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Introduction to this Symposium and a Guide to Issues in Mergers and Acquisitions

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SAMUEL C. THOMPSON, JR.*

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* Dean, University of Miami School of Law. I want to thank my research assistant, Sholonda Wright, a third year student at the University of Miami School of Law, for her helpful comments on this Article.

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I. INTRODUCTION

The articles in this Symposium Issue of the *University of Miami Law Review* are based on presentations made by the authors at the First Annual Institute on Mergers and Acquisitions, sponsored by the University of Miami School of Law on February 6-7, 1997. The Institute was Co-Chaired by Harvey Goldman of Steel, Hector and Davis LLP, Miami, Florida and Dennis S. Hersch, the head of the mergers and acquisitions practice at Davis Polk & Wardwell, New York. The speakers at the Institute included some of the leading lawyers, government officials, and judges working in the area of mergers and acquisitions.

This Article provides a guide to various issues that can arise in mergers and acquisitions and discusses the manner in which the articles in this Symposium fit into the guide. This Article also provides references to some of the vast literature addressing merger and acquisition issues.¹

Except in a stock acquisition of a closely-held target, where the acquirer deals directly with the target's shareholders,² the acquirer will

1. This guide is based in part on the approach to mergers and acquisitions taken in SAMUEL C. THOMPSON, JR., *BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS* (1997) [hereinafter THOMPSON, *BUSINESS PLANNING FOR M & A*]. See also LOU R. KLING & EILEEN NUGENT SIMON, *NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS* (1996) [hereinafter KLING, *NEGOTIATED ACQUISITIONS*]; MARTIN LIPTON & ERICA H. STEINBERGER, *TAKEOVERS & FREEZEOUTS* (1995) [hereinafter LIPTON, *TAKEOVERS*]. For a similar approach to the one taken here see Bernard Kury, *Acquisition Checklist*, 36 BUS. LAW. 207 (1981).

2. This Article does not specifically address issues that can arise in stock acquisitions of closely-held corporations. However, this topic is covered in detail in *Section of Business Law, AMERICAN BAR ASSOCIATION, MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY* (1995).

have to give consideration to approaching a potential target's directors. This is true even if the acquirer proceeds with a hostile tender offer, because the target's directors may undertake defensive measures. Thus, particularly in the acquisition of a publicly-held target, the target's directors will play a large role in the transaction, whether it be a negotiated transaction or hostile takeover, and early in the acquisition process the acquirer will have to consider the potential reaction of the target's directors.

Section II, therefore, addresses the law governing the target's directors in negotiated and hostile acquisitions. This is a hot topic, and various aspects of the topic are addressed in five articles in this Symposium. First, Melvin Eisenberg (the Koret Professor of Law at the University of California at Berkeley, the author of one of the leading corporations casebooks, and the Chief Reporter of the ALI's *Principles of Corporate Governance*³) addresses the role of a target's directors in negotiated acquisitions in his article entitled *The Director's Duty of Care in Negotiated Dispositions*.⁴

Second, John Coffee, a professor at Columbia University Law School and the author of leading casebooks on corporations and securities regulations, addresses the role of institutional investors in curtailing the control a target's directors have over the acquisition process. Professor Coffee's article is entitled *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests*.⁵

Third, Dennis Block (a partner at Weil, Gotshal & Manges LLP and co-author of a leading treatise dealing with the business judgment rule⁶) and two of his colleagues address the role of a target's directors in implementing defensive tactics and survey the various defensive tactics available.⁷ Their article is entitled *Defensive Measures in Anticipation*

[hereinafter MODEL STOCK PURCHASE AGREEMENT]. See also KLING, NEGOTIATED ACQUISITIONS *supra* note 1, at § 1.03[1]; THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at chs. 11 (stock acquisitions), 12 (asset acquisitions).

3. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) [hereinafter ALI, PRINCIPLES OF CORPORATE GOVERNANCE]. For a discussion of the provisions of these principles addressing mergers and acquisitions see Samuel C. Thompson, Jr., *The Merger and Acquisition Provisions of the ALI Corporate Governance Project as Applied to the Three Steps in the Time-Warner Acquisition*, 2 COLUM. BUS. L. REV. 145 (1994) [hereinafter Thompson, *ALI Principles*].

4. Melvin Aaron Eisenberg, *The Director's Duty of Care in Negotiated Dispositions*, 51 U. MIAMI L. REV. 579 (1997) [hereinafter Eisenberg, *Duty of Care*].

5. John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605 (1997) [hereinafter Coffee, *Bylaw Battlefield*].

6. DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE (4th Ed. 1993, Supp. 1995).

7. See generally ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE (5th Ed. 1995).

of and in Response to Unsolicited Takeover Proposals.⁸ Fourth, Dan Neff, a partner at Wachtell, Lipton, Rosen and Katz, addresses the impact of state takeover statutes on directors' fiduciary duties and examines the legality of continuing director provisions of shareholder rights plans (poison pills) in his article entitled *The Impact of State Statutes and Continuing Director Rights Plans*.⁹

In the final article addressing the law governing a target's directors, Vince Garrity and Mark Morton of Duane, Morris & Heckscher (Vince is the Chairman of the Negotiated Acquisitions Committee of the ABA Section of Business Law) address the use of various types of lock-up provisions under Pennsylvania and Delaware law in their article entitled *Would the CSX/Conrail Express Have Derailed in Delaware? A Comparative Analysis of Lock-Up Provisions Under Delaware and Pennsylvania Law*.¹⁰

At the Institute, Vice Chancellor Jack B. Jacobs of the Delaware Court of Chancery provided comments regarding directors' duties in both negotiated and hostile transactions.

The boards of both the acquirer and the target will generally have to make a judgment about the value of the target at an early stage in the acquisition process, and this topic is addressed in Section III. Although this Symposium does not contain an article addressing valuation, the topic was covered at the Institute by Bob Lovejoy, a Managing Director of Lazard Frères & Co. LLC.

The most desirable target may operate in the same line of business as the acquirer, and this could give rise to a potential antitrust challenge to the transaction. Thus, before proceeding with an acquisition a well-advised acquirer will attempt to determine whether the transaction is likely to be challenged on antitrust grounds. Also, the parties must determine whether the transaction will be subject to pre-merger notification under the Hart-Scott-Rodino Act. Although this Symposium does not contain an article dealing with the antitrust or pre-merger notification aspects of mergers and acquisitions, a presentation on this topic was made at the Institute by Mark Whitener, the Deputy Director of the Bureau of Competition at the FTC, and Section IV contains a short

8. Dennis J. Block et al., *Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals*, 51 U. MIAMI L. REV. 623 (1997) [hereinafter Block, *Defensive Measures*]. Dennis Hersch, co-chair of the Institute, substituted for Mr. Block at the Institute.

9. Daniel A. Neff, *The Impact of State Statutes and Continuing Director Rights Plans*, 51 U. MIAMI L. REV. 663 (1997) [hereinafter Neff, *State Statutes*].

10. Vincent F. Garrity, Jr. & Mark A. Morton, *Would the CSX/Conrail Express Have Derailed in Delaware? A Comparative Analysis of Lock-Up Provisions Under Delaware and Pennsylvania Law*, 51 U. MIAMI L. REV. 677 (1997) [hereinafter Garrity, *The CSX/Conrail Express*].

introduction to antitrust analysis in mergers and acquisition and to pre-merger notification.

Once a target has been identified, the acquirer must determine whether it is going to attempt to effectuate a negotiated acquisition or a hostile takeover. If the target is closely-held, a negotiated acquisition is practically the only way to complete the transaction. However, if the target is publicly-held, the transaction may be effectuated by a negotiated transaction or a hostile tender offer followed by a freeze-out merger. Thus, the acquirer has many different options available to it in structuring the acquisition.

