WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients

Defending Against Takeovers

The enclosed outline by Henry Lesser is a good current summary of the topic.

M. Lipton

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DEFENDING AGAINST CORPORATE TAKEOVERS

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* Extensive use has been made of materials prepared by the author's partners and associates. Seth Kaplan, a third-year student at Rutgers University School of Law -- Newark, assisted in the preparation of this outline. This outline is an updated version of a paper prepared for presentation at a panel to be held under the auspices of the Southeastern Corporate Law Institute on April 17, 1982.

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1. General Perspectives

1.1. Relevance of defensive considerations

No aspect of the law and practice relating to public company takeovers elicits more interest in the business, financial and legal communities than the defenses potentially available to the target of an unsolicited takeover bid and the prospects of successful assertion of any of those defenses. Law and practice in this area has undergone significant development in the last few years in response to the takeover "boom" which has witnessed numerous highly-publicized takeover bids involving vigorously contested battles, including last year's three-way battle for control of Conoco and the recent two-way battle for control of Marathon (see 5.4). As would-be acquirors have become increasingly sophisticated in their acquisition techniques, so targets have had to develop sophisticated responses and courts have had to increase their understanding of the dynamics and business realities of takeover situations. This paper attempts to give a broad overview of a continuously evolving area of the law.

1.2. "Friendly" v. "unfriendly" takeovers

Most takeovers of public companies have their origin in an unsolicited bid; public companies, except as a defense to an anticipated or actual unwelcome takeover bid, do not generally initiate their own takeover. This does not mean, however, that most takeovers are contested. Many initially unsolicited bids ultimately result in "friendly" transactions, where the final terms, in particular the amount and nature of the consideration to be paid to target shareholders, are negotiated. In some cases, negotiation commences soon after the bid is announced. In others, the raider's advances are fiercely resisted to the bitter end, with defensive measures running the entire gamut, from multiforum litigation and proceedings before administrative agencies asserting a broad range of securities law, antitrust and other defenses, to extensive public relations campaigns and approaches to state and federal legislative bodies designed to stir widespread opposition to the takeover. For a raider to complete a takeover successfully it must understand the dynamics of the possible approaches available to it and the range of possible target responses to its bid — favorable, unfavorable or neutral. However, no two situations are alike, and a takeover or a defense against one can only succeed by using the past as a base, rather than as a blueprint, for future strategy.

1.3. Success rates for takeovers and takeover defenses

The question of what constitutes "success" in a takeover may be analyzed from the raider's perspective, i.e., acquisition of substantially the entire number of shares initially sought at the price initially offered, or from the target's perspective, i.e., retaining its independence. Limited success for the target would mean that the raider's initial bid fails but one of the following occurs:

— the raider secures the target's acquiescence by increasing its bid;

— the target negotiates a "friendly" acquisition by a white knight which outbids the raider for the whole company (as occurred, e.g., in the Conoco and Marathon cases referred to in 1.1 above — see, also, 5.4 and 5.5 below) or acquires a part of the company that the raider desires (as is intended by the current American Home Products tender offer for Brunswick Corporation discussed in 5.4.2.1 below);

— the target liquidates and distributes its assets to its shareholders (see 5.4 below).

Statistics indicate that if absolute success is taken as the measure of a successful takeover defense, the target has a less than 50 percent prospect of success and that an unwanted bid tends both to expose and to exacerbate the target's vulnerability, so that it is more likely than not to be acquired by someone, whereas if limited success is taken as the yardstick the target has a greater than 50 percent prospect of success. E.g., a survey of 114 unsolicited tender offers made or proposed during the period 1976 through October 1980, prepared by Goldman, Sachs & Co., found that although only 28 percent of the surveyed targets remained independent, only 6 percent were acquired by the raider at the price initially offered; 26 percent were acquired by the original raider at a higher price; and 39 percent were acquired by a white knight. The experience of the author's firm indicates that about 10 percent of the targets of cash tender offers for all of the shares of the target remain independent, but that where the target is a large company, i.e., market value of $1 billion or more, more than 50 percent remain independent.

2. Vulnerability to a takeover bid

2.1. Criteria of vulnerability

Companies displaying one or more of the following characteristics are often considered susceptible to unwanted takeover attempts:

(a) low price-earnings ratio;

(b) book value of shares above market price;

(c) limited total market value of outstanding shares, *i.e.*, a low price tag;

(d) undervalued assets (*e.g.*, natural resources acquired long ago, especially if conservatively valued for accounting purposes and if their true worth is not reflected in the market price);

(e) highly liquid financial condition, especially a strong cash position — such assets can facilitate a "bootstrap" acquisition in which the target's shareholders are, in effect, paid out of the target's own assets;

(f) exceptionally high cash flow;

(g) unused borrowing capacity;

(h) above-average return on net worth;

(i) imminent turnaround from depressed earnings; and

(j) limited insider control — small percentage of stock in "friendly," *i.e.*, pro-management, hands.

National Association of Accountants, *Takeovers: The State of the Corporate Defense Art* Q.20 (1978); Davey, *Defenses Against Unnegotiated Cash Tender Offers*, p. 6-7 (1977).

There are other signs which may portend an even more imminent takeover bid and suggest specific precautionary defensive measures. For example, an unusual concentration of takeover bids in the company's industry may suggest that the company and its competitors are especially attractive acquisition candidates (for reasons such as a high cost of entry or perceived excellent growth prospects). A company in that industry may consider a diversification through a defensive acquisition in another market.

Although only improved financial results and more effective management can eliminate some of these characteristics, and others are the product of market forces beyond an individual company's control, precautionary measures can be implemented in an effort to eliminate other vulnerable traits. See 2.2.

Companies can take certain steps to aid early detection of unwanted takeover attempts, including the institution of a stock watch program to detect accumulations of shares and any suspect new share-ownership prior to the time such accumulation reaches the five percent level.

2.2. <u>Strategies to reduce vulnerability</u>

Companies feeling vulnerable to a takeover attempt might consider developing a formalized defense plan against any takeover attempt (although the existence of such a plan can be used later, when an offer is rejected, to attack directors' sincerity and exercise of reasonable business judgment), make arrangements with an investment banker and lawyer to be available for emergency action or compile a list of possible white knights.

Prior to becoming the target of an actual takeover bid, a company can implement certain structural changes (e.g., changes in how it is organized, its management structure, provisions of its corporate charter) to reduce its attractiveness as a takeover candidate and/or increase the impediments to a successful acquisition. Such steps generally require considerable time to implement and are therefore of little value if commenced after a bid has actually been made. Further, their implementation may:

(a) be of little practical deterrence value, especially against a determined, well-financed and patient acquiror prepared to take the steps it considers necessary to surmount all "roadblock" defenses (e.g., a charter provision requiring a "supermajority" (i.e., a greater favorable shareholder vote than the minimum required by the law of its state of incorporation) to approve any business combination would be unlikely to deter an acquiror willing to pay a substantial cash premium for all shares of a company);

(b) advertise that the company fears that it is a takeover candidate, thereby highlighting its vulnerability;

(c) as to a measure which requires shareholder approval (e.g., any amendment to add charter provisions), pose the danger (particularly where there are large institutional holdings) that the requisite vote will not be received and thereby advertise that the shareholders may be receptive to a takeover bid;

(d) cast doubt on the legitimacy of any rejection of a takeover proposal that might, in fact, be received in the future and therefore constitute an invitation to shareholder litigation in the event of such a rejection; and

(e) mislead management into a sense of false security.

Despite these drawbacks, pre-bid defensive measures may, in certain cases, be of some value since they may repel a less aggressive or well-financed raider and place obstacles in the path of even the most determined raider.

In the event a takeover proposal is actually made, directors might properly determine that the takeover should be rejected and may then authorize the taking of actions to accomplish that purpose, including litigation, complaints to governmental authorities, the acquisition of a company to create an antitrust or regulatory problem for the raider, the issuance of shares to a big brother, or the premium purchase of shares of the target from the raider.

3. <u>Legality of defensive tactics</u>

Recent decisions support the general proposition that the implementation of defensive tactics is permitted where an independent legitimate business purpose for the action exists notwithstanding the fact that those tactics may also be motivated by a desire to defeat an unwanted takeover. See 3.2 below. Moreover, where a prospective takeover is viewed in good faith as injurious to the best interests of the company and its shareholders, employees, suppliers or community, that circumstance alone may provide the legitimate business purpose to justify defensive tactics. See Cheff v. Mathes, 199 A.2d 548 (Del. Ch. 1964).

3.1. Legality of pre-bid defenses

As discussed above, certain organizational changes to reduce a company's attractiveness as a takeover candidate and/or increase the impediments to a successful takeover are frequently implemented before a specific takeover bid is received. However, such changes cannot be initiated by management with impunity since, if their sole purpose is to prevent any future takeover regardless of its attractiveness to shareholders, they may be actionable as breaches of management's common law fiduciary duty and, arguably, as securities fraud. It has been held under state law, for instance, that the issuance of shares by directors for the primary purpose of perpetuating control is a breach of fiduciary duty. See, e.g., Podesta v. Calumet Industries, Inc., CCH Fed. Sec. L. Rep. ¶ 96,433 (N.D. Ill. 1978). In Consolidated Amusement Co., Ltd. v. Rugoff, CCH Fed. Sec. L. Rep. ¶ 96,584 (S.D.N.Y. 1978), the court held, in essence, that corporate management is not entitled to take steps to block an unwanted takeover — such as placing a block of shares in "friendly" hands — where there is no independent legitimate business purpose to the transaction. The case, however, presented particularly aggravated circumstances, including the "parking" of the stock (i.e., placing it in friendly hands with agreements such that the holder had no financial interest and incurred no downside risk), the absence of investment bankers' advice, the acceptance of inadequate consideration and the making of false statements as to the purported reason for the transaction. The implementation of defensive tactics is permissible where an independent business purpose does exist, even though those tactics may also be motivated by a desire to defeat an unwanted takeover.

The adoption of certain structural defenses may also adversely affect a company's ability to obtain regulatory approval required for certain non-takeover-related corporate activities. E.g., the former Wisconsin Commissioner of Securities had indicated that he might refuse, under his state's "blue sky" law, to permit an issuer whose corporate charter contains a "supermajority" provision -- a requirement that certain corporate transactions be approved by a percentage of shareholder votes exceeding the statutory minimum (e.g., if the requirement under state law is a 66-2/3% vote of shareholders to approve a merger, a super-majority provision would be one requiring any percentage in excess of the state requirement, such as 80% (see 4.1.(c)) -- to sell equity securities in Wisconsin. Bartell, The Wisconsin Takeover Statute, 32 Bus. Law. 1465, 1468 (1977).

3.2. Directors' duties in responding to a takeover bid

Directors have no absolute legal duty either to explore a proposal to buy the target or to accept a bid which offers shareholders a substantial premium over market price. Their obligation, as fiduciaries, is to act in what they reasonably determine in good faith, after appropriate consideration, to be in the best interests of the company and its shareholders. Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979); Lipton, Takeover Bids in the Target's Boardroom; An Update After One Year, 36 Bus. Law. 1017 (1981); Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel, 55 N.Y. Univ. L.R. 1231 (1980). See, e.g., Crouse-Hinds Co. v. InterNorth, Inc., No. 80-7865 (2d Cir. Nov. 14, 1980) (actions taken by directors in response to a tender offer are governed by the business judgment rule: (a) the burden of proof will not shift to the directors to prove the fairness of a transaction entered into in response to a tender offer simply because the directors will retain control of the company after the transaction is completed; (b) the speed with which a board acts is not evidence of any improper purpose, because federal law requires a target company to inform its shareholders of its position with respect to a tender offer within ten business days; (c) the company's board had obtained an investment banker's opinion before determining to oppose the tender offer); In re Sunshine Mining Co. Securities Litigation, 590 BNA Sec. Reg. L. Rep. p. A-9 (S.D.N.Y. May 25, 1979); Berman v. Gerber Products Co., 454 F. Supp. 1310, 1319 (W.D. Mich. 1978)(held, in effect, that the directors have an affirmative duty to bring an action to enjoin a tender offer they believe in good faith to be violative of the law, even though the target's investment banker has advised that the offer price is fair); Anaconda Co. v. Crane Co., 411 F. Supp. 1210 (S.D.N.Y. 1975); Northwest Industries, Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 ("management has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its stockholders"). Cf. Bucher v. Shumway, CCH Fed. Sec. L. Rep. ¶ 97,142 (S.D.N.Y. 1979)("The law imposes no obligation upon the defendants to disclose mere inquiries or contacts made by those interested in acquiring the corporation or its stock"). Depending on the circumstances, the directors may reasonably conclude that the target has long-term prospects which will offer its shareholders a better return than the raider is offering, that the offer violates the law or that the offer should be opposed for other reasons.

However, it follows from their obligation to act in good faith that the target's directors owe its shareholders a duty not to make a decision based on the directors' own sectarian interests and they may be challenged to refute the accusation that their resistance to a takeover bid constitutes a breach of this duty because management is seeking to "entrench" itself; is expending corporate funds for an improper purpose; and is depriving shareholders of the economic benefit of the premium offered by the raider.

