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Memorandum with respect to Treatment by a Target Company of a Takeover Proposal

The following outlines the legal and practical considerations in the case of a takeover proposal or attempt:

1. There is no legal requirement that a target discuss acquisition or engage in acquisition negotiations with anyone who proposes such discussions or negotiations. There is no duty to negotiate even when a prospective acquiror indicates that it would offer a large premium if the target would agree to an acquisition.

2. The target should not permit the raider to misperceive the target's intentions. Many takeover attempts are attributable to the failure of the target to reject firmly and unequivocally the first approach. The target's equivocation misleads the raider into believing that it has a chance for a negotiated acquisition. The raider then invests time and effort in studying and developing a proposal and the management of the raider commits its prestige to accomplishing the acquisition. When the target does finally reject, the raider loses sight of the problems of a takeover attempt and proceeds with a tender offer where, if there had been an early clear-cut rejection, the raider would have abandoned the effort.

3. There is no requirement for public announcement by a target of rejected approaches requesting acquisition discussions. (However, there should be no insider trading at times when the insiders know that acquisition approaches are being made and rejected.)

4. If a raider makes a specific firm acquisition proposal, it should be considered by the target's board of directors and, except under special circumstances, such proposal should be announced publicly.

5. The target's board of directors has no duty to accept an acquisition proposal or to take a position on a takeover attempt. There is no case that has held the directors of a target liable for the rejection of an acquisition proposal or the defeat of a takeover attempt.

6. When considering an acquisition proposal or takeover attempt, the directors of a target must act in good faith and on a reasonable basis. The target's management and/or investment banker should put together the financial and business information (including management's five-year

projections and management's valuation of the target's assets on the basis of what they could be sold for) appropriate for consideration by the target's board of the adequacy of the price proposed by the raider.

7. It is reasonable for the directors of a target to reject an acquisition proposal or to seek to defeat a takeover attempt on any one of three bases:

> (a) the price is inadequate in that it does not reflect the value of the target if the target were to determine to seek to be acquired or to liquidate, or
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> (b) the belief that the timing is wrong and that a better deal could be obtained in the future, if then desired, or
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> (c) illegality, e.g., the acquisition would violate the antitrust or other laws or the takeover attempt violates the disclosure or other provisions of the federal securities or other laws.

Even if the price is adequate or unusually high and there is no determination that the timing is wrong, the target has an absolute right to reject an offer or seek to defeat a takeover attempt if the acquisition would violate the antitrust or other laws.

8. In addition to the above bases for rejection of an acquisition proposal, it is reasonable for the directors of a target to refuse to consider an acquisition proposal that is uncertain or conditioned in an unusual manner or that is for less than all of the outstanding shares of the target.

9. While there is no legal requirement that the directors of a target obtain the advice of an investment banker or legal counsel, reliance by the directors of a target on the advice of an independent investment banker and independent legal counsel has been held, in a number of cases, to establish the requisite good faith and reasonable basis for rejection of an acquisition proposal or action to defeat a takeover attempt. With respect to rejection on the basis of illegality, except in a very clear case, the opinion of counsel should be obtained.

Attached is an excerpt from Lipton & Steinberger, Takeovers and Freezeouts, which discusses and cites some of the case law on which this memorandum is predicated.

Martin Lipton

6.3. **Responding to pre-offer takeover attempts.**

6.3.1. **Friendly approach.** As long as it is acting in good faith, the management and board of directors of a target have no legal duty to engage in discussions or to negotiate with respect to the sale of the target, but management should advise the board of directors of any approaches. See *Berman v. Gerber Products Co., supra.* Friendly discussions are frequently misunderstood by the potential raider, and the termination of such discussions often results in a hostile offer. Such discussions should therefore be avoided and, assuming such is the fact, management should be authorized to inform any prospective raider that the target is not for sale and there is no interest in discussing the subject. Advance preparation of the board of directors and management in this regard is highly desirable. See generally *Management's Responsibility, supra.*