Section V briefly addresses some of the state corporate law issues that can arise in structuring a negotiated acquisition, such as the use of confidentiality agreements and letters of intent and dealing with the rights of the target's and the acquirer's shareholders to vote and to dissent and have their shares appraised. None of these topics is addressed extensively in the articles in this Symposium, but many of these topics were discussed at the Institute. For example, Vince Garrity discussed confidentiality agreements and letters of intent.

Section VI addresses certain issues under the federal securities laws impacting mergers and acquisitions, including the law governing the disclosure of merger negotiations, the drafting of proxy statements under the Securities Exchange Act of 1934 (the 34 Act), and the registration requirements under the Securities Act of 1933 (the 33 Act). This Symposium does not contain articles addressing these issues directly, but SEC Commissioner Ike Hunt's article entitled *Plain English—Changing the Corporate Culture*,¹¹ which is based on his luncheon address at the Institute, addresses the SEC's efforts to ensure that merger and other disclosure documents comply with the SEC's plain English initiative. Also, various issues involving disclosure under the SEC rules were addressed at the Institute by Catherine Dixon, Chief of Mergers and Acquisitions of the SEC's Division of Corporate Finance, Linda Quinn, co-head of the Corporate Finance Practice group at Shearman & Sterling, and Neil Anderson a partner at Sullivan & Cromwell.

Section VII addresses some of the tax and accounting aspects involved in structuring a merger or acquisition. Although this Symposium does not contain separate articles dealing with tax and accounting issues, at the Institute Michael Schler, a tax partner at Cravath, Swaine & Moore, addressed tax issues and Ron Weissman, a partner with Arthur Andersen LLP addressed accounting issues. Also, Section VII briefly introduces the tax and non-tax aspects of spinoffs, which may be

11. Issac C. Hunt, Jr., *Plain English—Changing the Corporate Culture*, 51 U. MIAMI L. REV. 713 (1997) [hereinafter Hunt, *Plain English*].

utilized in conjunction with an acquisition. At the Institute, the tax aspects of these transactions were addressed by Mr. Schler, and the non-tax aspects were addressed by John Bick of Davis Polk & Wardwell.

Before proceeding with an acquisition, the acquirer will in most cases conduct a thorough due diligence investigation of the target for the purpose of identifying potential risks associated with the target. Section VIII addresses this topic generally and also introduces an article by Howard Shecter, a partner at Morgan Lewis & Bockius LLP, entitled *Selected Risk Issues in Merger and Acquisition Transactions*.¹² In this article, Mr. Shecter addresses successor liability in asset acquisitions, employee benefit issues, environmental issues, labor and employment law issues, and intellectual property issues.

Section IX addresses issues that can arise in the drafting of the acquisition agreement and introduces two articles in this Symposium dealing with this topic. First, Lou Kling, a partner at Skadden, Arps, Slate, Meager & Flom LLP, and two co-authors address a range of issues that can arise in drafting an acquisition agreement in their article entitled *Summary of Acquisition Agreements*.¹³ Second, Gil Sparks, a partner in Morris, Nichols, Arsht & Tunnell, addresses lock-ups and fiduciary-out provisions of merger agreements in his article entitled *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*¹⁴ The law governing lock-ups and fiduciary-outs is in a state of flux and Gil Sparks provides a guide for approaching some of the issues.

Section X briefly discusses the impact of the open market purchase and tender offer rules under the Williams Act provisions of the 34 Act. These provisions are also addressed on a comparative basis in Section XI, which focuses on international acquisitions and introduces an article entitled, *Toward A Cohesive International Approach to Cross Border Takeover Regulation*,¹⁵ which was written by Ed Greene, a partner at Cleary, Gottlieb, Steen & Hamilton in London, and two of his colleagues.