"Directors are not required to accept any takeover bid that represents a substantial premium over market. . . . If the directors believe that a takeover is not in the best interests of the company as a business enterprise, there is no requirement that the takeover bid be submitted by the directors to the shareholders." Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101, 130 (1979), cited with approval in Panter v. Marshall Field & Co., 486 F. Supp. 1168, 1186 (N.D. Ill. 1980), aff'd, 645 F.2d 271 (7th Cir. 1981), cert. denied, 102 S.Ct. 658 (1981). Recent developments support this general proposition:

(a) Panter v. Marshall Field & Co., supra, is the first case to decide, after a full evidentiary hearing in a class action lawsuit, that there is neither federal nor state law liability if directors, acting in good faith and on the advice of independent advisers, determine to reject a takeover proposal.

(b) Lewis v. McGraw, 619 F.2d 192 (2d Cir. 1980), aff'g CCH Fed. Sec. L. Rep. ¶ 97,195 (S.D.N.Y. 1979) (dismissing a shareholder class action suit for damages against the directors of McGraw-Hill which alleged both fraudulent misrepresentations and breach of fiduciary responsibility; held that there was no Section 14(e) violation when directors rejected a tender offer proposal that did not ripen into an actual tender offer since the requisite reliance on the target's alleged misrepresentation could not be established by the target's shareholders), cert. denied, 49 U.S.L.W. 3332 (U.S. Nov. 3, 1980) (No. 79-2054). This case arose prior to the effectiveness in January 1980 of the SEC's tender offer rules, under which an offeror that has publicly announced an intention to make a tender offer is generally required to proceed with or abandon the offer within five business days (Rule 14d-2). Under present circumstances the type of fact pattern giving rise to the Lewis holding is unlikely to be repeated. Nevertheless, Lewis retains its validity in the instance where a takeover bid is couched as a merger proposal that does not trigger application of Rule 14d-2.

(c) In Treadway Companies, Inc. v. Care Corporation, CCH Fed. Sec. L. Rep. ¶ 97,603 (2d Cir. 1980), rehearing denied CCH Fed. Sec. L. Rep.

¶ 97,705 (2d Cir. 1980), the United States Court of Appeals for the Second Circuit firmly established that target company directors who approve defensive transactions in good faith, after obtaining a fairness opinion from an independent investment banker, will not be found liable for breach of fiduciary responsibility. Accord, Crouse-Hinds Company v. InterNorth, Inc., No. 80-7865 (2d Cir. November 14, 1980) (the mere fact that the directors of the target will retain control does not vitiate the business judgment rule and shift the burden of proof to the directors of a target which undertakes a transaction to defeat a takeover bid). See also Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980). But cf. Joseph E. Seagram & Sons, Inc. and JES Developments, Inc. v. Abrams, 81 Civ. 1919 (S.D.N.Y. March 25, 1981), in which the court issued a temporary restraining order against a proposed plan announced by St. Joe's Mineral Co., the target of a hostile tender offer by a Seagram subsidiary at $45 per share, which involved proposals for a partial self-tender, the issuance of a new preferred stock having a class vote on any merger, the sale of a subsidiary and, as a final ultimate alternative, the liquidation of the company intended to yield to shareholders the approximately $60 per share which the company considered its shares to be worth; the court reasoned that liquidation was a step not directly sanctioned by the business judgement rule, as formulated in Treadway and that, since it might involve a breach of fiduciary duty by the directors of the target, Seagram, as bidder and shareholder of the target, had raised a triable issue of fact justifying an evidentiary hearing.

(d) In In re Sunshine Mining Co. Securities Litigation, CCH Fed. Sec. L. Rep. ¶ 97,217 (S.D.N.Y. 1979), it was held that there is neither a Rule 10b-5 nor a Section 14(e) cause of action against the directors of a target company for rejection and frustration of a tender offer even if it were assumed that the directors were motivated solely by their own selfish interest and were acting in complete disregard of their fiduciary duties to the shareholders. Accord Vaughn v. Teledyne, Inc., CCH Fed. Sec. L. Rep. ¶ 97,637, at 98,417 (9th Cir. 1980)("A breach of fiduciary duty by corporate officers absent manipulation, deception, misrepresentation, or nondisclosure violating securities laws is actionable only under state law.")

(e) In Donovan v. Bierwirth, 81 Civ. 3408 (E.D.N.Y. Dec. 3, 1981), a case which arose out of Grumman Corporation's successful defense against a hostile tender offer by LTV Corporation, the court found that the trustees of Grumman's pension plan, who included members of Grumman's management, breached their fiduciary duties under ERISA in causing the plan to reject the LTV tender offer and to purchase Grumman stock in the face of the tender offer. The court held that, while ERISA recognizes that fiduciaries may have dual loyalties when acting on behalf of the plan, a "trustee having dual loyalties has 'an especial obligation to act fairly on behalf of those concerned with the results of the action taken'". ERISA requires fiduciaries to act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims." The court held that this subsumes the duty "to make an independent inquiry into the merits of a particular investment" decision. The court found that the Grumman trustees' actions were motivated solely by their desire to defeat the LTV bid, that they did not consider their actions from the point of view of the plan beneficiaries and that, therefore, they "failed to discharge their duty of prudence either diligently or in good faith." The court's opinion highlights the obligations of trustees who are members of target management to proceed carefully in the context of a hostile takeover bid and stresses the lack of attention paid by the Grumman trustees to the investment decision being made. Plan trustees should be certain that appropriate professional advice is sought and that all of their decisions are properly documented. However, the opinion should not be read as absolutely prohibiting purchases of target stock by target benefit plans of which target management are the fiduciaries.

Thus, management liability can be avoided through a properly conducted defense, in which the directors carefully review the alternatives and consider the advice of independent counsel and investment bankers before authorizing defensive measures. However, the prospect of having their motives in opposing the bid publicly impugned and of having to justify their opposition in protracted, costly, acrimonious and public litigation may itself have a "chilling" effect on the target's directors.

A further constraint on target management is the possibility of being sued by the raider or the target's own shareholders on the ground that management's disparagement of the bid for the purpose of soliciting shareholders to reject it is actionable under the securities laws or at common law.

See generally McIntyre, Shareholders' Recourse Under Federal Securities Law Against Management for Opposing Advantageous Tender Offer, 34 Bus. Law 1283 (1979). Section 14(e) of the Securities Exchange Act of 1934 prohibits fraudulent, deceptive or manipulative conduct in connection with a tender offer. A defeated raider lacks standing to sue the target (or any white knight) for monetary damages under Section 14(e). Piper v. Chris-Craft Industries, 430 U.S. 1 (1977). While the stated rationale of Piper — that only the target's shareholders were the intended beneficiaries of Section 14(e) — might be thought equally applicable to a raider's suit for equitable relief, Piper, supra, at 47 n.22, explicitly left open the question of the availability of injunctions to raiders in suits against targets under Section 14(e). That question had been resolved in favor of raiders before Piper, see, e.g., Emhart Corp. v. USM Corp., 403 F. Supp. 660, 662 (D. Mass.), vacated on other grounds, 527 F.2d 177 (1st Cir. 1975) (characterization by the target of a tender offer as "quite inadequate" and as an attempt to seize control "at bargain basement prices" was held materially misleading for failing to disclose that the target's stock had not traded above the tender offer price during the preceding 18 months and that the target had negotiated with the offeror for the acquisition of the target at less than 10% over the offer price within the preceding six months; however, raider was denied the injunction because the offer itself had already been enjoined)); it has been similarly resolved in post-Piper decisions, see, e.g., Weeks Dredging & Contracting, Inc. v. American Dredging Co., 451 F. Supp. 468 (E.D. Pa. 1978) (in the context of a tender offer of $30.25 per share, statement by target that its shares were worth $150 per share without a qualifying explanation that this amount was their asset value and not the price shareholders could expect to realize in the open market held grounds for enjoining use of management's soliciting material containing the actionable statement); cf. Seaboard World Airlines, Inc. v. Tiger International, Inc., CCH Fed. Sec. L. Rep. ¶ 96,877 (2d Cir. 1979) (raider's characterization of the target's opinion that it was worth $20 per share in a merger as "unrealistic" held to be not material despite the fact that the raider believed the liquidation value of the target to be $20 per share)).

In its amended complaint in American Express Company v. McGraw-Hill Inc., 79 Civ. 297 (S.D.N.Y. 1979), American Express, in addition to alleging that McGraw-Hill's solicitations to its shareholders to reject American Express' tender offer violated Section 14(e), also asserted common law causes of action for libel and tortious interference with prospective business advantage. These theories were never tested since the action was dismissed prior to any adjudication on the merits.

3.3. SEC position

Former SEC Chairman Harold Williams has stated:

> It is my view that a court — in reviewing such a well-monitored, fully-considered and documented special committee [of independent directors] determination to reject and resist an acquisition or tender offer bid — should and would give substantial deference to that decision and to any legal and ethical acts to resist the bid which are reasonably commensurate to the existing

threat to the corporation's and its shareholders' interests, provided that the acts themselves are not inconsistent with the corporation's viability.

Tender Offers and the Corporate Directors (speech before the Seventh Annual Securities Regulation Institute, San Diego, Cal., Jan. 17, 1980), reprinted in CCH Fed. Sec. L. Rep. ¶ 82,445, at 82,881.

Former Chairman Williams also endorsed the concept that a target's directors reviewing a takeover bid may properly consider its impact on employees, suppliers, customers, the public and the national economy. Tender Offers and The Corporate Directors, supra, at 82,881-82. See Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972)(held that directors, at least directors of certain kinds of corporations such as newspapers, may properly consider the impact of a takeover on employees and the community).

In 1981, President Reagan's nominee, John S. R. Shad, succeeded Chairman Williams. Chairman Shad has been devoting his attention to other areas of concern and has yet to express his view of these matters but it seems doubtful that he would articulate a more onerous standard for target directors than his predecessor.

3.4. Directors' consideration of a takeover bid

The current case law emphasizes the importance of the procedure to be followed by the board of directors of a target in considering a takeover bid. The SEC's tender offer rules also highlight this point through their requirement that a target's board consider and respond to a tender offer and that the target disclose the reasons for the board's decision (Rules 14d-9 and 14e-2). Thus, as noted in Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101, 121-24 (1979):

> A) Management (usually with the help of investment bankers and outside legal counsel) should make a full presentation of all of the factors relevant to the consideration by the directors of the takeover bid, including:
>
> (1) historical financial results and present financial condition
>
> (2) projections for the next two to five years and the ability to fund related capital expenditures
>
> (3) business plans, status of research and development and new product prospects
>
> (4) market or replacement value of the assets
>
> (5) management depth and succession
>
> (6) can a better price be obtained now

(7) timing of a sale; can a better price be obtained later

(8) stock market information such as historical and comparative price earnings ratios, historical market prices and relationship to the overall market, and comparative premiums for sale of control

(9) impact on employees, customers, suppliers and others that have a relationship with the target

(10) any antitrust and other legal and regulatory issues that are raised by the offer

(11) an analysis of the raider and its management and in the case of a partial offer or an exchange offer pro forma financial statements and a comparative qualitative analysis of the business and securities of both companies.

B) An independent investment banker or other expert should opine as to the adequacy of the price offered and management's presentation.

C) Outside legal counsel should opine as to the antitrust and other legal and regulatory issues in the takeover and as to whether the directors have received adequate information on which to base a reasonable decision.

D) If a majority of the directors are officers or otherwise might be deemed to be personally interested, other than as shareholders, a committee of independent directors, although not in theory necessary, from a litigation strategy standpoint may be desirable. The exigencies and pressures of a takeover battle are such that it is desirable to avoid proliferation of committees, counsel and investment bankers. The target will be best served if it is advised by one investment banker and one outside law firm.

E) It is reasonable for the directors of a target to reject a takeover on any one of the following grounds:

(1) inadequate price

(2) wrong time to sell

(3) illegality

(4) adverse impact on constituencies other than the shareholders

(5) risk of nonconsummation

(6) failure to provide equally for all shareholders

(7) doubt as to quality of the raider's securities in an exchange offer.

Once the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose, including litigation, complaints to governmental authorities, the acquisition of a company to create an antitrust or regulatory problem for the raider, the issuance of shares to a big brother, or the premium purchase of shares of the target from the raider.

4. Pre-bid defenses

4.1. Structural pre-bid defenses

The structural pre-bid defenses include:

(a) Reincorporation ("migration") in a state with a strong takeover statute (in view of the questionable constitutionality of state takeover statutes this is not presently in vogue).

(b) Adoption of a charter provision mandating staggered elections of directors and/or other provisions which make it difficult to change the target's board of directors (these and other amendments to a target's charter which may have the effect of discouraging unwanted takeover bids are commonly called "shark-repellent" provisions and are carefully scrutinized by the SEC, see 4.2.).