6.3.2. **Bear-hug approaches.** Although management has a duty to bring firm proposals to the board, and the board has the duty to consider carefully such proposals, there is no legal duty to sell the target. The response to a proposal can vary depending on the particular circumstances, and may range from outright rejection to discussions and/or negotiations. *Northwest Industries, Inc. v. B.F. Goodrich Co., supra* at 712 ("management has responsibility to *oppose* offers which, in its best judgment, are detrimental to the company or its stockholders"); *Selama-Dindings Plantations, Ltd. v. Durham,* 216 F. Supp. 104 (S.D. Ohio 1963), *aff'd,* 337 F.2d 949 (6th Cir. 1964) (depending upon circumstances, directors have duty to investigate potential raider and to advise shareholders); *Berman v. Gerber Products Co., supra* at 93,958 (target has affirmative duty not to refrain from bringing action to enjoin tender offer on antitrust and securities law disclosure grounds even though target's investment banker has advised that offer price is substantial). See also *Cummings v. United Artists Theatre Circuit, Inc.* 237 Md. 1, 204 A.2d 795 (Md. Ct. App. 1964). The board of directors should prevent an acquisition by those who it may have reason to know would loot or mismanage the assets of the target. *Insuranshares Corp. v. Northern Fiscal Corp.,* 35 F. Supp. 22 (E.D. Pa. 1940). In a decision upholding an acquisition by a target to defeat a takeover, a federal district court in Illinois said

> [M]anagement has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or to its stockholders. In arriving at such a judgment, management should be scrupulously fair . . . [and their] informed opinion should result from that strict impartiality which is required by their fiduciary duties. After taking these steps, the company may then take any step not forbidden by law to counter the attempted capture. *Northwest Indus., Inc.* v. *B.F. Goodrich Co.*, 301 F. Supp. 706, 712-13 (N.D. Ill. 1969)

Careful preparation of the board for consideration of a takeover offer is necessary; frequently it is desirable to have an investment banker's opinion as to the adequacy of the offer. See *Kaplan v. Goldsamt, supra*, at 6.2.8.2, to the effect that the courts will not second guess a good faith decision by the board as to value. If the board's decision is made in good faith and is reasonably based on the facts presented, there is no liability for rejection of a takeover offer. *Danziger v. Kennecott Copper Corp., supra,* although involving the converse situation—the propriety of directors authorizing a tender offer—demonstrates the value of an independent investment banker's opinion in a tender offer situation. *Danziger* involved an attempt by Kennecott shareholders to enjoin preliminarily the Kennecott tender offer for Carborundum. The essence of the shareholders' claims was that the Kennecott directors, in reaching a quick decision to offer for Carborundum at an aggregate price of nearly $600,000,000 (a price far in excess of Carborundum's book value and historical market price), "failed to thoroughly investigate the relevant factors and consider the best interests of Kennecott. . . . In the few days available to the [directors] to study the matter, they cannot possibly have given the type of detailed attention and study to such an important acquisition that the law requires." In response, the court stated:

> Kennecott's opposing papers include an extensive and detailed report on the proposed purchase. This analytical report was prepared by the First Boston Corporation, an independent financial adviser, at the request of Kennecott's

> board of directors. First Boston recommended the purchase. Thus, it is clear that Kennecott did thoroughly investigate the relevant factors and considered its own interests before deciding to make the tender offer. Kennecott explains that the $66 per share price was calculated to outbid another offeror which had previously made an offer of over $60 per share. . . .
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> [The New York Business Corporation Law] imposes a duty on corporate directors to discharge their duties "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." On the papers submitted, there is no showing that Kennecott's directors departed from this high standard in reaching their decision to offer to purchase Carborundum shares. It appears that the directors were thorough in their deliberations despite the relatively short period of time available for the decision-making process.