12. Howard L. Shecter, *Selected Risk Issues in Merger and Acquisition Transactions*, 51 U. MIAMI L. REV. 719 (1997) [hereinafter Shecter, *Selected Risks Issues*].

13. Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779 (1997) [hereinafter Kling, *Acquisitions Agreements*].

14. Gilchrist Sparks, III, *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*, 51 U. MIAMI L. REV. 815 (1997) [hereinafter Sparks, *Fiduciary Outs*].

15. Edward F. Greene et al., *Toward A Cohesive International Approach to Cross Border Takeover Regulation*, 51 U. MIAMI L. REV. 823 (1997) [hereinafter Greene, *Cross-border Takeover Regulation*]. Paul Shim of Cleary in New York substituted for Mr. Greene at the Institute.

II. LAW GOVERNING A TARGET'S DIRECTORS IN NEGOTIATED AND HOSTILE TRANSACTIONS

In the first article in this Symposium, which is entitled *The Director's Duty of Care in Negotiated Dispositions*,¹⁶ Professor Eisenberg points out that in many areas of the law the standards governing conduct and the standards governing review are conflated. As an example, he says that the "standard of conduct that governs automobile drivers is that they should drive carefully, and the standard of review in a liability claim against a driver is whether he drove carefully."¹⁷

This conflation does not exist, however, in the context of the performance by corporate officers and directors of their responsibilities in situations in which they are not interested. If they are not interested, the duty of loyalty is not implicated. In such cases, the standard of conduct governing the directors and officers is the duty of care. This doctrine requires the director or officer to act in good faith, in a manner he or she reasonably believes to be in the best interest of the corporation, and with the care that an ordinarily prudent person would be expected to exercise in a like position and under similar circumstances. The standard of review of such action, however, is governed by the business judgment rule. This rule broadly provides that if the director has made a "good faith" decision in what the director perceives to be in the best interest of the corporation after being properly informed, the director will not be held liable provided he or she does not have a financial interest in the matter. If, on the other hand, the business judgment rule is not satisfied, the standard of review is comparable to the standard of conduct in making the decision. Consequently, the standard of review is based on fairness. That is, if the business judgment rule is not applicable, the directors have the burden of proving that the transaction is "entirely fair."

In applying the business judgment rule, the question is whether the decision was rational, not whether it was reasonable. This rationality standard is much less stringent than the reasonableness standard. As Professor Eisenberg points out, "[i]t is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational."¹⁸ Professor Eisenberg argues that there are considerations of both fairness and policy which support the present formulation of the business judgment rule. He points out that in certain transactions that are not traditionally self-interested, the corporate law has developed a heightened standard of review. For

16. Eisenberg, *Duty of Care*, *supra* note 4.

17. *Id.* at 580.

18. *Id.* at 585.

example, in examining the actions of a target's directors in defending against a hostile takeover, the Delaware courts have developed an enhanced scrutiny rule as set forth in *Unocal Corp. v. Mesa Petroleum Company*.¹⁹ Under *Unocal*, a target's directors taking defensive actions have the burden of proving that first they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and second that the defensive measures adopted were "reasonable in relation to the threat posed." The first part of the test is satisfied by a showing of good faith and reasonable investigation, which can be more easily established if the board has a majority of independent directors.²⁰

Section 6.02(a) of the ALI's PRINCIPLES OF CORPORATE GOVERNANCE also adopts an enhanced standard of review. Under this provision, a target's board "may take an action that has the foreseeable effect of blocking an unsolicited tender offer, if the action is a reasonable response to the offer."²¹ Under the ALI formulation, the burden is on the plaintiff to establish that the board's action was not reasonable.