(c) Adoption of a charter provision requiring a supermajority vote to approve any business combination with a person owning more than a specified percentage (frequently ten percent) of the target's stock — absent such a provision, state statutes typically require a simple majority vote to approve any merger or consolidation, (e.g., Delaware General Corporation Law § 259(c)). In Telvest, Inc. v. Olson, et al., Civ. No. 5798 (Del. Chancery Ct. March 8, 1979), holding that the issuance of a preferred stock, the critical attribute of which would have been to impose an 80% supermajority requirement for the purpose of preventing a feared takeover by a 20% shareholder, was an impermissible attempt to alter the voting rights of existing shareholders without their approval, the court noted that management had originally contemplated seeking shareholder approval for a supermajority charter amendment and it questioned whether such an amendment would have been valid under Delaware law. However, Seibert v. Gulton Industries, Inc., Civ. No. 5631 (Del. Chancery Ct. June 21, 1979), held a supermajority charter provision (requiring an 80% vote to approve a takeover by any five percent shareholder unless the takeover was approved by the target's board before the proposed acquiror acquired its five percent interest) valid under the Delaware Corporation Law. In Labaton v. Universal Leaf Tobacco Co., Inc., CCH Fed. Sec. L. Rep. ¶ 96,944 (S.D.N.Y. 1979), the plaintiff alleged that the proxy statement for a special shareholders meeting which adopted a supermajority provision was materially false and misleading. Finding that any damages sustained by the plaintiff could be redressed by injunctive relief, the court granted defendants' motion for partial summary judgment dismissing all damage claims and decertifying the action as a class action. The court reasoned that "the damage would be the value of the stock with a 66-2/3 percent majority clause in the articles of incorporation minus the value of the stock with the 80 percent majority clause;" however, "if plaintiff proves that the proxy statement was improper he will be entitled to injunctive relief effectively repealing the amendment. The stock will then no longer be depressed to a lower value by the restriction and the plaintiff will no longer be damaged." Id. at 95,947.

(d) Adoption of a charter provision requiring a specified minimum price to be paid to shareholders in any "second-step" merger (e.g., a requirement that a specified percentage premium over the market price one month before a tender offer be paid to all non-tendering shareholders) — see Hochman and Folger, Deflecting Takeovers: Charter and By-Law Techniques, 34 Bus. Law. 536, 548-556 (1979).

(e) Adoption of a charter provision authorizing consideration of the social and economic effects of any transaction proposed by another company and thereby enlarging the constituency of interests to be considered in evaluating any such transaction — even without such a provision, a target's management may be entitled to take into account other interests besides those of the shareholders, see e.g., Herald Co. v. Seawell, 472 F.2d 1081, 1097 (10th Cir. 1972) (impact of takeover on employees and the community is a proper consideration for target's directors; however, target was newspaper and court recognized "a sincere desire to keep the . . . newspaper responsive to public needs"), but such a provision gives management the comfort of a shareholder-approved mandate to take account of the interests of other "constituents".

(f) Adoption of by-laws restricting the transferability of shares or the eligibility of certain persons to become shareholders. In Pacific Realty Trust v. APC Investments, Inc., No. A81-11-06903 (Ore. Cir. Ct. December 15, 1981) a case arising out of APC's partial tender offer for shares of Pacific, the court sustained the validity of a by-law restricting the transfer of shares of a real estate investment trust to persons who, after such transfers, would be the beneficial owners of more than 9.9% of the shares of the trust. The court's conclusion was premised solely on its finding that the trustees acted in "good faith" in adopting the by-law ostensibly for the purpose of protecting the status of the trust as a qualified real estate investment trust under the Internal Revenue Code. The court's finding of the trustees' good faith was not disturbed by evidence that the by-law which was adopted was much broader than necessary to achieve the result desired by the trustees.

Absent a finding of bad faith on the part of the trustees, the court would not disturb or alter the particular by-law which was adopted. The state court's decision upholding the validity of the restrictive by-law was subsequently held, in a companion federal court case, to be determinative of Pacific's motion for a preliminary injunction against APC's tender offer. The federal court assumed, on the basis of the state court decision, that the by-law was valid; accordingly, it held that the tender offer should be enjoined. Pacific Realty Trust v. APC Investments, Inc., Civ. No. 81-18462A (D. Ore. Dec. 21, 1981).

In Joseph E. Seagram & Sons, Inv. v. Conoco Inc., 519 F. Supp. 506 (D. Del. 1981), the court was faced with a by-law provision that restricted the transfer of stock ownership to aliens which, if enforced, would have foreclosed Seagram's tender offer for Conoco shares since Seagram is a Canadian company. In reaching its decision that the restrictive by-law should not be upheld, the court side-stepped the issue of whether the by-law itself was "manifestly unreasonable" and therefore not permitted by the statute. Rather, the court relied on a provision of the Delaware law that requires that any restriction on the transfer of securities imposed after the issuance of the securities be subject to the consent of the holder of such securities, either pursuant to an agreement of the holder or a vote in favor of the restriction.

A novel shark-repellant charter provision is contained in MCI Communications' charter. Designed to discourage and sterilize block holdings in excess of 10%, the provision provides that such a block-holder is entitled to only 1/100th of one vote for his shares in excess of 10% if and so long as he does not consummate a tender offer which meets certain price and other terms. See MCI Communications Corporation proxy statement dated June 5, 1981. This provision is substantively similar to (i) having two classes of stock, each with different voting rights, and (ii) follow-up acquisition requirements, such as those contained in the Ontario Securities Code and the London City Takeover Code, which compel a person who has acquired a given percentage (in the 30-50% range) of a company to make an offer of equivalent value to the remaining stockholders.

(g) Providing management with long-term employment contracts, the right to large severance payments in case of a change of control or an option plan which has accelerated vesting in the event of such a change. The SEC has adopted the position that the amendment of an employee stock option plan to provide for special options and stock appreciation rights exercisable within a limited period following a takeover bid does not require stockholder approval in order for the plan to retain its exempted status under the so-called "short-swing profit" recovery provisions of the federal securities laws. <u>See</u>, <u>e.g.</u>, <u>Norton Simon, Inc.</u> (SEC No-Action File, available November 2, 1980); <u>Champion International Corp.</u> (SEC No-Action File, available September 13, 1979); <u>cf.</u> <u>Garfinckel, Brooks Brothers, Miller & Rhoads, Inc.</u>, (SEC No-Action File, available July 20, 1981).

(h) Agreeing to control clauses in loan agreements or other material contracts permitting the lender to call the loan or the other contracting party to cancel the contract in the event of a change in management (but such clauses can backfire in the event that target management seeks to expedite a white knight acquisition which the lender or other contracting party does not favor).

(i) Placing stock in "friendly hands," frequently with an agreement (a so-called "standstill agreement") limiting the buyer's right to acquire more shares or dispose of the purchased shares as a block (but note the constraints on the private placement of a class of securities with special voting rights — see Telvest, supra). In Consolidated Amusement Co., Ltd. v. Rugoff, supra, the court held that corporate management is not entitled to take steps to block an unwanted takeover, such as placing a block of stock in "friendly" hands, where there is no independent legitimate business purpose to the transaction. As noted above, the case presented particularly aggravated circumstances, and should not, therefore, be interpreted broadly as precluding the issuance by the target of a block of stock where an independent business purpose does exist, albeit the transaction may also be motivated by a desire to defeat an unwanted takeover.

In Treadway Companies, Inc. v. Care Corporation, supra, Treadway had sold a large block of its common stock to Fair Lanes, Inc., selected as a white knight to rescue Treadway from a threatened takeover by Care. The sale was made to facilitate a proposed Treadway-Fair Lanes merger and to defeat the attempt by Care (owner of one-third of the Treadway stock) to take control of Treadway's board of directors at the upcoming annual meeting. The district court had enjoined the voting of Fair Lanes' Treadway shares on the ground that Treadway's primary motivation in consummating the sale was to protect its incumbent management against Care's takeover effort. The Second Circuit reversed, ruling that Care had not established any basis under New Jersey law (construed in light of general corporation law, including the law of Delaware), for overturning the business judgment of the Treadway directors. The Second Circuit stated that the business judgment rule, "which presumes that directors have acted properly," id. at 98,210, applies both to the determination that a threatened takeover would be detrimental to the target and to the choice of particular defensive measures, including the issuance and sale of stock, to oppose such a detrimental takeover. Thus, a party challenging a defensive transaction has the burden of proving that the directors of the target "acted in bad faith, or in furtherance of their own interests, or for some other improper purpose." Id. Even if that party carries its burden, the directors' action is still protected if they show that they approved the challenged transactions for "a proper corporate purpose and not merely for the directors' selfish purposes." Id. at 98,211. The directors need not also prove that the actual terms of the transactions were fair. The Second Circuit further made it clear that the substance of the directors' deliberations will not be scrutinized once it is apparent that business judgment was in fact exercised.

(j) Development of an employees' stock purchase plan to create more insider holdings.

(k) Disclosure in public filings of problems that might be created (e.g., threatened loss of material regulatory licenses or permits) by a change of control — this disclosure can lend credence to allegations of those same problems in any subsequent takeover fight.

(l) Reduction in the amount of the company's surplus cash (e.g., through an extraordinary dividend or the acquisition of another company for cash) so as to prevent a bootstrap takeover and hopefully increase the market value of the company's shares.

(m) Making an acquisition to create an anti-trust block, or to increase the number of outstanding shares, thereby raising the total market value of the company and reducing the universe of potential raiders who could afford to make a takeover. In Panter v. Marshall Field & Co., supra, shareholders challenged certain defensive acquisitions undertaken by a target company. The court, in directing a verdict for the defendant directors and officers of the target, found that

> [a]s to the acquisitions which defendants authorized [target] management to make . . . each was consummated after defendants considered business projections by management, received the advice of lawyers and experts, and consulted with accountants and investment bankers. Despite a great deal of straining with financial data, reports and statistics, plaintiffs have not produced evidence which

could prove that any of these acquisitions were unsound business ventures.

486 F. Supp. at 1194. Cf. Crouse-Hinds Company v. InterNorth, Inc., No. 80-7865 (2d Cir. Nov. 14, 1980).

(n) Acquisition of a regulated business or one a change in control of which would subject the prospective new owner to prior approval by a regulatory agency.

4.2. SEC position

The SEC staff has stated that it will "review closely proxy materials containing anti-takeover proposals in order to ensure that there is adequate discussion of their disadvantages as well as advantages." SEC Release No. 34-15230, CCH Fed. Sec. L. Rep. ¶ 81,748 (October 13, 1978). In general, the SEC staff will require explicit statements with respect to proposed shark-repellent provisions, detailing their negative impact on shareholders (e.g., that they may make less likely a takeover bid at a price which will benefit non-management stockholders) and the benefits to management (e.g., that they may have the effect of making more difficult the removal of management). More recently, the SEC voiced concern that the use of shark-repellant provisions may be deterring tender offers to the detriment of investors and contrary to the intent of Congress in adopting the Williams Act. The SEC has requested comments on the impact of defensive corporate charter amendments on tender offer practice and the need for rule-making under the 1934 Act. SEC Rel. No. 34-16385, CCH Fed. Sec. L. Rep. ¶ 82,374, at 82,614. Should the SEC adopt rules in this area, any requirement involving more than disclosure may, however, be beyond the authority of the SEC since the adoption of charter and by-law provisions has traditionally been a matter of state corporate law. Cf. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (held that Section 10(b) and Rule 10b-5 do not constitute a general federal law of fairness in internal corporate matters and that Congress left it to state law to determine the scope of a director's or officer's fiduciary duties to shareholders).

4.3. State review

By letter dated April 11, 1980, an attorney in the Office of the Secretary of State of North Carolina advised that the Secretary of State cannot file a charter amendment which would require the affirmative vote of a majority of the shares held by shareholders other than those held by a five percent or more shareholder in connection with a business combination with such shareholder. The letter stated that the so-called majority of the minority provision runs afoul of North Carolina's statutes in that such a provision creates a special class to which rights and preferences would be granted in a manner not permitted by North Carolina's statutes. The attorney's comments were based upon his review of a proposed charter amendment that also called for a 75% supermajority for a business combination with a five percent or more shareholder. He did not comment on that phase of the proposed amendment. The action of the North Carolina Secretary of State's Office suggests that there will be continuing legal attacks on defensive structural changes in corporate charters and that if such provisions are to be considered, pre-clearance for filing should be discussed with the appropriate state officials.

5. Deflecting an identified potential raider

In addition to implementing structural defenses which create hindrances to a takeover, a company can take more direct action to thwart an impending takeover bid once it has identified the potential bidder.

5.1. Repurchasing shares

A potential raider may accumulate a block of stock of the target prior to making any takeover bid but under circumstances which suggest that such a bid may be imminent. Alternatively, a shareholder whose acquisition was not originally takeover-motivated may subsequently adopt a potentially hostile posture. In either of those situations, if the company can pay the potential raider a sufficiently attractive premium over the current market price and thereby induce it to relinquish its stock, such a repurchase may terminate the threat. Such a repurchase is also a common feature of settlements of litigation ensuing from actual takeover bids by raiders that have acquired some target stock.

