

January 5, 1977

To Our Clients:

Tender Offers

Applied Digital Data Systems, Inc. v. Milgo Electronics Corp., 76 Civ. 5454 (S.D.N.Y. 1976) bids well to be one of the leading tender offer cases. ADDS proposed a merger with Milgo which was rejected. ADDS then announced its intention to make an exchange offer. Milgo, without having filed a Schedule 14D, announced its rejection of the proposed exchange offer saying that its was "less favorable" than the previously rejected merger proposal. Milgo then announced the sale of unissued shares equal to 15.5% of its outstanding shares to an English joint venture partner saying that the proceeds would be used to reduce bank borrowing. The documentary evidence showed that the issuance of shares by Milgo was for the purpose of defeating ADDS' exchange offer. ADDS, which was then preparing its exchange offer registration statement and Schedule 13D, commenced an action to enjoin the issuance of the shares by Milgo and obtained a temporary restraining order. A week later ADDS filed its exchange offer registration statement and Schedule 13D and moved for a preliminary injunction. In granting the preliminary injunction, Judge Weinfeld passed on some major tender offer issues as to which there has been sparse or no prior authority.

First, the court held that the offeror has standing to seek relief against a target's Williams Act violations and such standing arises upon the announcement of the offer even though the offer has not then been formally made. The court said:

In practical terms, the situation is no different when the offer has been announced but not formally made. Thus, when ADDS made a public announcement of its forthcoming offer, it had a legally cognizable interest in Milgo and in the actions taken by the Milgo Board of Directors in response to the announcement. Allowing it to maintain this suit not only provides a remedy to the wronged offeror, but also serves to effectuate the broader purposes of the Williams Act by putting the tools for enforcement of its fair-play provisions into the hands of those most likely and able to make use of them.

The contention that the requirements of section 14(d) and (e) are not applicable until an exchange offer has actually been promulgated is thus better viewed as bearing upon whether ADDS states a claim for relief under those sections. At the outset, it must be noted that this argument, insofar as it rests on statutory language, is not logically sound. There is no apparent reason why any given action may not be taken "in connection with" a development reasonably certain to take place in the future or why a recommendation to reject a proposed tender offer is not also a recommendation to "reject a tender offer." Indeed, Rule 10b-5, which was adopted by the SEC under section 10(b) of the Securities Exchange Act and after which section 14(e) was closely patterned, requires that a complaint of action take place "in connection with the purchase or sale of a security," yet it repeatedly has been held to create a cause of action to enjoin purchases or sales of securities that have been proposed but not yet effected. Moreover to the extent the defendants claim that no pre-offer communications or actions can ever be taken "in connection with" a tender offer, the force of their argument is greatly impaired by a line of cases holding that to be actionable under Rule 10b-5 the fraud must have occurred prior to or contemporaneous with the sale of securities.

* * *

Defendants' overly strict and literal reading of the statute, which would confine the disclosure and fair-play provisions of the Act to the period after an offer has been formally made, would obviously frustrate the express remedial purposes of the statute. Indeed, it would be anomalous were sections 14(d) and 14(e) not applicable to the offeror or target corporation once a public announcement of an imminent tender

or exchange offer made, for numerous misstatements, omissions and half-truths could be promulgated with relative impunity until the offer was actually filed with and approved by the SEC. Although the shareholders might not in the pre-offer period be faced with a present decision whether to exchange their stock in the target corporation, statements and actions of the target corporation and the offeror during this period clearly have the capacity to affect any future decision and should thus fall within the purview of the statute. This is especially so when, as here, the competing parties by their acts and conduct clearly indicate that in fact they deem the proposal of an exchange offer to be genuine. Thus, on December 13th, shortly after its announcement, ADDS filed with the SEC its Schedule 13D and a lengthy registration statement on Form S-1 covering the preferred stock to be issued in exchange for Milgo common shares. Moreover, Milgo's press release of November 17th reveals that the Milgo Board of Directors anticipated that the proposed offer would indeed be forthcoming. The fact that ADDS had already approached the Milgo Board with a merger offer further indicates that the exchange offer was imminent and that whatever its merits the proposal was made in good faith.

