June 20, 1983

To Our Clients:

Takeovers: The Convertible Preferred Stock Dividend Plan

We believe that a corporation has the absolute right to

(1) have a policy of remaining an independent entity,

(2) have a policy of refusing to entertain takeover proposals,

(3) reject a takeover bid,

(4) take action to remain an independent entity, and

(5) guarantee its shareholders a right to retain an equity interest in the corporation even if someone is successful in obtaining control and forcing a second-step merger.

Over the years, we have tried a number of different means to accomplish these objectives -- litigation, charter amendments, legislation (state takeover laws), counter tender offers, and structural (capitalization) changes such as placements of blocks of voting securities and the warrant dividend plan. While we have had considerable success in achieving these objectives, none of these means has proven to be generally applicable and effective. Except for fair price charter amendments and self tenders, it has become virtually impossible to defend against the stampeding effect of partial and front-end loaded tender offers and assure all shareholders of fair treatment.

The SEC Tender Offer Committee has not recommended new rules which would redress the imbalance; that would give the target of a tender offer a reasonable opportunity to remain an independent company so that those shareholders who desire to continue their equity interest could do so; and that would eliminate the creeping tender offer and the front-end loaded takeover.

Recently, we devised a plan that combined the "flip-over" provisions of the warrant dividend plan and the distribution to the common stockholders of a dividend of a convertible preferred stock with fair price provisions that we devised for the defense of El Paso. A variation (containing some, but not all of the features) of our plan is the subject of litigation in the Lenox case, in which an injunction was denied today. We have no doubts about the legality of the plan. More important, we are convinced of its efficacy in achieving the objectives referred to above.

The Convertible Preferred Stock Dividend Plan,

(1) protects shareholders against being frozen-out in an unfair second-step merger following a front-end loaded tender offer,

(2) enables those shareholders who wish to reject a tender offer and retain their equity interest to do so without loss of liquidity,

(3) removes the ability of a raider to stampede the shareholders of a target into tendering their shares in order to protect themselves against loss of the premium or being locked into a minority position, and

(4) protects against partial tender offers by bootstrap raiders who do not intend a second step until they can accomplish it by using the assets and credit of the target.

The Convertible Preferred Stock Dividend Plan does not prevent tender offers and does not prevent a second-step merger after a raider has seized control. All it does is assure fair treatment of all shareholders and the right of those who so desire to continue their equity interest following a takeover. The Plan does not have any potential adverse impact on the market value or marketability of the corporation's stock. The NYSE will list the convertible preferred stock and the underlying common stock into which it is convertible. The distribution to the common stockholders of the dividend of shares of the convertible preferred stock is tax-free.

The only significant problem inherent in the Plan is that it complicates doing a white knight deal if the corporation should become the target of a tender offer, and makes a negotiated takeover, other than a common stock merger, more difficult. These are very small prices to pay for the overwhelming benefits and protections afforded by the Plan.

How Does It Work

While the Plan can be put into effect after a tender offer has been made, it is most effective if it is done before there is even a threat of takeover. It is something that every corporation should consider now, before it becomes a target.

The Plan is simple. The corporation distributes to its common stockholders a dividend in the form of a convertible preferred stock. The preferred is convertible into the same (or larger) number of shares of common as are outstanding so that the distribution is the equivalent of a 2 for 1 (or greater) stock split with the result that half (or more) of the outstanding equity is represented by the preferred. In other words, a corporation with 10,000,000 shares of common distributes, as a dividend to the holders of its common, a new issue of preferred that is convertible into an additional 10,000,000 shares of common. This is accomplished by creating a class of 400,000 shares of preferred with each share of preferred being convertible into 25 shares of common. One share of the preferred is distributed for each 25 shares of common. The corporation now has outstanding 10,000,000 shares of common and 400,000 shares of preferred with the preferred being convertible into 10,000,000 shares of common. A holder of 100 shares of common has those 100 shares plus 4 shares of preferred which are convertible into 100 shares of common. After the distribution the common and preferred would trade separately. Each would be listed. The distribution of the preferred to the holders of the common is tax-free.

Since the distribution of the preferred is the equivalent of a 2 for 1 stock split, the cash dividend on the common is reduced by 50% and the cash dividend on each share of the preferred is set at slightly more than 25 times the halved common stock dividend. Thus each holder of common has the same cash dividend he had before the distribution plus a little bit more. Since the dividend on the preferred will be set so as to increase with any increase in the dividend on the common, the preferred dividend will always be a little bit more than the common and there will therefore be a disincentive for the holders of preferred to convert into common.