It has been generally held that the acquisition by a company of its own stock at a premium over market price constitutes a proper corporate act if the "primary purpose" of such acquisition is to eliminate a real threat posed by a dissident shareholder to the company's business or policies. See, e.g., Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977), Cheff v. Mathes, supra. In Heine v. The Signal Cos., CCH Fed. Sec. L. Rep. ¶ 95,898 (S.D.N.Y. 1977), the court sustained, under both the federal securities law and Delaware corporate law, the repurchase at a premium of a block of shares by a company from a dissident and litigious holder without giving all the company's shareholders an equal opportunity to sell at the same price. See generally Schiff, Sale of Control: The Equal Opportunity and Foreseeable Harm Theories under Rule 10b-5, 32 Bus. Law. 507 (1977). Delaware courts do, however, place the burden on the directors to "justify such a purchase as one primarily in the corporate interest." Bennett v. Propp, 187 A.2d 405, 409 (Del. Ch. 1962).

5.2. Creation of an antitrust block

The purchase of a business conducted in, or the formulation of plans to expand into, a new geographic or product market so as to create a potential antitrust block (on the grounds of horizontal competition — see 6.2.4.1.) to a takeover by a specific potential acquiror can be an effective deterrent to a bid. The usefulness of this tactic, however, like that of the structural defenses, depends on management's ability to withstand shareholder litigation brought to enjoin the contemplated action on the grounds of corporate waste, breach of fiduciary duty or violation of the anti-fraud provisions of the 1934 Act. Compare Royal Industries, Inc. v. Monogram Industries, Inc., CCH Fed. Sec. L. Rep. ¶ 95,863 (C.D. Cal. 1976), where injunctive relief against this type of defensive acquisition was held to be available under the 1934 Act, with Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977) which denied such relief under the authority of Santa Fe Industries, Inc. v. Green, supra, and Crane Co. v. American Standard, Inc., 603 F.2d 244 (2d Cir. 1979).

5.3. The "unconventional" tender offer defense

A target may respond to an open-market and/or privately negotiated accumulation of its shares by commencing litigation or instigating regulatory proceedings on the basis that the purchases constitute a "tender offer" made in violation of the disclosure and/or procedural requirements of the Williams Act and/or the state takeover laws.

5.4. Disaggregation Defenses

5.4.1. General

A more extreme response to a potential or actual hostile takeover attempt is for the target company to propose a substantial restructuring of itself through the sale of divisions, partial liquidations, spin-offs, self-tender and the like, referred to collectively as "disaggregation" transactions. These defensive maneuvers usually come under consideration where the target believes its stock prices do not adequately reflect underlying asset values. Alternatively, in the case of a target in the natural resource industry or a similar type of business, disaggregation may be considered because the target's assets are comprised principally of limited commodities. In addition, many companies that are involved in a variety of businesses have not be able or willing to devote the necessary attention or capital to the operations of each of their businesses with the result that the true value of these businesses are not reflected in the companies' stock prices. Simplification of these companies' portfolios benefits the continuing enterprise by making it easier to manage and perhaps finance, and easier for the market to follow and understand, while at the same time permitting the shareholders to participate in the potential of greater market recognition of the values of the continuing and disposed of businesses.

The recent wave of takeover bids for natural resource companies, the most notable being the contest for Conoco waged by Seagram, Du Pont and

Mobil, and the struggle for Marathon Oil between Mobil and U.S. Steel, has been in large part the result of the interest of raiders in acquiring undervalued assets at a bargain price. Estimates of the per share asset value of Conoco stock were in the area of $150, while the stock was selling at approximately $49 just prior to the Dome Petroleum offer of $65 per share in May 1981. Du Pont won the contest for Conoco with an offer of $98 per share in cash for 45% of Conoco and 1.7 shares of Du Pont common stock for the remaining Conoco shares tendered in a second step stock merger.

Because of the increasing difficulty of fending off a hostile bidder with legal defenses, the recent wave of takeovers has re-emphasized the need for an actual or potential target to find a financial alternative to an unwanted bid. Defensive disaggregation transactions (with the exception of a simple sale of assets by the target in respect of which the sale proceeds are not distributed to the shareholders) offer shareholders of the target company an alternative to accepting a raider's bid. In order for the defense to be successful, the shareholders must determine that the target's proposed actions will provide greater financial returns than the raider's offer. In proposing a disaggregation transaction, the target is in effect making a competing offer to its shareholders, which they are free to accept or reject.

It is clear that the business judgment rule applies to such transactions, even if they are implemented against an actual or potential hostile bid. Although Judge Pollack in the Seagram/St. Joe Minerals contest granted a temporary restraining order against St. Joe's proposed self-tender/liquidation defense, <u>Joseph E. Seagram & Sons, Inc.</u> v. <u>St. Joe Minerals Corp.</u> 81

Civ 1419 (S.D.N.Y. March 25, 1981), more recently, Judge Weinfeld refused to grant Seagram a similar temporary restraining order in its contest for control of Conoco, Conoco Inc. v. The Seagram Company Ltd., et al., 81 Civ. 4029 (S.D.N.Y. July 3, 1981).

5.4.2. Types of disaggregation defenses

The following section discusses major types of disaggregation strategies.

5.4.2.1. Sale of attractive or undervalued assets. A target may be able to make an unsolicited bidder drop its bid by selling off those assets which are most attractive to the raider. For example, in Whittaker's recent bid for Brunswick, it was thought that Whittaker's bid was motivated in large part by its desire to acquire Brunswick's medical group (one of a few separate business segments of Brunswick). While the Whittaker bid was pending, Brunswick entered into an agreement with American Home Products for the latter's acquisition of that division. The transaction is structured as a tender offer by AHP for approximately 64% of Brunwick's shares pursuant to an agreement providing for Brunswick to redeem the shares purchased by AHP in exchange for the medical division, this structure being intended to enable Brunswick to avoid recognition of a taxable gain on the disposition of the medical division; although the AHP transaction does not involve a "second-step" merger, whereas Whittaker is proposing such a merger in which the remaining shares would be exchanged for Whittaker debentures, it is viewed as competitive with Whittaker's offer because it is being made for a large number of shares at a higher price and offers shareholders whose shares are not purchased an increased percentage interest in the balance of Brunswick's business. Whittaker's motion for a temporary restraining order against the proposed sale was denied, a U.S. district court noting that the transaction did not "fall outside the limits of appropriate business judgment." Whittaker Corp. v. Edgar et al., 82 C 443 (N.D. Ill. Feb. 11, 1982). Subsequently, the court denied Whittaker's preliminary injunction motion, holding, inter alia, that the Brunswick board had not breached its fiduciary duty in approving the sale of the medical division to American Home Products. The court concluded that the board (although it included two current Brunswick officers, a former officer and a partner in the law firm representing Brunswick) was independent as well as financially sophisticated, that Whittaker had not made a sufficient showing that the board's primary motive was to retain control and that even assuming, arguendo, that the burden of persuasion had shifted to Brunswick's board, Brunswick had established that the proposed sale to American Home Products was within the business judgment rule. Whittaker Corp. v. Edgar, et al., 82 C 443 (N.D. Ill. February 25, 1982), aff'd, Dkt. Nos. 82-1305, 82-1307 (7th Cir. March 5, 1982). Following the Seventh Circuit's affirmance of the lower court's denial of the preliminary injunction sought by Whittaker, Whittaker terminated its offer. See also 5.5.2.3, below.

Even if the sale of undervalued or attractive assets fails to force the bidder to withdraw of its own accord, the proceeds of such a sale may be used to acquire a business which poses anti-trust or regulatory problems for the bidder or to finance a self-tender offer which substantially reduces the target's capitalization and/or raises the percentage held by major shareholders who support target management. Such a sale also reduces the bidder's ability to finance its offer through its sale of such assets after the acquisition.

5.4.2.2. Partial liquidation. A target with undervalued assets can sell off those assets and distribute the proceeds to its shareholders. The attractiveness of this alternative is that it provides both an immediate cash return to shareholders and the opportunity for investors to remain as shareholders in the ongoing business concern. In addition, it deprives the raider of the benefits of the assets sold and gives the target an opportunity to demonstrate to its shareholders that the company's value is greater than the raider's price. On the negative side, the target may be unable to realize top dollar on the assets sold because of the pressure to sell quickly, thus reducing the amount it will be able to distribute to shareholders. In addition, the market will discount the value of the partial liquidation by the time required to consummate the transaction and the uncertainties associated with achieving the promised values. (These two problems may be handled by combining the partial liquidation with a spin-off, as discussed below.) Finally, as with a sale of assets, a raider may be undeterred by a partial liquidation. In that case, as with any other sale of assets, the only effect of the partial liquidation may be that the raider can consummate its offer at a price lower than its original offer.

5.4.2.3. Spin-off. A variation of the partial liquidation is a spin-off by a target of an undervalued asset group either directly, by distributing the shares of a subsidiary to shareholders, or indirectly, by transferring the assets into a separate entity such as a trust, a partnership, or another corporation, the shares or interests in which are then distributed to the target's shareholders. In contrast to the partial liquidation, in which shareholders receive one or more lump-sum payments, a spin-off provides shareholders with a continuing source of income from the undervalued assets. As with the partial liquidation, the target company remains independent. An additional advantage of the spin-off is that the members of target managment who move over to the spun-off entity can set up their own stock option and incentive compensation plans, which should provide greater incentives for superior management performance, since the benefits are more directly tied to the business which management manages, rather than to the performance of the entire company.

Use of a spin-off may also, in certain circumstances, have tax advantages over a "straight" partial liquidation. For example, a distribution of a subsidiary's shares is generally tax-free so long as both the subsidiary and the distributing corporation are engaged in sufficiently aged separate businesses. However, a spin-off of an asset group by way of a trust or a partnership is not a distribution of "shares" for tax purposes, and thus, except in special circumstances, the distribution of trust or partnership interests will be taxable to the target shareholders.

5.4.2.4. <u>Total liquidation</u>. If a target is advised by its investment bankers that the company's individual assets have liquidation values in excess of the price the raider is offering, the target may attempt to realize those higher values by proposing to liquidate the target at a price in excess of the raider's offer. As in the case of a partial liquidation, in order to defeat the raider, the liquidation value of the target must be greater than the raider's price, and must be high enough to overcome the discount that will prevail to account for the time necessary to effect the liquidation and the uncertainty in achieving the values promised. Such discount will be smallest when the asset values of the company can relatively easily be established, i.e., when the company has "hard" assets such as oil and gas reserves or real estate.

Target management must of course be prepared to carry through with the proposal even if the raider goes away which makes the total liquidation alternative unacceptable for many targets. Another problem with total liquidation is that it places a price on the company, which makes it very difficult to resist a bidder which comes in at a higher price (or the original bidder, if it raises its offering price above the announced liquidation value). However, as noted above, total liquidation can be proposed for just that purpose: to force a raider to raise its initial offer or to attract another bidder at a price equal to or greater than the proposed liquidation price.

5.4.2.5. Self-tender. A target may make a competing offer by offering to purchase a portion of its own shares for cash at a price substantially in excess of the bidder's price. This option has the advantage of affording shareholders the choice of obtaining cash pursuant to the self-tender or remaining shareholders in a company which target management promises will provide higher returns over time. One problem with using this approach as a response to an any-and-all cash tender offer is that target shareholders may be unwilling to risk proration of their shares even at the higher price offered by target; moreover, if target shareholders are unimpressed by management's promises of the target's future earnings potential, they will be unwilling to stay with the target when faced with the prospect of receiving cash immediately for all their shares from the raider. It should also be noted that cash self-tenders are more likely to be effective in defeating an offer for a larger company then they will be in defeating an offer for a smaller company. With smaller companies, unless after such transactions a majority of the target's stock is in friendly hands, the net effect may be to make the overall cost of the offer lower and thus to make it easier rather than more difficult for the raider to succeed. With larger companies this is not a significant factor. In addition, it is unlikely that the arbitrage of a very large takeover (in the $2-5 billion range) will exceed 10% of the target's shares. In such cases, Wall Street professionals do not control the destiny of the target. Thus, if the target's institutional investors can be induced to maintain their investment positions, a restructuring of the target's capitalization can be an effective defense.

5.4.2.6. Exchange offer by target. A variation of the cash self-tender approach is an exchange offer by the target for a portion of its shares in which the security offered is either a preferred equity security with a higher dividend than the common stock (and/or a conversion feature) or a debt security. This approach is designed to afford shareholders a higher immediate return on their investment in the target without requiring the target to use cash. In addition to raising the same problems which the cash self-tender raises, the exchange offer poses an additional problem: the target must assure itself of an income stream sufficient to pay the dividend or interest on the security being offered. An example of a defensive exchange offer by a target was the proposed exchange offer by St. Joe in response to the Seagram bid.

5.5. "White Knight" defense

For several years, the most common strategy for a target of an unsolicited takeover attempt has been to search for an alternative buyer of its choice, a "White Knight". Even when disaggregation is under consideration, the target should consider seeking out potential White Knights substantially concurrently with its pursuit of disaggregation, since the failure of the disaggregation alternative may leave the target with too little time before the expiration of the raider's offer to begin a White Knight search; further, the success of a disaggregation defense can be determined only after it is announced, since the market reaction will be the principal measure of success, and if the disaggregation announcement does not achieve its intended effect, i.e., the target's stock price does not rise above the raider's offer, the target must be prepared to succumb to the raider unless it can find a White Knight willing to make a higher bid for the company. However, the target must also be aware that once a White Knight search is undertaken, it may be difficult to control, and that a White Knight search often attracts "Grey Knights." An example of the Grey Knight (some would say "Black Knight") problem was illustrated by the Conoco/Seagram situation: in response to a cash tender offer by Dome Petroleum for a portion of Conoco's stock, Seagram was invited to make a proposal to Conoco involving the purchase of a large position in Conoco subject to a standstill agreement; after Conoco rejected its proposal, Seagram made a hostile tender offer for Conoco. As noted above, Conoco was ultimately acquired by DuPont.

