March 28, 1977

To Our Clients:

Tender Offers; Repurchase of Shares from a Holder Threatening a Tender Offer or Proxy Fight; Definition of Tender Offer

Heine v. The Signal Cos., CCH Fed. Sec. L. Rep. ¶ 95,898 (S.D.N.Y. Mar. 4, 1977) is a well reasoned decision by Judge Frankel sustaining under both federal securities law and Delaware corporate law the repurchase at a premium of a block of shares by a corporation from a dissident holder without giving all of the shareholders an equal opportunity to sell at the same price.

A Group acquired 11% of Signal "for investment". Signal sued for divestiture claiming the Group sought control. The Group expressed disagreement with Signal's diversification policy and proposed alternative policies. The Group then brought a suit to enjoin the sale of a Signal division and to recover damages from Signal's directors. During the pendency of both suits the Group entered into an agreement to sell its shares to a third party at a premium. The third-party sale aborted with respect to 62% of the shares and Signal bought the 62% at the same premium price as the third party and shortly thereafter made a repurchase tender offer at the same price for about 5% of its shares to its own shareholders, which tender its directors had approved (conditioned on the closing of the repurchase from the Group) at the same time as the repurchase from Group. The tender was greatly oversubscribed resulting in a 15% proration. Shortly after the repurchase the Group dropped the derivative action against the Signal directors. Signal's directors approved the repurchase from the Group on the basis that (1) it was in Signal's best interest to eliminate a large, troublesome shareholder whose fundamental policy differences with Signal's management had led to time consuming litigation and inhibitions on Signal's freedom of action and (2) Signal had excess cash and the repurchase would result in a pro forma increase in per share earnings and book value. Plaintiffs brought a class (not derivative) action on behalf of the shareholders who tendered but had only 15% of the shares they tendered accepted asserting that the failure to purchase all the shares violated the federal securities laws and Delaware corporate law.

The basic holding of the court was that the causes action, if any, would be derivative against the directors and not direct against Signal. However, the court went on to state that even if the plaintiff had sued derivatively, there would be no violations of law.

First, Judge Frankel said that even if Rule 10b-5 and Section 14(e) were violated by a corporate repurchase with no valid corporate purpose, no such violation occurs when the repurchase was to eliminate a fundamental policy disagreement with a major shareholder and the corporation had large cash reserves and the repurchase resulted in a pro forma increase in per share earnings and book value. Judge Frankel rejected the contention that the sole motivation of the repurchase was to perpetuate control and terminate the derivative action against the Signal directors as being inconsistent with the lack of action on the part of Signal until after the transaction between the Group and the third party partially aborted.

Second, Judge Frankel summarized the Delaware law as to repurchases as follows:

> ". . . Delaware law, with reasonable liberality, permits the use of corporate funds by directors to buy out dissident shareholders when such a tack is based on a "sincere belief that the buying out of the dissident stockholder[s] [is] necessary to maintain . . . proper business practices." Cheff v. Mathes, 199 A.2d 548, 554 (Sup. Ct. 1964); see also Bennett v. Propp, 187 A.2d 405 (Sup. Ct. 1962); Kors v. Carey, 158 A.2d 136 (Del. Ch. 1960). Only "if the board has acted solely or primarily because of the desire to perpetuate themselves in office, [is] the use of corporate funds for such purposes improper." Cheff v. Mathes, supra at 554. In recognition of "the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved," Delaware courts do place the burden of proof on the directors to "justify such a purchase as one primarily in the corporate interest." Bennett v. Propp, supra at 409."

Judge Frankel then said:

> "Signal's directors would have no difficulty in satisfying such a burden on the basis of the record before the court. As previously discussed, the policy differences between the . . . Group and Signal's directors were fundamental. And, as the various lawsuits and maneuvers preceding them demonstrate, these differences were readily translatable into antagonistic skirmishes consuming the time and resources of both parties. Consequently, it is not at all surprising that both Signal and the . . . Group should have been interested in

> terminating their tumultuous relationship. The record is devoid of any evidence to support the claim that Signal's directors felt their personal positions to be jeopardized by the . . . Group; in fact, the testimony of . . . the President of Signal, is quite to the contrary. Nor is there any evidentiary basis for the contention that Signal's directors authorized the transaction with the . . . Group solely for the purpose of extinguishing the threat of personal liability held out by the Delaware derivative action. Finally, <u>the record discloses additional purely financial reasons for the repurchase transaction which are probably sufficient in themselves to support the directors' chosen course</u>. The court is persuaded that the transaction with the 13D Group was undertaken for reasons completely consistent with the legitimate business interests of [Signal] and thus that there was no breach of the directors' fiduciary duty to the corporation under Delaware law." (Emphasis supplied.)

Thus it would appear that Judge Frankel would find that <u>either</u> resolution of a policy dispute <u>or</u> financial benefits to the corporation is sufficient to sustain a premium repurchase without equal opportunity for all the shareholders.

In addition to the fundamental fiduciary duty claims, the plaintiff argued that the repurchase from the Group and the repurchase tender offer should be integrated with the result that this violated the Rule 10b-13 proscription against purchases outside of a tender offer from the time the tender offer is publicly announced and until its expiration. Judge Frankel rejected the integration argument and observed:

> "The court also has serious questions about the applicability of Rule 10b-13 to the disputed transactions. Plaintiffs' argument appears in rest upon a reading of the rule as requiring an offeror to treat all those who tender on equal terms. Defendants appropriately point out that such an interpretation of the rule, if applied to Signal in this case, would seem to conflict with § 14(d)8 of the Williams Act, 15 U.S.C. 78n(d)(8), which exempts issuer tender offers from the proration requirements the Act imposes on other tender offers. See 15 U.S.C. § 78n(d)(6). Plaintiffs in response maintain that the proration requirement contained in the Williams Act was designed to

to prohibit the "first-come-first served" provisions once common in conventional tender offers, and that any exemption from the requirement should be narrowly read as only repealing that prohibition, not as giving an issuer free rein to accept tendered stock on any basis he sees fit.

It would appear that the SEC, in promulgating Rule 10b-13, was primarily concerned with outside purchases by the offeror at prices different from those provided tendering shareholders. See SEC Release No. 34-8712, _supra_. While the court agrees that the exemption of the issuer from the pro rata requirement of the Williams Act constitutes a gap in the regulatory scheme, there is no evidence that Rule 10b-13 was intended to fill it."

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