The court distinguished the Corenco case often cited to the contrary as follows:

Corenco Corp. v. Schiavone & Sons, Inc., 488 F.2d 207 (2d Cir. 1973), cited by the defendants, is not to the contrary. The court in that case held that an announcement of an already-effective tender offer did not itself constitute a "tender offer" within the meaning of section 14(d) requiring the defendant to include all the terms of the offer in the announcement. Id. at 216. Because the announcement clearly stated that it did not constitute an offer and that shareholders could only tender their shares by obtaining

a copy of the formal Offer to Purchase, the court found that no purpose of the Williams Act would be served by requiring the defendant to reproduce the entire Offer to Purchase along with the announcement. Corenco thus did not deal with the issue whether an announcement prior to the making of a tender offer and actions taken in response to such an announcement were covered by the Act. The mere fact that an announcement of an offer has been held not to constitute an offer in no way implies that the announcement, and actions responding to it, are not taken "in connection with" a tender offer.

Second, the court distinguished the line of cases which have held that preformal offer purchases are not part of the formal offer and provided a sound rationalization for those decisions. The court said:

The cases cited by defendants to support their position cannot be read to indicate that sections 14(d) and 14(e) are not applicable once a public announcement of an imminent exchange offer has been made. Nearly all of these cases deal with the question whether purchases of a potential target company's stock prior to the filing of a Schedule 13D and prior to any announcement of a tender offer should themselves be characterized as part of the offer. Under such circumstances, the target company itself is not likely to be aware of the possibility of an offer, and the purchaser will not have indicated that one is contemplated since he will not have reached the five per cent holding of securities that triggers the requirement of filing a Schedule 13D. At that early stage, there is no contest for control with the attendant dangers of misrepresentations, nor has the purchaser acquired a large enough block of stock to warrant shareholder concern over possible shifts in corporate management. Thus, the purposes of the Williams Act would not be materially furthered by applying it to the offeror or the target company. When,

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however, a public announcement of a proposed offer has been made, the very dangers that the Act was intended to guard against come into play, and the application of sections 14(d) and 14(e) is thus appropriate.

Third, it is violation of § 14(e) for a target to issue shares without a valid business purpose and for the sole purpose of defeating a tender offer.

Fourth, a statement rejecting a merger proposal does not violate § 14(e) because it was not made "in connection with" a tender offer.

Fifth, a statement by a target with respect to a proposed tender offer is "in connection with" a tender offer and therefore is subject to both § 14(d) and § 14(e).

Sixth, agreements permitting the purchaser of shares to be issued by a target to opt out in the event of litigation and to elect two designees of the purchase to the board of the target are material matters and the failure to disclose them constitutes a § 14(e) violation.

Seventh, a statement that a tender offer proposal is even less favorable than a previously rejected merger proposal is a recommendation by the target within § 14(d)(4) and cannot be made prior to the filing of a Schedule 14D by the target.

Eighth, where management of a target is subject to § 14(d)(4), § 13(d) is not applicable to them. The court said:

It has been held that when management personnel join with outside shareholders in an agreement to hold or acquire stock for the purpose of preserving control of a corporation, a Schedule 13D must be filed. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221 (S.D.N.Y. 1975). Whether or not section 13(d) should be applied to such a group, the Court cannot accept ADDS' suggestion that a Schedule 13D must be filed when management personnel owning greater than five per cent of their corporation's equity shares "agree" with outsiders who as yet hold no shares to use management's stock to preserve them in control.

Ninth, the court indicated that an announcement by an offeror prior to filing a Schedule 13D of intention to make a tender offer may technically violate § 14(d)(1). Recognizing the need in certain cases to make such disclosure prior to the filing of a Schedule 13D, the court indicated that the prefiling announcement should be limited and the court referred to the type of prefiling announcement by a target permitted by Rule 14d-2.

This case, when read with Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975); Royal Indus., Inc. v. Monogram Indus., Inc., Dkt. Nos. 76 Civ. 3348-R & 76 Civ. 3356-R (C.D. Cal. Nov. 29, 1976); Crane Co. v. Anaconda Co., 411 F. Supp. 1208 (S.D.N.Y. 1975), reflects a growing judicial condemnation of "tricks" like issuing shares to friends or acquiring competitors of the offeror or making "shark repellent" amendments to charters to defeat tender offers. This trend provides some counter balance to the additional time afforded to targets by state takeover laws and will facilitate a resurgence of exchange offers which do not have a longer time frame than cash offers under most state takeover statutes and which provide greater price flexibility to the offeror. Given a favorable market, the exchange offer resurgence has become a real possibility.

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