5.5.1. Lock-up agreements—General

Should the target opt for the White Knight strategy, various devices, known collectively as "lock-ups," may be employed to make consummation of the transaction more certain. A lock-up has the advantages to the target of encouraging bidders who might otherwise be unwilling to participate in an auction of the company, and discouraging potential or actual hostile bidders from disrupting the transaction.

5.5.2. Forms of lock-ups

5.5.2.1. Stock purchase agreements. The target may sell the friendly offeror preferred stock with special voting rights. While this lock-up greatly deters hostile bids it is vulnerable to the attack that it artifically "manipulates" the market for target stock. See Mobil Corp. v. Marathon Oil Co., CCH Fed. Sec. L. Rep. ¶ 98,399 (6th Cir. Dec. 23, 1981) (discussed in 5.5.3 infra). The issuance of preferred stock with special voting rights by a corporation's board of directors could also be subject to attack on the grounds that voting rights were being manipulated without shareholder approval. See Telvest v. Olson, supra. Consideration should also be given to stock exchange rules which prohibit the acquisition of more than specified percentages (18.5% in the case of the NYSE) of a company's stock without shareholder approval.

5.5.2.2. Stock options. The flexibility inherent in the option contract has accounted for the recent popularity of this form of lock-up. The granting and exercise of lock-up options are subject to the same legal constraints as discussed above with respect to stock purchase agreements. See also, 5.5.3 below.

5.5.2.3. "Crown jewel" options. These are only useful where the target has a "crown jewel" which is the raison d'etre for acquiring the target — e.g., Marathon's Yates field. It should be kept in mind that agreements to sell major assets at low prices could give rise to fiduciary claims, and that, after Mobil Corp. v. Marathon Oil Co. (see 5.5.3 below), these options are particularly vulnerable to claims of manipulation. However, in Whittaker Corp. v. Edgar et al., supra, the court, in denying Whittaker's motion for a preliminary injunction against Brunswick's sale of its medical division to American Home Products, held that the agreement to sell the medical division was not a "lock-up" within the Mobil holding inasmuch as it did not create an artificial price ceiling in the tender offer market and was not expressly designed solely for the purpose of completely blocking normal, healthy market activity. In the court's view, neither the fact that the sale was structured as a tender offer followed by a redemption of the shares for assets nor the fact that it involved the sale of a substantial asset of the corporation in the face of a hostile tender offer themselves made the transaction a violation of the artificial manipulation prohibition of the Williams Act. The crucial distinction between the Marathon and Whittaker cases is that U.S. Steel only had an option, triggered by a competing bid, whereas American Home Products had an enforceable option to buy under a contract found by the court to be consistent with the exercise of the Brunswick board's business judgment. While the enforceability of that right may result in Whittaker dropping its bid for business reasons, the agreement did not, as a matter of law, "lock-up" Brunswick and prevent the shareholders from getting the better deal.

5.5.3. Specific legal considerations concerning lock-ups

In Mobil Corporation v. Marathon Oil Company, CCH Fed. Sec. L. Rep. ¶ 98,399 (6th Cir. December 23, 1981), the United States Court of Appeals for the Sixth Circuit reversed a denial of a preliminary injunction against the unissued stock and "crown jewel" asset options granted to U. S. Steel by Marathon. In the view of the Court of Appeals, the options, both individually and in combination, were intended to choke off a potential auction for control of Marathon; they accordingly had "the effect of circumventing the natural forces of market demand in this tender offer contest," and thereby constituted "'manipulative acts' in the connection with the tender offer, violative of Section 14(e) of the Williams Act." In the opinion of the court, this was true even if the Marathon directors acted in "good faith and loyalty" in issuing the options to U. S. Steel in order to enlist U. S. Steel as a white knight: the illegality would then flow from "the conduct of U. S. Steel in demanding and obtaining the option." As relief, the court directed that the U. S. Steel offer be kept open for a reasonable period of time (without benefit of the options) and that the withdrawal period under the offer be extended for a sufficient period of time "to permit the acceptance of any competing tender offers" made by other potential bidders who may previously have been deterred from coming forward by the options.

Although the Sixth Circuit's decision is an extreme extension of the definition of "manipulation" in the federal securities law, it will undoubtedly inspire many similar challeges to lock-up arrangements and result in delays to many white knight transactions. Although lock-ups may still be appropriate in certain special cases, they are not "boiler-plate" to be used automatically in every white knight deal and negotiated acquisition. Cf. Whittaker Corp. v. Edgar, et al., discussed in 5.5.2.3 above.

6. Post-Bid Defenses

6.1. Scope of potential challenges

Direct attacks on the legality of a takeover bid can be made in both judicial and regulatory forums on each of the federal and state levels. In addition to bringing its own proceeding in any of those forums, a target can approach federal and state enforcement and regulatory agencies urging them to commence their own independent enforcement actions. An enterprising target might even purchase shares of its potential acquiror and thereby qualify to bring a shareholder suit to block the acquisition.

Depending on the target's criterion of a successful defense, the ultimate disposition of these proceedings is often of less immediate concern than the tactical advantage to be gained from timely action to slow down the raider and "chill" arbitrage activity in the target's stock. Indeed, because of the volatile dynamics of a takeover contest, such proceedings frequently do not reach the stage of a final decision on the merits.

The target will, within the constraints of time and manpower resources, seek to assert as many challenges as possible unless it has one particularly strong line of defense the force of which it does not want to weaken by introduction of secondary defenses. It need win only one motion for a preliminary injunction in one court or obtain one hearing before one regulatory agency in order to delay the acquisition and, further, it may only be necessary to prevail on one issue to win such motion or obtain such hearing. Conversely, the raider has to fend off every challenge in every forum in order to be assured of proceeding at its desired pace — losing one battle may be tantamount to losing the whole war. However, a target must be cautious not to undertake too many defensive activities, since in certain circumstances more may turn out to be less. See Royal Industries, Inc., supra ("improperly motivated" defensive maneuvers — proposed charter amendments and defensive acquisition, acceleration of deferred compensation plans and commencement of additional litigation — preliminarily enjoined as violations of Section 14(e) and breaches of fiduciary duty).

Whatever forum may be selected, the one ever-present constraint is time. To be successful, whether as a "show-stopper" or a "roadblock," the challenge must be instituted immediately and relief which has the effect of delaying consummation of the bid must be strenuously sought. "[I]n corporate control contests the stage of preliminary injunctive relief, rather than post-contest lawsuits, 'is the time when relief can best be given.'" Piper v. Chris-Craft Industries, Inc., supra at 42. It is virtually impossible to "unscramble the scrambled eggs" in the event that the acquiror is ordered, in a post-acquisition adjudication, to divest itself of the shares. Chemetron Corp. v. Crane Co., 1977-2 Trade Cases ¶ 61,717 at 72,932 (N.D. Ill. 1977).

6.2. Challenges in federal court

A lawsuit in federal court seeking equitable relief to prevent a takeover bid from going forward will generally set forth one or more of the following causes of action: (1) disclosure violations; (2) margin violations; (3) breach of fiduciary duty by a party to the proposed transaction or a conflict of interest involving such a party; and (4) antitrust violations.

6.2.1. Disclosure violations

6.2.1.1. General. The tender offer disclosure requirements of the Williams Act and the SEC's rules thereunder provide a fertile source of challenge for the target. The raider's Schedule 14D-1 is required to contain information concerning numerous specified topics and its disclosures in any one of those areas can be attacked as materially incomplete or inaccurate. In addition, the Williams Act imposes a general obligation of full disclosure of material information and the creative target can subsume within this "catch-all" requirement an infinite variety of disclosure violation allegations relating to topics not specifically listed in the Schedule 14D-1 requirements. Disclosure violations are not "show-stoppers" because corrective disclosures can be made. Cf. Chromalloy American Corp. v. Sun Chemical Corp., CCH Fed. Sec. L. Rep. ¶ 97,127 (E.D. Mo. August 29, 1979) (finding no need to keep a preliminary injunction in force once a shareholder amended its Schedule 13D to reflect its control intentions). Indeed, a court may even decline to enjoin a tender offer if corrective disclosure can readily be made. See, e.g., Weeks Dredging, supra, at 93,497. Nonetheless, disclosure challenges (i) are often the best defenses immediately available as the basis for forcing the raider into court, (ii) can embarrass the raider, "chill" arbitrage activity in the target's stock and generally weaken the appeal of the raider's bid, and (iii) can lay the foundation for wide-ranging pretrial "discovery," i.e., production of documents, oral or written examination of witnesses and propounding of written interrogatories, where the bases for stronger defenses may be unearthed. For these reasons, allegations of disclosure violations form the target's first line of resistance.

6.2.1.2. Specific disclosure allegations. Challenges based on the specific Schedule 14D-1 information requirements can allege inadequate or inaccurate disclosure with respect to such matters as the following:

— Past contacts, transactions or negotiations with the target or any of its officers or directors (e.g., failure to disclose that in discussions with target management the raider offered inducements to a "friendly" takeover, such as employment contracts or purchases of their stock on special terms designed to qualify for favorable tax treatment, see Chemetron Corp. v. Crane Co., supra).

— The source and amount of funds or other consideration to be used for the purchase of securities pursuant to the offer — allegations of breach of fiduciary duty related to the financing of the offer, as well as being independently asserted, can be the subject of a disclosure challenge under this caption. In Humana, Inc. v. American Medicorp, Inc., Bench Opinion, 77 Civ. 4809 (S.D.N.Y. Jan. 7, 1978), at 156-57, it was held that, in a partial cash offer where a second step merger is contemplated and there is some question about repayment of the debt incurred to finance the offer, the offeror's financial statements and a full description of its business were material. In Riggs National Bank v. Allbritton, 516 F. Supp. 164 (D.D.C. 1981) it was held that (i) where an individual is seeking to acquire shares that will give him approximately 35% ownership of the target and is borrowing large sums to finance the purchase, full financial statements are not required, but sufficient information about financial condition to enable evaluation of debt service requirements is necessary; and (ii) disclosure of a loan agreement default provision that might result in the acquired shares being "liquidated" is required (in a partial tender offer) in that the possibiltiy that the acquired shares might be "dumped" on the market is material to the decision to hold shares in the target. It is not clear, however, whether the court would have required such disclosure if the target was not a bank or the acquired shares were not being pledged as collateral. In Prudent Real Estate Trust v. Johncamp Realty, Inc., CCH Fed.

Sec. L. Rep. ¶ 96,833 (2d Cir. 1979), the court held that the financial information disclosure requirements of Schedule 14D-1 may apply even in an any-and-all cash tender offer. In <u>Prudent</u>, the offering circular did not contain financial statements with respect to certain privately-held affiliates of the raider, which upon consummation of the offer were to own 40% of the target stock acquired, pay 20% of the purchase price and have exclusive voting rights (on most matters) as to the target stock acquired. In preliminarily enjoining the offer, the court noted that, although the ability of the offeror to pay for shares tendered was not at issue, the lack of publicly available information concerning the affiliates whose financials were not presented resulted in a material omission by the offeror, since shareholders may wish to know whether an offeror is in flourishing financial condition (possibly inducing the shareholder to hold onto his shares in the hope of a higher bid after termination of the original offer or an infusion of new capital into the company by the new parent) or in poor financial condition (possibly inducing the shareholder to tender out of fear that control of the company is passing into irresponsible hands). In <u>Life Investors, Inc.</u> v. <u>AGO Holding, N.V.</u>, CCH Fed. Sec. L. Rep.

¶ 98, 356 (8th Cir. October 21, 1981), the court held that the tender offeror — AGO Holding, N.V., a Dutch insurance company — was required to make full financial and business disclosures notwithstanding that (i) AGO already owned 41% of the stock of the target — Life Investors, Inc. — and was seeking only an additional 15% interest; (ii) AGO's tender offer was internally financed and its ability to pay for tendered shares was not in issue; and (iii) much of the non-disclosed financial information was favorable to AGO, especially inasmuch as application of "generally accepted accounting principles" as applied in the United States would increase AGO's net worth by 50%. The court noted that the offeror, as a foreign company, was not subject to the financial disclosures required of publicly-held companies in the United States. Consequently, full financial disclosure in the tender offer was deemed particularly important since target shareholders could not otherwise obtain such information. The court reasoned that target shareholders confronted with a partial offer are "intensely interested in how [the offeror] has run its business" whereas target shareholders "confronted with an offer for all the stock . . . have little concern for the bidder's financial condition." Accordingly, the court held that in a partial tender offer the offeror must disclose <u>all</u> material information even if the information is favorable and the offeror's ability to pay for the tendered shares is unchallenged.

