antitrust issues in connection with Service Corporation's offer.

Bear in mind the possible risk that if strong antitrust objections are raised by T to the antitrust regulators, T may find it harder to do a transaction with A if A subsequently increases its bid to a level T finds attractive. Antitrust litigation is a genie that is not always easy to put back in the bottle.

- *Disclosure.* Note that a bidder often is able to cure allegedly insufficient disclosures by supplemental disclosures, and then to continue with its offer.

- *Other.* For example: does A's bid breach a standstill agreement?

(ii) Regulatory/Governmental/PR

- Examples include BAT's all-out opposition, before the

[32] United States v. Oracle, No. C 04-0807 (N.D. Cal. Sept. 9, 2004) (states and DOJ failed to prove that a takeover of PeopleSoft by Oracle would be anticompetitive).

insurance regulators of nine states, to the takeover attempt of Sir James Goldsmith; SunTrust's suggesting to the Federal Reserve that First Union (the competing bidder for Wachovia) was underreserved.

- T may also seek help in the state legislature. For example, in 1998, Echlin, the target of a bid by SPX, tried to convince the Connecticut legislature to say that the obstacle presented to a hostile bid by the Connecticut Business Corporation Act could be waived only by directors who were in office before someone announced an intention to acquire more than 10 percent of the company's shares. Echlin also proposed to change the law to prevent removal of directors without cause at a special meeting held within 12 months after someone announced an intention to buy more than 10 percent.

  In the 1998 AlliedSignal bid for AMP, the target sought legislation in Pennsylvania permitting directors to be removed only at an annual meeting.

In response to SunTrust's 2001 bid for Wachovia, the North Carolina legislature, at the target's request, amended the state's corporation statute to provide that holders of 10 percent of the shares could call a meeting of shareholders only if the company's charter (not charter or bylaws) so provided.

In 2003, in the Simon bid for Taubman, after a court construed the Michigan Control Share Act to mean that the Taubman family could not vote its 31% stockholding because the family had formed a group with holders of 3% of the company's stock, the Michigan legislature passed an amendment to the effect that shares without voting rights because of the formation of a group are to have the same voting rights they would have had before the group was formed.

- Is the takeover politically sensitive? Can Congressmen and Governors be encouraged to voice their concerns?

(iii) Poison Pills

Adopting or strengthening a poison pill (for example, lowering the threshold, or eliminating the window of redemption), or simply deciding not to redeem it. See, e.g., the adoption by the outside directors of Hollinger International of a rights plan to block Conrad Black's efforts to sell a controlling block of stock in the company;[33] the adoption by Neuberger Berman Real Estate Fund of a rights plan after the Hresji trusts started a tender offer for control by the fund.[34]

(iv) Amending Governing Instruments

Bylaws typically can be amended by directors without shareholder approval (for example, to put in a requirement for advance notice for a shareholder proposal). Charter amendments require shareholder approval, which is usually not possible for companies with substantial institutional share ownership in the context of a hostile takeover that is at a premium over the pre-bid market price for T shares.

(v) Employment Agreements and Severance Agreements

Typically, these agreement are not show-stoppers; however, they may affect the price A is willing to pay.

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[33] Hollinger International, Inc. v. Black, C.A. No. 183-N (Del. Ch. Feb. 26, 2004)

[34] *Neuberger Berman Real Estate Income Fund, Inc. v. Lola Brown Trust No. 1B*, Civil No. AMD 04-3056 (D.Md. Oct. 22, 2004).

A variant of this is putting into a union contract, in a labor-intensive business, a provision allowing the agreement to be renegotiated in the event of a takeover. (UAL tried this, in response to takeover talk; the court held the provision violated Delaware law because it was intended to benefit incumbent management and one union, not the shareholders.[35])

(vi) Issuing Shares to Employees or Other Allies

- T may attempt to issue a substantial block of its stock to an employee stock option plan in the hopes that the employees will vote the stock against A's acquisition proposal (for example, Polaroid's issuance to an ESOP in response to Shamrock's proposed acquisition).[36]

- Note, however, that a substantial block of T stock held by T's employees may not necessarily be an ally of T's continued independence (for example, the campaign in 1998

[35] *Airline Pilots Ass'n Int'l v. UAL Corp.*, 717 F. Supp. 575, 580 (N.D. Ill. 1989), *aff'd*, 897 F.2d 1384 (7th Cir. 1990).

[36] Bills have been introduced in Congress following the Enron and Worldcom meltdowns to amend the ERISA and the Internal Revenue Code to require ESOPs to diversify their portfolios beyond employer stock. If such a requirement becomes law, it may reduce the effectiveness of this defense.

by Nationwide, in its initially hostile bid for ALLIED, to encourage the participants in ALLIED's ESOP to instruct the trustee to tender shares).