But see *Royal Industries, Inc. v. Monogram Industries, Inc., supra,* in which the Court found that a target's press release, which stated that the target was "guided" in its decision to reject the offer by an investment banker's report, was misleading because it failed to state that the investment banker had prepared such report "virtually overnight and without the necessary time and deliberation for fair evaluation" and because, in any event, the board's decision to oppose was not "guided" by the investment banker's report but rather by the self interest of the target's management and directors. To avoid the *Royal Industries* problem, it is desirable that the company's investment banker keep up to date on the company so that it can render a considered opinion on short notice if the need arises. See 6.1.2(c). But see *Elfenbein v. Braunschweiler,* Bench Opinion, 75 Civ. 2202 (S.D.N.Y. June 2, 1978) and discussion at 8.4.2.

6.3.3. **Responding to accumulations through open-market and other purchases.** Pre-offer accumulations have the purposes, among others, of recouping the raider's expenses in the event the raider is topped by a competing offeror, and, if such purchases are sufficiently large, of discouraging other suitors of the target. In addition, in certain cases open-market and other accumulations have resulted in an actual shift in control of the target or have given the raider additional leverage with the target. Typical litigation attacks the raider's disclosure of "investment" intent, raises the usual antitrust and margin claims and alleges a "creeping tender offer." See 1.5.2 and 2.3.1.7.

6.3.4. **Public announcement of the raider's approach.** The question of whether the target must make a public announcement of the raider's approach depends upon various factors. If the proposal has meaningful conditions or is otherwise "iffy", a strong argument can be made that no disclosure by the target is required. If, however, the proposal does not have meaningful conditions and specifies a price, it would appear that disclosure is required. In any event, target and insider trading is prohibited pending announcement or resolution of the question whether there will be a "real" offer. No announcement need be made of invitations to negotiate. In *Berman v. Gerber Products Co., supra,* the court said that overtures that are not firm offers are not material information that is required to be disclosed under Section 14(e). See discussion of announcement of specific offers at 6.4.1.

For a general discussion of disclosure obligations by public companies, see *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971); and *SEC v. Geon Industries, Inc., supra* (condemning selective disclosure of preliminary negotiations relating to potential merger of Geon but expressly noting that the holding did not mean that public disclosure of preliminary negotiations is either necessary or appropriate); see also Freund, *Selected Acquisition Problems under Rules 10b-5 and 10b-6 and under Section 16(b),* in Mundheim, Fleischer & Vandegrift, ed., *Eighth Annual Institute on Securities Regulation* (1977). The NYSE Company Manual and Amex Company Guide each contain guidelines with respect to disclosure obligations of listed companies, see discussions at 4.1.1 and 4.2.1, respectively.

6.3.5. **Considerations in responding to takeover attempts.** The Williams Act does not compel the board of directors of a target to take a position with respect to an offer. *Berman v. Gerber Products Co., supra.* Under state law the management of a target company must act in accordance with what it reasonably believes to be the best interests of the target's shareholders. The decision is essentially an economic and financial one and the board of the target must act in an objective manner toward that end. The recommendation of a course of conduct by truly independent outside advisors, *e.g.*, investment bankers and/or independent directors, is most helpful in sustaining target company decisions (see 6.3.2). Among the factors to be considered in responding to a takeover attempt are:

(a) the adequacy of the offering price given the present value and future earnings prospects of the target;

(b) the nature of the consideration offered by the raider, *e.g.*, cash or securities (and the value and prospects of such securities);

(c) whether the raider is seeking all of the target's stock or only a portion, and if it is a partial offer, what the effect will be on remaining shareholders (*e.g.*, market liquidity and price; effect on relationships with customers and suppliers and, consequently, on target's business; future prospects of a "freezeout"), see 6.5.2.5;

(d) whether this is the right time to sell the target (a reasonable good faith decision as to timing is a sufficient basis in and of itself on which to reject a takeover offer);

(e) the availability of other alternatives (See 8.4.2 with respect to the factors to be taken into account by the investment banker advising the board, all of which are appropriate for the board to independently consider); and

(f) the legality of the takeover offer (in *Berman v. Gerber Products Co., supra,* the court held that the target had an absolute right to litigate the takeover offer which the board of the target in good faith believed to violate the securities and antitrust laws).