At this point, Professor Eisenberg reaches the central thesis of his article. He argues that "[i]n the case of a simple negotiated disposition, there are several reasons why the decision-making process should be reviewed under a standard of enhanced scrutiny, even though, unlike blocking actions, dispositions are not engaged in for entrenchment purposes."²² He points out that this is a standard of review and does not interfere with the current standard of conduct that governs directors in a disposition transaction. He further argues that the following four Delaware cases broadly support this "disposition principle:" *Smith v. Van Gorkom*;²³ *Cede v. Technicolor, Inc.*;²⁴ *Revlon v. MacAndrews & Forbes Holding, Inc.*;²⁵ and *Paramount Communications, Inc. v. QVC Network, Inc.*²⁶

In connection with the *Van Gorkom* decision, he argues that it can be "explained by the disposition principle, that is, that in the case of a negotiated disposition the decision-making process would be reviewed with special scrutiny to insure that the process provided reasonable assurance that the disposition was made at the best price reasonably available."²⁷

19. 493 A.2d 946 (Del. 1985).

20. Eisenberg, *Duty of Care*, *supra* note 4, at 591-92.

21. Section 6.02 is discussed in Thompson, *ALI Principles*, *supra* note 3, at 224-43.

22. Eisenberg, *Duty of Care*, *supra* note 4, at 28.

23. 488 A.2d 858 (Del. 1985).

24. 634 A.2d 345 (Del. 1993).

25. 506 A.2d 173 (Del. 1985).

26. 637 A.2d 34 (Del. 1994).

27. *Id.* at 49.

The fundamental reason for advancing the disposition principle is that even though negotiated acquisitions are at arm's length, they typically involve significant conflicts of interest, which Professor Eisenberg argues were present in *Van Gorkom*, *Technicolor*, *Revlon* and *QVC*. He concludes that "in all four cases . . . boards acted in a way that defies explanation except on the ground of being ill-informed, subservient, or both."²⁸

Finally, Professor Eisenberg argues that even though the Delaware cases do not explicitly adopt the enhanced scrutiny embodied in his disposition principle, the cases can be "rationalized on the basis of that rule better than on the basis given in the opinions,"²⁹ and he goes on to argue that prudent lawyers should encourage directors in negotiated acquisitions to "make their decisions as if the strict scrutiny rule or something very like it will be applied to their conduct."³⁰

In his article entitled *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*,³¹ Professor Coffee addresses three questions. First, to what extent can shareholders give the board mandatory instructions through a bylaw amendment? Second, if the shareholders provide such a bylaw, can the board respond by repealing it? Third, if the board can repeal a shareholder-passed bylaw, can the shareholders limit this power by use of procedural provisions in the by-law?

These issues bear on the ability of shareholders to limit the defensive tactics a target's board can undertake. Professor Coffee begins by pointing out that under Delaware law the answer to these questions is not at all certain, because of the inherent conflict in section 109 of the Delaware General Business Corporation Law, which seems to give the shareholders such power, and section 141(a), which gives the board of directors the authority to manage the corporation.

The Securities and Exchange Commission (SEC) gets involved with these issues through its Rule 14a-8 under the Securities Exchange Act of 1934, which regulates shareholder proposals and proxy statements. Professor Coffee points out that Rule 14a-8(c)(1) permits a corporation to exclude any shareholder proposal that "under the laws of the registrant's domicile, is not a proper subject for action for security holders," and he goes on to review the recent actions by the SEC in dealing with precatory shareholder proposals. In the 1993 Pennzoil No-Action

28. Eisenberg, *Duty of Care*, *supra* note 4, at 49.

29. *Id.* at 61.

30. *Id.*

31. Coffee, *Bylaw Battlefield*, *supra* note 5.

letter,³² the SEC backed-off an earlier position that took a liberal view in permitting such proposals. As a consequence of this action, Professor Coffee points out that institutional investors have not recently made extensive use of the bylaw amendment approach under Rule 14a-8. He further discusses the efforts by Guy Weisser-Pratte to have the shareholders of Wallace Computer Services adopt a mandatory bylaw amendment requiring the redemption of an existing poison pill. Although this effort was not successful, Mr. Weisser-Pratte is engaged in a similar effort with regard to Rexene Corporation.