— Disclosure with respect to controlling persons or bidders. Generally courts have been reluctant to require full disclosure of all of the information required by Schedule 14D-1 with respect to controlling persons of bidders which themselves have substantial financial resources. *See, e.g.*, *Gray Drug Stores* v. *Simmons*, 522 F. Supp. 961 (N.D. Ohio 1981). However, in *General Steel Industries, Inc. v. Walco National Corporation*, No. 81-1410 C(1) (E.D. Mo. December 8, 1981) the court granted a target company's request for a preliminary injunction against a partial tender offer on the grounds that the bidder, which was a major corporation with assets of nearly $130 million, did not disclose (i) the financial condition of an individual who controlled approximately 42.9% of its stock or (ii) the fact that such controlling person used the assets of the bidder for his personal and political benefit.

— The purpose of the offer and any plans or proposals of the offeror to effect, among other things, an extraordinary corporate transaction (*e.g.*, a merger, reorganization, liquidation, sale or transfer of a material amount of the target's assets or a change in the present composition of the board of directors, capitalization or dividend policy of the target) — see, e.g., Otis Elevator Co. v. United Technologies Corp., 405 F. Supp. 960 (S.D.N.Y. 1975) (offeror's statement in its offer that it "has not formulated any plan or proposal to merge" the target held not only materially misleading, but false where (i) the offeror had prepared a document, in connection with an attempt to negotiate a friendly merger, which discussed the relative merits of a cash tender offer followed by a second-step merger and (ii) after the friendly merger proposal was rejected by the target, the offeror's board reviewed the document, without taking any formal action with regard to it, and authorized a tender offer), but see Crane Co. v. Harsco Corp., 509 F. Supp. 115 (D.Del. 1981) (must show that offeror has present intention to take control, not merely likelihood that investment intention will change in future); Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 948 (2d Cir. 1969) ("[i]t would be as serious an infringement . . . to overstate the definiteness of the plans as to understate them"); cf. Chromalloy American Corp. v. Sun Chemical Corp., supra (enjoining purchase of additional shares until Schedule 13D is amended to express adequately shareholder's intention to exert influence over the corporation's board of directors, and, through this influence, direct the management of the company).

— The impact on the offer of regulatory requirements (e.g., state takeover statutes), the margin regulations and the federal antitrust laws — the target can allege that failure to disclose substantive violations of any of the foregoing is itself a disclosure violation whether or not the target has standing to assert the substantive violations themselves. See Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., 356 F. Supp. 1066 (S.D.N.Y.), aff'd, 476 F.2d 687 (2d Cir. 1973).

Under the "catch-all" material disclosure requirements of Section 14(e) of the 1934 Act, the raider's omissions or misstatements as to any violation of law, misconduct or questionable activity — whether or not directly related to the takeover itself and whether or not, in the case of a violation of law, the target has standing to assert it as a separate claim — which could adversely reflect on the integrity of the raider or engender reluctance to tender on the part of a target shareholder is a potential basis for a disclosure violation allegation. Whether or not the omitted or misstated information would ultimately be held "material", and that the disclosure violation, even if established, can be promptly cured by additional disclosure, are considerations often less significant in strategic terms than the effect of making the allegation and the ensuing investigation. See Raybestos - Manhattan, Inc. v. Hi-Shear Industries, Inc., CCH Fed. Sec. L. Rep. ¶ 97,806 (E.D.N.Y. December 16, 1980)(past violations of securities law held not material).

Although a target has been held to lack standing to allege a claim under Section 9 of the 1934 Act — which prohibits market manipulation — on the ground that Section 9 grants standing only to a person who buys or sells securities at prices affected by the manipulation, Copperweld Corp. v. Imetal, 403 F. Supp. 579 (W.D. Pa. 1975), charges of unlawful market manipulation (e.g., causing a "leak" of news of an intended takeover bid in order to force target stock into the hands of the arbitrageurs) are commonly made against raiders, especially where the raider has made pre-offer purchases of target stock, on the theory that failure to disclose the manipulation is a Section 14(e) disclosure violation.

6.2.1.3. Materiality criterion. The major substantive constraint on the scope of the disclosure violation defense is the materiality standard, under which a disclosure violation must relate to information which a reasonable shareholder of the target would have been substantially likely to consider important in deciding whether or not to tender his shares. Seaboard World Airlines, Inc. v. Tiger International Inc., supra (applying to Section 14(e) the Rule 14(a) standard enunciated in TSC Industries, Inc. v. Northway Inc., 426 U.S. 438 (1976)).

> The fact that the alleged violation occurred in the context of a hotly contested battle for control of a target is a circumstance to be considered in determining whether there has been an actionable failure to disclose material facts. In addition, the fact that there is a contest for control means that a failure to present information may be rendered harmless by disclosure from others, such as the target company, the competing tenderor or outside sources. A defendant may not be faulted for failure to repeat material information which has been publicly proclaimed in various ways on other occasions. The adequacy of disclosure of material information must be evaluated by a consideration of the total mix of all information conveyed or available to investors.

Spielman v. General Host Corp., 402 F. Supp. 190, 194-95 (S.D.N.Y. 1975), aff'd, 538 F.2d 39 (2nd Cir. 1976).

Taken to the extreme, the disclosure violation defense can backfire on target management because "Congress intended to assure basic honesty and fair dealing, not to impose an unrealistic requirement of laboratory conditions that might make the [disclosure requirements] a potent tool for incumbent management to protect its own interests against the desires and welfare of the stockholder." Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 948 (2d Cir. 1969). See also SEC v. United Financial Corp., CCH Fed. Sec. L. Rep. ¶ 96,879 (D.D.C. 1979) (SEC views on what constitute material disclosures).

6.2.2. Margin regulation violations

Under rule-making authority conferred by the Securities Exchange Act of 1934, the Board of Governors of the Federal Reserve System has promulgated regulations which limit the acquisition of publicly-traded securities on credit, or "margin".

Regulation U, 12 C.F.R. §§ 221.1 et seq., as amended effective February 15, 1982, restricts the amount of bank credit which may be used for the purpose of purchasing or carrying "margin securities" (defined to include (1) stock registered on a national securities exchange, (2) an OTC margin stock, (3) a debt security (i) convertible into a margin stock or (ii) carrying any warrant or right to subscribe to or purchase a margin stock, (4) any such warrant or right, and (5) any security issued by an investment company other than a small business investment company, 12 C.F.R. § 221.3(v)) where such credit is collateralized, directly or indirectly, by margin securities. More specifically, Regulation U is violated when a bank makes a loan for the purpose of purchasing any margin securities, in an amount exceeding the maximum loan value of such securities as prescribed by the Federal Reserve Board (presently 50% of current market value), if the loan is directly or indirectly secured by margin stock. Negative covenants restricting the borrower's right to use or dispose of the purchased stock may constitute "indirect security" for the credit if the bank actually relies on the covenants as security in making its decision to extend the credit. 12 C.F.R. §§ 221.113 (f)(3), 221.3(c). See also Alaska Interstate Co. v. McMillian, 402 F. Supp. 532 (D. Del. 1975). (Prior to February 15, 1982, the Regulation U prohibition applied where the purpose loan was secured by any stock (including non-margin securities) and typical negative covenants against asset alienation were troublesome where the affected assets included stock of subsidiaries, e.g., in the case of a holding company borrower. The recent amendment has removed this problem, as well as problems arising from standard cross-default clauses. In addition, in an interpretative letter dated February 25, 1982 relating to a proposed loan to finance an acquisition of a bank holding company the State and the Federal Reserve Board approved its view that a loan agreement provision which permitted the sale or pledge of margin stock held by the borrower only to the extent that the assets underlying the margin stock were first conveyed to the borrower or its wholly-owned subsidiaries would not be deemed to create indirect security for the loan under Regulation U.)

Regulation T, 12 C.F.R. §§ 220.1 et seq., prohibits a broker-dealer from extending credit or arranging for the extension of credit for the purpose of purchasing or carrying any securities other than those which either are registered on a national securities exchange or are widely traded over-the-counter stocks set forth on a list of "OTC Margin Stocks" issued by the Federal Reserve Board or are "exempted securities" as defined in Rule 7c2-1 of the 1934 Act, except on collateral consisting of such "margin securities," and then only to the extent that the broker himself may extend credit, currently 50%. An exception exists if the credit is arranged in a private placement and will not be used to purchase or carry a publicly-held security. The Board of Governors of the Federal Reserve System takes the position that credit is extended on the date when the lenders enter into a binding commitment to provide the financing for the acquisition of a public company, even if no drawdown can occur until the acquisition has been effected and the company's stock has therefore ceased to be within the prohibition. Letter to Sullivan & Cromwell dated November 29, 1979. Regulation T would not apply, however, with respect to credit extended for purchase of asset transactions. See Proxy Statement, dated January 8, 1980, of Congoleum Corporation.

Until recently, Regulation T significantly inhibited the activities of investment bankers engaged in the mergers and acquisitions sector; since investment bankers are generally also registered broker-dealers, Regulation T prohibited them from helping to secure financing for public company acquisitions even where the extension of credit would otherwise be lawful on the parts of both the lender and the borrower. However, as amended effective February 15, 1982, Regulation T now permits an investment banker who is also a broker/dealer to arrange credit for a customer which does not violate Regulations G and U and results solely from investment banking services provided to the customer, including but not limited to underwritings, private placements, and advice and other services in connection with exchange offers, mergers and acquisitions, except for underwritings that involve the public distribution of an equity security with installment or other deferred payment provisions.

Regulation G, 12 C.F.R. §§ 207.1 et seq., governs the lending by persons other than broker-dealers and banks who engage in the business of making loans for the purpose of purchasing or carrying "margin" securities. Regulation G subjects lenders to the margin requirements only if credit is secured by "margin" stock, whereas Regulation U subjects banks to the margin requirements where the credit is secured by any "stock" if it is for the purpose of purchasing or carrying "margin" stock.

Regulation X, 12 C.F.R. §§ 224.2 et seq., prohibits, among other things, the borrowing of money which is lent in violation of the margin rules.

There have been cases holding that the margin regulations were not intended to create private causes of action, see, e.g., Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 603 F.2d 1073 (4th Cir. 1979); First Alabama Bancshares, Inc. v. Lowder, CCH Fed. Sec. L. Rep. ¶ 98,015 at 91,249 (N.D. Ala. May 1, 1981); Martin v. Howard, Weil, Labouisse, Friedricks, Inc., 487 F. Supp. 503 (E.D. La. 1980), and that the target in any event has no standing to allege margin violations, see, e.g., D-Z Investment Co. v. Holloway, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,771 at 96,562 (S.D.N.Y. 1974); Nachman Corp. v. Halfred, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,445 (N.D. Ill. 1973). In Pargas, Inc. v. Empire Gas Corp., 423 F. Supp. 199, 242 (D. Md.), aff'd per curiam, 546 F.2d 25 (4th Cir. 1976), the court, while referring to those cases, suggested that, since the raider might have to dispose of target stock purchased in a tender offer with funds obtained by means of a margin violation and the target might suffer harm as a result of such disposition, the target should be considered an intended beneficiary of the margin regulations. The court also recognized that although a margin violation can form the basis of a Section 14(e) disclosure claim, the raider's failure to disclose the violation can be cured by corrective disclosure so that the potential harm to the target resulting from the underlying violation is left unremedied unless the target is permitted to assert a separate claim. Id. However, the court did not find it necessary to render a final decision on the merits of those arguments in order to dispose of the issues directly raised in the case.

6.2.3. Breach of fiduciary duty/conflict of interest

6.2.3.1. Commercial and investment banks. Banks which finance tender offers play a "critical role in determining whether tender offers will go forward" and as a result exert "[a] significant influence in determining whether management [of the target] survives." Humana, Inc. v. American Medicorp, Inc., CCH Fed. Sec. L. Rep. ¶ 96,286 at 92,829 (S.D.N.Y. 1978). The number of financial institutions willing and able to extend credit in the required amounts is limited, particularly with respect to "mega-dollar" acquisitions like Conoco and Marathon. Accordingly, tender offer financing has become, in significant part, the preserve of the major commercial banks. Those same banks also tend to have banking relationships with the kinds of major companies that have been the targets of the recent large tender offers. This situation can result in instances where a bank financing a tender offer has also, at some stage, had a banking relationship of some kind with the target.

Similarly, there is a limited number of investment banking firms with the experience and expertise sought by raiders embarking upon acquisitions of major public companies and these same firms tend to be prominent in other areas of investment banking (e.g., securities underwriting, private placements and brokerage) which bring them into contact with those kinds of companies. This situation can result in instances where an investment banking firm advising a raider has also, at some time, had a relationship of some kind with the target.