3 The preferred will be noncallable for 10, 15 or more years -- whatever period is set by the corporation, keeping in mind that too short a period might raise tax questions. Also, when the preferred becomes callable the protection of the Plan disappears. 3 Therefore, we recommend at least 10 to 15 years as the noncallable period.

For those companies that do not have sufficient authorized common stock and blank check preferred stock. it would be necessary to have a shareholder vote to authorize the requisite stock. Those companies that have sufficient authorized stock can implement the Plan through action by their board of directors alone.

The preferred does not contain any blocking votes, shark repellents or other provisions inhibiting a tender offer or merger. The preferred votes with the common as one class with each share of preferred having a number of votes equal to the number of shares of common into which it is convertible.

The preferred would contain the normal boilerplate provisions protecting the conversion rights in the event of a merger or other business combination, including a "flip-over" provision which is the essence of the Plan.

In the event of a tender offer followed by a freeze-out merger the conversion rights would flip-over to the common stock of the raider and the preferred would be convertible into the common stock of the raider. This conversion into the common stock of the raider would be accomplished pursuant to a conversion exchange ratio that results in the holder of the preferred receiving shares of common stock of the raider having a market value at the time of the conversion equal to not less than the cash tender offer price for the target.

In addition, if the cash tender offer results in the raider acquiring 50% (this percentage could be set anywhere between say 20% and 50%) of the target's common, the preferred is thereafter redeemable by the stockholder, at any time, at a redemption price equal to the cash tender offer price. Thus, even if there is no second-step merger, the holder of the preferred is assured of the tender offer price in cash as a floor and has upside potential if there is a second-step merger and the market price of the raider's common goes up. The holder of the preferred has no market risk if the raider's common goes down; he always gets a sufficient number of shares of the raider to at least equal the highest ~~tender~~ price paid ~~offer price.~~ Since the tender offer sets a floor cash value for the preferred and it continues to have valuable conversion features, after a tender offer is announced it should sell in the market at a premium over the tender offer price for the common and therefore there is little incentive for a holder of the preferred to tender unless there is a separate tender for the preferred at a price that reflects the extra premium. The conversion exchange ratio formula is expressed as the greater of the tender offer price or the highest market price of the target's common prior to the date of conversion divided by the lower of the raider's market price on the date of the second-step merger or on the date of conversion. Thus, the raider runs the risk of a decline in the market price of its common.

If the preferred dividend is the equivalent of a 2 for 1, 3 for 1 or 4 for 1 split, then 50%, 66-2/3% or 75% of the target's common equity is protected against being frozen out and is assured of the tender offer premium. This gives the shareholders of the target a real alternative to tendering in that with respect to the bulk of their holdings it protects them against being locked into a minority position and subjected to a future freezeout at a price less than the tender price. Since the preferred dividend is fixed, it also protects them against the raider reducing or eliminating dividends on the target's common, if the raider decides to attempt only partial ownership and does not effectuate a second-step merger.

The target which has implemented the Plan presents a difficult problem to a raider contemplating a hostile tender offer. A raider must think twice about the economics of being faced with the issuance of a significant number of shares of its own common stock, valued for conversion exchange purposes at the lower of current market at the time of the second-step merger or at the time of conversion. The raider is faced with a conversion exchange ratio that results in increased dilution as the market price of its common goes down, which dilution may further depress the market price of the raider's common stock.

One way for the raider to deal with the Plan is to tender for the target's preferred and common and to set a high (80% or greater) minimum condition in the tender offer so as to be faced with a relatively small number of shares of preferred in the second-step merger. Of course, this helps achieve the objectives of the Plan -- elimination of partial and front-end loaded tender offers, assurance that all shareholders will have a reasonable opportunity to receive the full cash bid for their shares, and reduction of bootstrap bids by raiders who must use their own securities and the target's assets to finance the takeover. In addition, high minimums inhibit arbitrage by casting doubt on whether the tender offer will succeed. Further, since the preferred is fully protected against loss of the tender offer premium and being locked into a minority position and being squeezed by reduction or elimination of dividends, there is much less incentive to tender for a holder of preferred who does not hold common.

Similar results may be achievable through charter amendments and issuance of warrants and convertible debentures. Other provisions such as tax reimbursement if a second-step merger destroys the tax-free nature of the conversion may be added. The special characteristics of each corporation should be taken into account in tailoring the Plan. It is suggested that those corporations interested in considering the Plan form a task force including the corporation's counsel in its state of incorporation and its investment banker so that a recommendation to adopt the Plan is presented to the directors with approving legal and financial opinions.

Martin Lipton