- Also note that by issuing a substantial block of T stock to an employee stock participation program as a defensive measure, T's directors may breach their fiduciary duties under the *Unocal* or *Blasius* standards, if such issuance is found to constitute a legal strategy to frustrate a shareholder vote. The Delaware Chancery Court held in *Aquila, Inc. v. Quanta Services, Inc.*[37] that unless there is a "fit" between the voting dilution caused by such stock issuances and the identified threat to corporate policy and effectiveness, this defensive measure may violate the "strong Delaware policy of protecting the shareholder franchise."[38]

(vii) Buying in Stock

[37] 805 A.2d 196 (Del. Ch. 2002).

[38] *Id.* at *30-31.

For example, Unitrin's purchases of its own shares in response to American General's bid. The result was to increase the percentage owned by the target's directors from 23 percent to 28 percent. Under a supermajority provision in Unitrin's charter, a merger with someone that owned 15 percent or more of Unitrin's stock had to be approved by holders of at least 75 percent of the outstanding shares, unless the merger had been approved by Unitrin's continuing directors.

(viii) Recapitalization

For example, Interco's recapitalization in response to Danaher's bid. The dangers are excessive leverage and depletion of equity.

(ix) Raising Questions as to A's Financing

(x) Sale or Spin-Off of Key Assets

- Is shareholder approval needed under state law? (For example, Hilton-ITT: under Nevada law, perhaps not if the spin-off did not change corporate governance; but needed if a fundamental part of the spin-off was to impose a classified board on the company that was to own most of the predecessor's assets, without a shareholder vote on the change in governance.)

  In the case of a sale, if the asset is important enough, is there a

duty to get the best price reasonably available – and to talk to A as a possible buyer?

(xi) Buying Out A's Holdings of T

- Typically the repurchase would be coupled with a standstill agreement, under which A agrees not to pursue T.
- What is to prevent someone else from coming after T?
- Greenmail tax.
- State statutes relating to greenmail (*e.g.*, N.Y. Bus. Corp. L. Section 513(c), requiring shareholder approval for repurchase of more than 10 percent from a shareholder at a premium).

(xii) The Pac-Man Defense

T could make a tender offer for A. But then A's shareholders, not T's, would get the premium. This tactic has become rarer in recent years, but was used in 1999 when TotalFina and Elf Aquitaine bid for each other and in 2000 when Chesapeake responded to a public bear hug from Shorewood by launching a tender offer for Shorewood.

(xiii) New Change of Control Provisions

T might enter into agreements with third parties containing change of control provisions (for example, the provisions in the hotel management contracts ITT entered into after Hilton started its hostile tender offer; the joint venture that P&O Princess entered into with Royal Caribbean concurrently with the announcement of their merger and in the face of the threat from Carnival; or the Customer Protection Program implemented by PeopleSoft, challenged by Oracle in Delaware litigation as a "nonredeemable poison pill," which provides customers substantial financial protection in the event an acquiror discontinues the sale, development or support of PeopleSoft's products within a specific time period after an acquisition).

5. T Explores a Strategic Merger with a White Knight

a. Law

Under *Paramount-Time*, a strategic merger does not trigger a duty to seek the best price reasonably available, if the transaction does not involve a change of control – in other words, if, after the transaction, control remains in a fluid aggregation of public shareholders. (Contrast the Viacom-Paramount transaction, in which Paramount shareholders would have received a substantial percentage of the stock, but Sumner Redstone – Viacom's largest shareholder – would have had 70 percent of the vote.)

That does not mean, however, that T's directors have no duties in connection with a strategic

merger. As the Delaware Chancellor made clear in *Phelps Dodge Corp. v. Cyprus Amax Metals Co.*,[39] the directors still have a duty to "be informed of all material information reasonably available," even though they are not under a duty to negotiate with a competing bidder. The court in that case found troubling "no-talk provisions" in a friendly merger agreement under which each merger partner agreed not to provide any information to or to have any discussions with a competing bidder – without an exception for actions called for by the directors' fiduciary duty. The court indicated that provisions that completely foreclose the opportunity to talk with a competing bidder are "the legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care."[40]

It is also true that the *Unocal* test is applicable in analyzing actions taken by parties of a negotiated merger to defend against the possibility of a competing bid. See, for example, the Delaware Supreme Court decision in *Omnicare, Inc.* v. *NCS Healthcare, Inc.*,[41] holding that deal protection devices put in place to protect a stock-for-stock merger are subject to enhanced scrutiny under the *Unocal* test.

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39 Civ. A. Nos. 17398, 17383, 17427, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sep. 27, 1999).

40 *Id.* at *4-5.