Being aware that the occurrence of these kinds of situations is possible and that they furnish a potential target with the opportunity for making embarassing and reputation-damaging charges of breach of fiduciary duty, conflict of interest and misuse of confidential information, both commercial and investment banks have implemented internal control systems designed to ensure that their acquisitions departments and, in the case of banks, their loan departments, do not receive from other departments any nonpublic information about companies with which those other departments have contacts. These systems, which have come to be known by the generic label "Chinese Wall," are designed to permit those other departments to conduct their regular business while ensuring that if any company with which such business is being conducted should at some point become a target of a take-over bid by a client of the acquisitions department or a customer of the loan department, such department can demonstate that it in fact received no confidential information about the target and that the target therefore suffered no harm. An effective "Chinese Wall" can enable raiders to resist injunction motions based on the conflict of interest/breach of confidentiality defense, even though that defense has been recognized as legally sustainable. See, e.g., Humana, Inc. v. American Medicorp, Inc., supra, at 92,825-29 (S.D.N.Y. 1978); American Medicorp, Inc. v. Continental Illinois National

Bank and Trust Co. of Chicago, No. 77-2865, slip op. at 7, 12 (N.D. Ill. Dec. 30, 1977); see generally Colling, The Chinese Wall and Conflict of Interest in Banks, 34 Bus. Law 73 (1978); Chazen, Reinforcing The Chinese Wall: A Response, 51 N.Y.U.L. Rev. 552 (1976); Lipton and Mazur, The Chinese Wall: A Reply to Chazen, id., 579; Lipton and Mazur, The Chinese Wall Solution to the Conflict Problems of Securities Firms, 50 N.Y.U.L. Rev. 459 (1975); Note, Regulating the Use of Confidential Information in Tender Offer Financing: A Common Law Solution, 55 N.Y.U.L. Rev. 838 (1980).

The continued vitality of the "Chinese Wall" rebuttal to the breach of confidentiality defense has been affirmed in several proceedings in recent years:

(a) In Washington Steel Corp. v. TW Corporation, 602 F.2d 594 (3rd Cir. 1979), the Third Circuit reversed a decision by a district court which had enjoined Chemical Bank from financing a contested offer for Washington Steel by Talley Industries. The District Court had held that Chemical Bank, by virtue of its receipt of confidential information from Washington Steel as a 25% member of a syndicate which had made a loan to Washington Steel, had incurred an agent's duty of loyalty to Washington Steel which the bank had violated by agreeing to finance Talley's subsequent tender offer, which was inimical to the interests of the bank's principal, Washington Steel. The District Court had made no finding that Chemical Bank had actually used the information, but had, in effect, held that a bank which has had a relationship with a target commits a per se breach of fiduciary duty when it agrees to finance a tender offer at a point when it is not known whether the target will oppose the offer and the bank has not obtained a waiver of its loyalty obligation from the target. This *per se* theory, under which the "Chinese Wall" rebuttal would be nullified, was rejected on appeal as both unprecedented and objectionable on "important policy grounds" since it "would wreak havoc with the availability of funding for capital ventures." In addition, the Third Circuit rejected Washington Steel's argument that if Chemical Bank's lending department had used information received from Washington Steel in determining whether to make the Talley loan — which the court held, on the facts, had not happened — such conduct would be actionable. The court held "that the use within the loan department of information received from one borrower, in evaluating a loan to the other borrower, does not, without more, state a cause of action against the bank." The court expressly declined, however, to state a view as to what the legal consequences might have been if Chemical had actually relayed the confidential information to Talley or to some separate bank department, such as the trust department whose function it is to recommend investments.

(b) The South Carolina Securities Commissioner refused to adopt a *per se* theory of bank liability in proceedings arising from Brascan's tender offer for Woolworth, in which it was alleged that the Canadian Imperial Bank of Commerce, which had loaned Brascan $700 million of the $1.1 billion required for the offer and had been the principal lender to, and represented on the board of, Woolworth's Canadian subsidiary for several years, had breached its fiduciary duty to the subsidiary by financing the offer. See N.Y. Times, June 11, 1979, p. D1.

(c) In Harnischfeger Corporation v. Paccar, Inc., CCH Fed. Sec. L. Rep. ¶ 97,119 (E.D. Wis. 1979), aff'd on other grounds, No. 79-1767 (7th Cir. 1980), the court, in finding on the evidence no violation of fiduciary duty by Citibank in providing advisory services to Paccar in connection with the identification of Harnischfeger as one of a number of possible acquisition candidates, rejected the target's per se violation contentions and stated that Citibank's "Chinese Wall" had not been breached.

(d) In Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980), the Second Circuit held that Morgan Stanley, an investment banker, was under no duty to refrain from using for its own purposes — arbitrage investment in Olinkraft stock — information obtained earlier from Olinkraft when Morgan Stanley was acting as a merger adviser to a potential friendly acquiror of Olinkraft. After the friendly negotiations terminated unsuccessfully, Olinkraft became the subject of a hostile tender offer, whereupon Morgan Stanley purchased Olinkraft stock for its own account and disclosed the confidential information, despite Olinkraft's express wishes to the contrary, to a rival bidder in an ultimately successful effort to induce a higher bid. An Olinkraft shareholder brought a derivative action demanding an accounting by Morgan Stanley of profits made from its transactions in Olinkraft stock. The Second Circuit dismissed on the ground that the misuse of confidential information, absent a prior fiduciary relationship, did not give rise to a cause of action.

(e) One of the SEC's tender offer rules (Rule 14e-3), CCH Fed. Sec. L. Rep. ¶ 24,887 L, prohibits a person who receives material non-public information about a tender offer which another person has commenced, or taken a substantial step to commence, which he knows or has reason to believe is non-public and came directly or indirectly from the person, the target company or any officer, director, partner or employee of either of the foregoing from purchasing or selling the subject securities unless he publicly discloses the information and its source within a reasonable time prior to the purchase or sale. But cf. Chiarella v. U.S., CCH Fed. Sec. L. Rep. ¶ 97,309 (U.S. Sup. Ct. 1980) ("a duty to disclose under Section 10(b) does not arise from the mere possession of non-public market information"), rev'g 588 F.2d 1358 (2d Cir. 1978). However, Rule 14e-3 also provides that a non-natural person (e.g., an investment banking firm) may purchase or sell securities as to which the person possesses undisclosed information, provided such person discharges the burden of showing that (1) the individual making the investment decision on behalf of such person (e.g., its arbitrage department) does not know or have access to the non-public information, and (2) such person had implemented one or a combination of procedures, reasonable under the circumstances, taking into account the nature of the person's business, to ensure that individuals making investment decisions would not violate the prohibition of the Rule. The policies and procedures may include those which (i) restrict purchases and sales or (ii) prevents such individuals from knowing such information.

The promulgating release, Release No. 33-6239 (September 4, 1980) explicitly states that procedures such as a "Chinese Wall" and a "restricted list" of securities which the institution is prohibited in buying for its own account or recommending to others, may, depending on the circumstances, satisfy the exception but that the reasonableness of a particular practice is to be tested by reference to the particular institution, not just the industry, and by the timing of its implementation as well as its substance. Beyond the scope of Rule 14e-3, the extent to which the federal securities laws prohibit trading on inside information about a tender offer is not clear. In Chiarella v. U.S., 445 U.S. 222 (1980), a prosecution of a financial printer for violating the general anti-fraud proscription of Rule 10b-5 by buying the securities of companies which he knew from his work were the targets of impending tender offers, the U.S. Supreme Court held that no duty to disclose under Rule 10b-5 arises from the mere possession of non-public material information and that a Rule 10b-5 violation could be established only if the defendant were found to have violated a fiduciary obligation not to trade on the inside information. By contrast, in United States v. Newman, 664 F.2d 12 (2d Cir. Oct. 30, 1981), the Second Circuit Court of Appeals reinstated an indictment against employees of two investment banking houses and a securities trader for violating Rule 10b-5 by trading on inside information concerning proposed acquisitions, holding that a criminal violation of Rule 10b-5 occurs when the defendant breaches a duty of confidentiality owed to his employer or client, even if the latter is neither a purchaser or seller of securities in any transaction with the defendants, and that these defendants had defrauded their employers by sullying their reputations. However, the court distinguished between a criminal prosecution or SEC enforcement action, on the one hand, and a Rule 10b-5 private civil action for damages, on the other, noting that the court-imposed purchaser-seller standing requirement of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) applies to the latter type of action.

For an analysis of amendments to the Williams Act (the provisions of the Securities Exchange Act of 1934 which regulate tender offers and stock acquisitions) proposed by the SEC in 1980 in connection with the financing of tender offers and related matters, but which the SEC does not currently appear to be actively pursuing, see Fogelson, Wenig and Friedman, Changing The Takeover Game: The Securities and Exchange Commission's Proposed Amendments To The Williams Act, 17 Harvard Journal on Legislation 409 (1980).

The breach of fiduciary duty/conflict of interest defense is not a "showstopper" — even the district court in Talley granted an injunction only against the financing, conducting, planning, or arranging of the tender offer by Chemical Bank; the tender offer itself was not enjoined from going forward nor was it ruled illegal. However, the need for Talley to arrange new financing resulted in a delay during which Washington Steel was able to find a white knight, thus demonstrating the potential strategic significance of the defense as a "roadblock."

6.2.3.2. Directors of raider. It is not uncommon for public companies to have interlocking directorates and, accordingly, instances of the raider and the target sharing a common director sometimes occur.

where the common director is an outside director of the raider, i.e., not a member of management, the charge that he violated his fiduciary duty to the target in connection with the raider's takeover bid may be difficult to sustain unless the director can be shown to have actively promoted the idea of the bid in his capacity as a director of the raider or have passed on to the raider nonpublic information obtained in his capacity as a director of the target. However, where the common director is a member of the raider's management, and may therefore be characterized as an instigator of the bid, the target can seek to base a defense alleging breach of a fiduciary duty on the very circumstance of the director's involvement in two conflicting capacities. Cf. Washington Steel Corp. v. Talley Industries, supra. In Hi-Shear Corp. v. Klaus, No. 74-2665 (9th Cir. Oct. 1 and Nov. 22, 1974), the court held that even where a common director has violated his fiduciary duty to the target by passing to the raider confidential information about the target, the target will not ordinarily be entitled to an injunction against the tender offer because the target, as a corporate entity, will generally be unable to establish that it has suffered cognizable harm not compensable by monetary damages. See Complaint in Applied Digital Data Systems Inc. v. Mitel Corp., 80 Civ. No. 4412 (S.D.N.Y. July 31, 1980); McGraw-Hill v. Morley, Index No. 01324/79 (N.Y. Sup. Ct. 1979).

6.2.4. Antitrust violations

6.2.4.1. Substantive grounds. An antitrust challenge is potentially the most significant defense to a takeover because, if successful, it is frequently a "showstopper" (but see 6.2.4.5 below). The federal statutory bases for such a claim include:

- Clayton Act Section 7, 15 U.S.C. § 18: that a proposed acquisition may have the effect, in any line of commerce in any section of the United States, of substantially lessening competition or tending to create a monopoly. This is the most frequently employed basis for challenge. The generally established theories for Section 7 recovery are:

  - Lessening of "horizontal" competition by the acquisition of a direct competitor in a relevant geographic and product market. See, e.g., F. & M. Schaefer Corp. v. C. Schmidt & Sons, Inc., 597 F.2d 814 (2d Cir. 1979) (affirming grant of preliminary relief enjoining purchase of subordinated, debentures convertible into 29 percent of company's outstanding shares after conversion); Boyertown Burial Casket Co. v. Amedco, Inc., 1976-1 Trade Cas. ¶ 60,792 (E.D. Pa. 1976).

  - Vertical foreclosure of sales, by the acquisition of a supplier or customer, of sufficient magnitude to result in a substantial lessening of competition in a relevant market. See Gulf & Western Indus., Inc. v. Great A. & P. Tea Co., Inc., 476 F.2d 687 (2d Cir. 1973) (affirming grant of preliminary injunction enjoining consummation of tender offer on the ground, inter alia, that there was a reasonable likelihood of success on the merits of a claim of violative vertical integration); Crouse-Hinds Co. v. InterNorth, Inc., 1980-81 Trade Cas. ¶ 63,763 (N.D.N.Y. 1980) (preliminary injunction denied; insufficient evidence of probable vertical foreclosure as a result of acquisition).

— Elimination of "potential competition," i.e., that the acquisition of an existing operation in a geographic or product market in which the acquiror is a potential new entrant in its own right, or is perceived to be such by competitors of the target company in that market, will reduce competition in that market. An "actual" potential competition case requires proof that (1) the relevant market is oligopolistic in structure and non-competitive in performance and (2) the proposed acquiror is, through capability and inclination, a potential independent entrant in the near future, either through entry _de novo_ or through "toe-hold" acquisition of a company lacking significant market share. A "perceived" potential competition case additionally requires a showing that the proposed acquiror (3) is perceived by existing firms in the relevant market as a potential independent entrant and (4) has exercised a tempering impact on the competitive conduct of existing sellers. However, a court may presume a "tempering impact" from a competitor's perception that the proposed acquiror is a potential independent entrant. See _U.S. v. Falstaff Brewing Corp._, 410 U.S. 526 (1973) (denial of injunction and remand for factual determination of Falstaff's status as a perceived potential entrant); _U.S._ v. _Penn-Olin Chem. Co._, 378 U.S. 158 (1964) (formation of joint venture company held violative of Section 7 on this theory); _U.S._ v. _Siemens Corp._, 621 F.2d 449 (2d Cir. 1977); _FTC_ v. _Exxon Corporation_, 1979-2 Trade Cas. ¶ 62,763

(D.D.C. July 28, 1979) (acquisition via tender offer temporarily restrained at the request of the FTC on the theory that the acquisition would eliminate the acquiror as the most likely actual new or toehold entrant into a product market in which the target was dominant); but _cf_. _BOC International Ltd._ v. _FTC_, 557 F.2d 24 (2nd Cir. 1977) (generally limits scope of "potential entrant" theory).