Management may wish to delay the raider's tender offer in order to gain time to negotiate a defensive merger or White Knight tender offer. See *Commonwealth Oil Refining Co. v. Tesoro Petroleum Corp., supra,* and *Jewelcor, Inc. v. Pearlman, supra.* However, it should be noted that *Grossman, Faber & Miller P.A. v. Cable Funding Corp.*, CCH Fed. Sec. L. Rep. ¶ 94,913 (D. Del. 1974), a pre-*Green* decision, held that if target company management engages in a campaign to defeat one tender offer and insure the success of a competing tender offer for personal reasons, rather than in the best interests of the target and its shareholders, such conduct might be deemed a scheme to defraud within Rule 10b-5 as well as a breach of common law fiduciary duty. See also *Klaus v. Hi-Shear Corp., supra*; and *Del Noce v. Delyar Corp.*, CCH Fed. Sec. L. Rep. ¶ 95,670 (S.D.N.Y. 1976). With respect to disclosures of the target in connection with an attempt to defeat competing tender offers, see *SEC v. Thermal Power Co., supra*. Among other things, the complaint in *Thermal Power* sets forth the proposition that where management recommends one offer over a competing offer, failure to disclose advantages flowing to members of management by virtue thereof is a violation of Rule 10b-5 and Section 14(e). Specifically, the SEC alleged a failure to disclose that the president of the target had reached an agreement with the "favored" offeror to retain his position following the recommended exchange offer and that the target's directors who recommended a tax-free exchange offer over competing cash tender offers had a low tax basis in their stock as compared to the tax basis of the target's public shareholders.

6.3.6. **"Rule of reason."** In *Monogram Industries, Inc. v. Royal Industries, Inc.*, Civ. No. 76 3356-R (C.D. Cal. Nov. 17, 1976 and Dec. 13, 1976), the court held that improperly motivated defensive maneuvers may be preliminarily enjoined as violations of Section 14(e) and/or breaches of fiduciary duty. This decision was presaged by such cases as *Anaconda Co. v. Crane Co., supra*; *Grossman, Faber & Miller P.A. v. Cable Funding Corp., supra*; and *Condec Corp. v. Lunkenheimer, supra*. Note, however, that the Section 14(e) basis is questionable in light of *Green*.

In *Monogram*, the court preliminarily enjoined Royal from:

(a) holding a meeting of stockholders to vote on proposed amendments to Royal's charter to increase to 90% the percentage stockholder vote required to effect a business combination with the holder of 30% or more of Royal's stock;

(b) acquiring another corporation which had an antitrust action pending against Monogram and which Royal alleged to be a competitor of Monogram;

(c) making any payments under the acceleration features of Royal's deferred compensation plans, which plans had been adopted several years prior to the Monogram tender offer and provided for immediate payment of substantial sums if an offeror acquired more than 25% of Royal's stock in a transaction not approved by a majority of Royal's board of directors;

(d) prosecuting Royal's most recently commenced lawsuit against Monogram in the Delaware Court of Chancery, which suit was one of a total of nine initiated by Royal in the six and one half weeks since Monogram announced its intention to make the offer; and

(e) commencing or financing any additional litigation related to Monogram's tender offer, other than in the United States District Court for the Central District of California where most of the tender offer litigation was being conducted.

The court, finding that the proposed charter amendment, the proposed acquisition and the acceleration features of the deferred compensation plans all had as their "sole, primary, controlling, principal and compelling purpose" the blocking of tender offers and the maintenance of Royal's officers and directors in their positions, stated that the proposed charter amendment and acquisition raised "serious questions" as to violations of Section 14(e) and breach of fiduciary duty, and the acceleration provisions constituted a breach of fiduciary duty. The court held that Royal, by commencing the litigation in Delaware to avoid prosecution of a related suit in the Central District of California (see *Royal Industries, Inc. v. Monogram Industries, Inc., supra*) and to promote vexatious litigation, had violated Section 14(e), and that further litigation relating to the offer, other than in the Central District of California, would be vexatious and unnecessarily costly.

In determining a defensive strategy, it must be remembered that, in certain circumstances, more may turn out to be less.