Notwithstanding the ambiguity in Delaware law, Professor Coffee discusses a recent decision under Oklahoma law which held that shareholders have a right to advance a non-binding resolution calling for a shareholder vote prior to the adoption of a poison pill.³³ Professor Coffee points out the Delaware law is essentially the same as Oklahoma law with respect to the issue addressed in this case. He goes on to conclude that "[s]hareholder ratification of a future poison pill seems well within Section 109's scope, particularly to the extent that Delaware decisions also recognize that there is an element of self-dealing in defensive tactics."³⁴

Turning to the question of whether the board may repeal a shareholder adopted bylaw amendment, Professor Coffee contends that although the answer to this question is uncertain, the shareholders should be able to specify the manner in which any shareholder adopted bylaw can be amended by the board. Also, Professor Coffee points out that section 10.20 of the Revised Model Business Corporation Act especially recognizes that the shareholders have the authority to prohibit board amendment of a shareholder passed bylaw. He further points out that twenty-two states have provisions to a similar effect in their corporate codes.

Professor Coffee concludes by saying that the law in this area is still in the process of development and that we are at a "critical junction for future by-law amendments."

In the next article, Dennis J. Block, Jonathan M. Hoff, and H. Esther Cochran address the target's directors' duties in a hostile transaction in their article *Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals*.³⁵ One of the first points the authors make is that a target's directors should prepare in advance to

32. *In re Pennzoil Corporation*, SEC No-Action Letter (March 22, 1993), available in 1993 SEC No-Act LEXIS 503 at *1.

33. See *International Brotherhood of Teamsters General Fund v. Fleming Companies, Inc.*, No. Civ. 96-165C-A (W.D. Okla. Jan. 14, 1997).

34. Coffee, *Bylaw Battlefield*, *supra* note 5.

35. Block, *Defensive Measures*, *supra* note 8.

respond to an unsolicited takeover. They further point out that as illustrated in the *Unocal* decision the takeover measures may be implemented for the purpose of entrenching the target's board as well as for the purpose of advancing shareholder interest. Consequently, the enhanced scrutiny test of *Unocal* was adopted.

Much of this article is an elaboration upon the *Unocal* theme, and the authors discuss many cases that illustrate the contours of *Unocal*. For example, the authors discuss *Unitrin, Inc., v. American General Corp.*,³⁶ where the court articulated a two-step approach under *Unocal*. In *Unitrin*, the Delaware Supreme Court said that the defensive measure cannot be "coercive" or "preclusive" and must fall within a "range of reasonableness." Thus, the coercion, preclusive, and range of reasonableness tests are applied in determining whether the defensive measure is reasonable in response to the threat posed. The court specifically found that the target's repurchase program was not coercive or preclusive and was within the range of reasonableness.

In addition to the *Unocal* test, the authors also discuss the *Revlon* principle, which applies in a sale of control situation in which the directors' role changes from "defenders of the corporate bastion to auctioneers charged with getting the best price for the shareholders." The authors explore the limits of the *Revlon* principle and among other things show how it was applied in *Paramount Communications, Inc. v. QVC Network, Inc.*³⁷

Another seminal case dealing with defensive tactics that the authors discuss is *Moore Corp. Limited v. Wallace Computer Services, Inc.*³⁸ In *Moore*, the target's directors merely stood by their poison pill in the face of a hostile tender offer. The directors had analyzed the offer and concluded, after seeking advice from various experts, that the long-term strategy the target was following was more valuable to the shareholders than the price being offered by the acquirer. Applying *Unocal*, the court found that the target's board was reasonable in concluding that the acquirer's offer was inadequate and thereby posed a threat to corporate policy and effectiveness. Thus, the board satisfied the first prong of the *Unocal* test. The court went on to say the refusal by the target's board to redeem the poison pill was "reasonable in relation to the threat posed because the refusal was neither preclusive nor coercive."