41 818 A.2d at 936 (holding deal protection devices "designed to coerce the consummation of the [negotiated] merger and preclude the consideration of any superior transaction" are "not within a reasonable range of responses to the perceived threat").

b. Reality

Will the strategic merger require a vote by the shareholders of T? For instance, would T be a party to a merger, or would T be issuing 20 percent or more of its shares so that a shareholder vote is needed under stock exchange rules?

If so, is there any chance of getting a favorable vote, if A is offering a premium over market and the strategic merger is offering no premium or a lesser premium?

c. The Financial Adviser's Opinion as to Fairness

Note that the adviser's analysis will be summarized at length in the merger proxy statement, and that the SEC staff is likely to ask to see the board books.

6. <u>T Enters into a Deal with an Alternate Suitor or with A</u>

If T talks to other suitors, and is able to get other suitors to agree to standstill restrictions as well as agreements to keep nonpublic information about T confidential, may T refuse to divulge confidential information to A unless A also agrees to standstill restrictions?

Suppose A offers $24 per share. May T sign up a deal with an alternate suitor at, say, $28 per share, with all sorts of lock-ups (e.g., an option to buy a subsidiary, plus a termination fee, plus a no-shop covenant) – and put the game away?

Under *Paramount - QVC*, if T's board determines to sell control, the board must seek the best price reasonably available. In *Paramount*, the Delaware Supreme Court

struck down, as unreasonable and a breach of fiduciary duty, a combination of a stock option to the favored suitor (the exercise price payable only in part by cash, with the balance by note, and the option being puttable to T at the spread with no limit on the potential value of the option to A), a $100 million bust-up fee, and a no-shop clause.

Other cases have struck down "crown jewel" options, under which the favored suitor can buy a key part of T at a price that may be less than its market value.

Similarly, in *Omnicare*, a majority of the Delaware Supreme Court struck down as preclusive and coercive a combination of a requirement to submit a merger to a stockholder vote even if the directors no longer recommended approval of the merger, an agreement of stockholders with a majority of the voting power to vote in favor of the merger, and the absence of an effective fiduciary out. The court found the combination made it impossible and unattainable for "any other transaction to succeed, no matter how superior the proposal."[42]

So T's management cannot put the game away, if the transaction involves a sale of control of T. But courts have permitted clauses under which T cannot initiate discussions with competing bidders, so long as T may talk to a competing bidder if required by the fiduciary duties of T's directors (for example, in the *Phelps Dodge-Cyprus Amax* case as to flat no-talk provisions). Courts have also permitted clauses under which, if T goes with another bidder, T receives a reasonable termination fee. Termination fees lately have been running around 2 percent to 3 percent of the deal's value, although there is a dictum in a Delaware Chancery Court case that termination fee provisions "in the

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[42] 818 A.2d at 914.

range of one to five percent of the proposed acquisition price are reasonable."[43] In more recent case the Delaware Chancery Court stated that a termination fee of 3.5 percent was "at the high end of what our courts have approved" but "still within the range that is generally considered reasonable"[44], and that a termination on fee of 3.3 percent was "well within the range of reasonableness".[45] The Delaware Chancellor in the *Phelps Dodge* case indicated without having to decide the question that a termination fee of 6.3 percent "seems to stretch the definition of the range of reasonableness and probably stretches the definition beyond its breaking point."[46] Delaware Vice Chancellor Strine has noted that "[w]hile Delaware cases have tended to use equity value as the benchmark for measuring a termination fee, no case has squarely addressed which benchmark is appropriate. Each benchmark has analytical arguments in its favor."[47] The Chancery Court opinion in the *Omnicare* case[48] (in a point that was not addressed in the Supreme Court opinion) looked at the reasonableness of the termination fee as a percentage of total enterprise value, since the target was in the zone of insolvency.

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[43] *Matador Capital Management Corp. v. BRC Holdings Inc.*, 729 A.2d 280 n.15 (Del. Ch. 1998).

[44] *McMillan v. Intercargo Corp.*, C.A. No. 16963 (Del. Ch. Apr. 20, 2000).

[45] *In re The MONY Group Inc. Shareholder Litig.*, C.A. No 20554 (Del. Ch. Feb. 17, 2004).

[46] 1999 Del. Ch. LEXIS 202, at *5.

[47] *In re Pennaco Energy, Inc. Shareholders Litig.*, 787 A.2d 691, 703 n.16 (Del. Ch. 2001).

[48] *In re NCS Healthcare, Inc. Shareholders Litig.*, 825A.2d 240 (Del Ch. 2002).

How can T and its financial adviser best maximize the price obtainable from A or from a competing bidder? One technique, of course, is to play one bidder off against the other.

If peace is made with A, or if T enters into an agreement to be acquired by an alternate suitor, issues that will need to be addressed in the transaction agreement include: representations and warranties; conditions to the tender offer; conditions to the post-closing merger; and the size and triggers for the payment by T to the acquiring company of a termination fee and expense reimbursement.