— "_Entrenchment_," _i.e._, that the acquired company has a dominant or substantial share of a relevant market and the acquisition, by making available the resources of the acquiring company, will increase that dominance either directly or by deterrence of other potential entrants. See, _e.g._, _FTC_ v. _Proctor and Gamble_, 386 U.S. 568 (1967).

— "_Reciprocity effect_," _i.e._, that the acquisition will create a market structure whereby suppliers of one party to the merger, in order to maintain or increase sales thereto, will tend to increase their purchases from the second party to the merger, thereby foreclosing customers from the second party's competitors.

— Sherman Act Section 1, 15 U.S.C. § 1: that a proposed acquisition involves a contract, combination or conspiracy in restraint of interstate or foreign trade or commerce. See, e.g., United States v. First National Bank & Trust Co. of Lexington, 376 U.S. 665 (1964) (merger of commercial banks violated Section 1).

— Sherman Act Section 2, 15 U.S.C. § 2: that a proposed acquisition involves the monopolization or attempted monopolization of inter-state or foreign trade.

— Clayton Act Section 8, 15 U.S.C. § 19: that (i) a proposed acquisition involves an acquiring or target corporation with capital, surplus and undivided profits aggregating more than $1,000,000, (ii) the acquiring and target corporations are competitors by virtue of their business and location of operation and (iii) as a result of the acquisition they would have at least one common director (a director interlock may constitute an unfair method of competition proscribed by Section 5 of the Federal Trade

Commission Act even if it does not fall within the proscription of Clayton Act Section 8 — see Perpetual Federal Savings & Loan Assoc., 90 F.T.C. 608 (1977)).

Only a few takeovers have been preliminarily enjoined on antitrust grounds and none have been stopped on theories of potential entrance, entrenchment or reciprocity effect. See e.g., Carrier Corp. v. United Technologies Corp., 1978-2 Trade Cases ¶ 62,405 (2d Cir. 1978), aff'g without adopting 1978-2 Trade Cases ¶ 62,393 (N.D.N.Y. 1978) and Babcock & Wilcox Co. v. United Technologies Corp., 435 F. Supp. 1249 (N.D. Ohio 1977) (conglomerate theories argued, but injunction denied). However, traditional theories of horizontal competition have proven more successful "showstoppers" in the past, see, e.g., Chemerton Corp. v. Crane Co., supra and Harnischfeger Corporation v. Paccar, Inc., supra. Two well-publicized 1981 Circuit Court of Appeals decisions, Grumman Corp. v. The LTV Corporation, 81-2 PH Trade Cas. ¶ 64364 (2d Cir. 1981) and Marathon Oil Company v. Mobil Corporation Nos. 81-3704-3713 (6th Cir. December 23, 1981) reinforce the viability of lawsuits brought by target companies under Section 7 of the Clayton Act aimed at blocking horizontal acquisitions. As the Second Circuit stated in the Grumman case:

> "If the effect of a proposed takeover may be substantially to lessen competition, the target company is entitled to fend off its suitor. Our focus is therefore not upon [the target's] motivation for bringing

> this suit, but upon the adequacy of its preliminary showing that the proposed takeover will violate [the antitrust laws]."

However, it has been suggested that the violation must be particularly clear and the potential damage to the target particularly grave before such relief should be granted against a tender offer, otherwise Section 7 can become too powerful a weapon in the hands of target management. *Missouri Portland Cement Co.* v. *Cargill, Inc.*, 498 F.2d 851 (2d Cir.), *cert. denied*, 419 U.S. 883 (1974). In addition, the *Mobil* case reaffirms the reluctance of the courts to consider "cures" to antitrust problems which are proffered only after the issue has been litigated. In *Mobil*, the district court was upheld in rejecting the proposed "hold separate order" that Mobil had advanced only after the grant of the preliminary injunction. This lends further support to the precedents suggesting that only those curative steps proposed *before* the grant of an injunction will be considered by a court as possible alternatives to the preliminary injunction. See, *e.g.*, *Chemetron Corp.* v. *Crane Co.*, *supra*.

6.2.4.2. *Conglomerate acquisitions*. The size of the parties to an acquisition is not *per se* a basis for a successful antitrust challenge. Bills were introduced in the last Congress which would have significantly altered this situation. One such bill (S600, introduced March 8, 1979) would have prohibited acquisitions of control where (i) each party had assets or sales exceeding $2 billion (absolutely prohibited) or (ii) each party had assets or sales exceeding \$350 million or one has such assets or sales and the other has 20% of the net sales in a domestic line of commerce with aggregate annual net sales of \$100 million (certain affirmative defenses, e.g., enhancement of competition would be available). S1246 (introduced May 24, 1979) would, until 1991, have absolutely prohibited the major U.S. oil-producing companies from acquiring control (defined to include 15% ownership) of any other company with assets of \$100 million. The Antitrust Division drafted an alternative to S1246 which would qualify the prohibition by allowing the affirmative defense of pro-competitiveness, but would redefine the covered oil producers to increase the bill's initial reach from 16 to 18 U.S. companies. See Letter dated July 31, 1979 from the Assistant Attorney General, Antitrust Division, Department of Justice, to the Chairman of the Senate Judiciary Committee. Both these bills have lapsed and it is doubtful that their sponsors in the Senate (who are Democrats) will reintroduce them in the current Congress (which has a Republican-controlled Senate).

6.2.4.3. Government enforcement guidelines. The Antitrust Division of the Department of Justice has issued Merger Guidelines, 1 CCH Trade Reg. Rep. ¶ 4510, setting forth the standards it applies in determining whether it will challenge corporate mergers under Section 7. The Guidelines relate to horizontal, vertical and conglomerate acquisitions, including those involving potential entrance, and those which create the danger of reciprocal buying or an entrenchment of market power. Although the Guidelines do not have the force of law, they have been held entitled to some consideration, particularly where elements in them find support in the developing case law. See, e.g., Allis-Chalmers Manufacturing Company v. White Consolidated Industries, Inc., 414 F.2d 506, 524 (3d Cir. 1969), cert. denied, 396 U.S. 1009 (1970). William French Smith, President Reagan's appointee as Attorney General, and William Baxter, President Reagan's appointee as the Assistant Attorney General in charge of the Antitrust Division, are reportedly planning a major overhaul and relaxation of the guidelines, see BNA Antitrust & Trade Reg. Rep. (Vol 42), Feb. 18, 1982, p. 374, The Wall Street Journal, June 25, 1981, p. 6, col. 2, and Business Week, June 8, 1981, p. 55.

In addition, the Federal Trade Commission has issued statements setting forth its antitrust enforcement policies with respect to certain violations such as the food distribution and dairy industries. 1 CCH Trade Reg. Rep. ¶ 4515 et seq.

6.2.4.4. Hart-Scott-Rodino Act violations. The target can assert formal deficiencies or factual inaccuracies in the raider's filings under Title II of the Hart-Scott-Rodino Antitrust Improvements Act and the rules promulgated by the FTC thereunder, which require pre-acquisition filings with the federal antitrust enforcement agencies in connection with most large acquisitions of U.S. companies (including acquisitions by foreign companies or individuals). While it is questionable whether the target has standing to assert a violation of those requirements by the raider, the target can try to finesse that issue by arguing breach of Hart-Scott-Rodino as a disclosure violation, e.g., that the raider's Schedule 14D-1 is materially misleading in its description of the proposed timetable for consummating the takeover inasmuch as the Hart-Scott-Rodino violation has prevented the waiting period from commencing to run. Cf. Heublein, Inc. v. General Cinema Corporation et al., 82 Civ. 1002 (S.D.N.Y. Feb. 19, 1982) (complaint alleges 13D violation based on failure to disclose that open market purchases were made in violation of Hart-Scott-Rodino). While successful assertion of this argument cannot be (as to which there are no court decisions) a "show-stopper," it may secure a tactically useful delay in the raider's timetable.

6.2.4.5. Relief. Even a successful antitrust defense is not necessarily a permanent bar to a takeover. The raider may be able to persuade the court that the goals of antitrust enforcement will be satisfied by court-approved undertakings by the raider (i) to maintain the separate existence of the target pending a final determination of the merits of the antitrust allegations, so that divestiture can be effectively accomplished should the allegations ultimately be sustained; cf. FTC v. Exxon Corporation, supra, and/or (ii) to divest itself of the business which has created the alleged violation, see the FTC's consent order in Cooper Industries Inc., FTC File No. 791 0038, announced March 29, 1979, CCH Trade Reg. Rep. ¶ 21,551 (acquiror's undertaking to divest certain assets accepted as a basis for the FTC's withdrawal of its objections to a planned acquisition on the ground of elimination of competition). However, as indicated in 6.2.4.1, the courts are leery of curative divestiture undertakings proffered only after antitrust litigation has been initiated.

6.3. Proceedings under state law

6.3.1. State takeover statutes

To the extent that the state takeover statutes remain enforceable, claims which can be asserted under those statutes include:

— disclosure violations — most state takeover statutes require specific disclosure regarding enumerated topics generally similar to (and in some instances, e.g., with respect to financial information about the raider, more extensive than) those set forth in the SEC's Schedule 14D-1 requirements, as well as a "catch-all" requirement of "full and fair disclosure"; accordingly, claims thereunder resemble those at the federal level;

— market manipulation — while clearly within the proscriptions of state securities and takeover laws, market manipulation claims may, however, be matters more appropriately in the domain of the SEC, see In the Matter of Pabst Brewing Co., CCH Blue Sky Rep. ¶ 71,415 n.77 (Wis. Comm'r Sec. 1978); and

— violation of those state statutes requiring that a takeover bid be fair and equitable to offerees — in Pabst, supra, the Wisconsin Securities Commissioner found unfairness to the non-tendering shareholders because the raider would have to divert the target's assets and earnings to itself in order to service the debt incurred to finance its offer and, since that offer was not being made for all outstanding shares, some target shareholders would be left as minority, and essentially powerless, investors in a depleted enterprise.

6.3.2. <u>State "blue sky" laws</u>

A target can challenge a raider's activities pursuant to state securities laws. Claims (<u>e.g.</u>, market manipulation) can be alleged under the general antifraud provisions of such laws, either in court or before the state securities regulatory agency.

Depending on its registration provisions, a state blue sky law may be used to challenge the issuance of the raider's securities in an exchange offer. Such securities must either be registered under the relevant state's blue sky law or qualify for a registration exemption thereunder in order to be lawfully issued in that state. Most blue sky statutes confer an automatic exemption where the securities have been registered with the SEC under the federal securities laws, have been approved for listing on a national securities exchange or are of senior or substantially equal rank to other securities of the same issuer which are so listed. However, under the Wisconsin statute the exemption must be affirmatively granted by the Securities Commissioner. In <u>Pabst</u>, the Commissioner denied an exemption request by the raider, APL, finding that the issuance and sale of the proposed securities "would be unfair and inequitable to purchasers, principally because APL's earnings would have been insufficient to expect that it can make interest payments when due, and because APL's funded debt would be disproportionately high compared to its shareholders equity." Pabst, supra at 68,359.

Alternatively, prior issuances of a raider's securities may be attacked in a current contest for control under state blue sky laws. See In the Matter of Takeover Bid by InterNorth, Inc. and I N Holdings, Inc. For Equity Securities of Crouse-Hinds Company (N.Y. Attn'y General, November 5, 1980).

6.3.3. Other state laws

Claims based on violations of general state law can include:

— breach of a fiduciary duty by, or a conflict of interest involving, a party to the transaction — e.g., McGraw-Hill instituted a state court action against American Express, its senior executives and its directors on the grounds, essentially, that (i) American Express' president had violated his fiduciary duty as a McGraw-Hill director by promoting an American Express takeover. The complaint alleged that, in the event American Express successfully consummated the takeover, damages should be set at the difference between the amount that McGraw-Hill was worth and the tender offer price, which was alleged to be in excess of $500 million. See complaint dated January 19, 1979, filed in McGraw-Hill, Inc. v. Roger H. Morley, et al. (New York Sup. Ct., N.Y. Co.); and

— antitrust violations — state antitrust laws may be significant in certain cases (e.g., a combination of two companies with a high degree of intrastate horizontal competition), but antitrust issues are usually fought out in the federal domain, see State of Tennessee v. United Technologies Corporation, No. 78-3555 (M.D. Tenn. December 14, 1978) (state antitrust law held unconstitutional as applied), except where lessening of competition is a specific statutory criterion for the denial of approval of the acquisition in a state regulatory proceeding (e.g., under a state insurance holding company statute, see, e.g., Recommendation of the Superintendent of Banks, State of New York, Barclays Bank Ltd. and Barclays Bank International Ltd. (Long Island Trust Company), Annual Report of Superintendent of Banks, p. 72 (1973) (recommending denial of Barclays Bank's application for permission to acquire Long Island Trust Company on the ground that the acquisition would adversely affect competition in the banking market)).