An appreciation of the principles in these four decisions will go a long way to understanding the many defensive tactics explored by the authors. Some of the more important defensive measures addressed are

36. 651 A.2d 1361 (Del. 1995).

37. 637 A.2d 34 (Del. 1994).

38. 907 F. Supp. 1545 (D. Del. 1995).

the adoption of a staggered board to prevent an acquirer from immediately replacing the target's board pursuant to a proxy contest and the adoption of shareholder rights plans, which is probably the most effective deterrent against hostile offers. In this regard, the authors discuss the possible implications of the use of a continuing director, or a "Dead Head" provision, which provides that only those directors who were seated at the time the poison pill was adopted can redeem the pill. These provisions are also discussed by Mr. Neff and are explored further below.

Another defensive tactic is the issuance of stock into friendly hands. Such transactions may be particularly beneficial in helping to make the target takeover-proof under a state takeover statute such as Delaware's business combination statute which does not apply if an acquirer acquires 85% of the target shares in one transaction. Thus, if more than 15% of the stock of a target can be placed in the hands of a person friendly to the target, this exception to the Delaware business combination statute would not be available. Another important defensive tactic addressed in a comprehensive way by the authors is the use of employee stock ownership plans. These plans can be particularly helpful in defending the target, but also, as the authors indicate, the plans must be used carefully and significant issues under ERISA must be addressed. The authors also address the strategies for offering economic alternatives such as recapitalizations. These strategies may be enjoined if, for example, the economic alternative is in essence preclusive or coercive and does not fall within the range of reasonableness, as set forth in *Unitrin*.

The authors explore in a detailed way the implications of using lock-ups and leg-ups, which give a potential acquiring corporation the right to acquire a stock interest in the target corporation as a way of discouraging hostile offers from an unwanted acquirer. The authors point out that these devices must not foreclose the possibility of the target's board considering other possible offers. The topic is also touched on by Gil Sparks in his article dealing with fiduciary outs.³⁹

The authors also address other topics such as change of control employment contracts, defensive acquisitions, state regulation of takeovers, including the application of the Pennsylvania Business Corporation Law in *Norfolk Southern Corporation v. Conrail, Inc.*⁴⁰ The authors point out that Pennsylvania law explicitly rejects the *Unocal* and *Revlon* principles. Under Pennsylvania law, a corporation's directors are given much more latitude in constructing defensive measures and

39. Sparks, *Fiduciary Outs*, *supra* note 14.

40. C.A. No. 96-CV-7167 (E.D. Pa. 1997).

will be scrutinized under the standard business judgment rule as opposed to enhanced scrutiny required by *Unocal*.

Neither Professor Eisenberg nor Dennis Block and his co-authors address precisely the action a target's board is required to take when it negotiates a friendly acquisition of the target by an acquirer in exchange for the acquirer's stock and a hostile acquirer then shows up and makes a bid for the target. The authors do not specifically indicate whether the target's directors can negotiate the transaction with the acquirer without first doing some kind of market test to determine the best price reasonably available to the target, and they do not indicate what the target's actions should be in the event a third-party acquirer shows up. This is an important question because most acquisitions involve friendly negotiations between an acquirer and a target, and many friendly transactions may end up in a hostile mode.

In the next article dealing with the role of a target's directors, *The Impact of State Statutes and Continuing Director Rights Plans*,⁴¹ Dan Neff addresses two broad topics: the impact of state statutes on fiduciary duties of directors in takeovers, and the impact of continuing directors provisions of shareholder's rights plans.

Mr. Neff begins by observing that although there have not been any significant changes in the basic doctrines under Delaware law dealing with defensive tactics in mergers, there have been several recent developments in states other than Delaware that have provided greater protection to a target's directors in a takeover context than the enhanced scrutiny that applies in Delaware under such cases as *Unocal* and the auction requirement of *Revlon*. Mr. Neff outlines the principle types of state statutes regulating takeovers. These include control share acquisition statutes, which deny a hostile acquirer that acquires in excess 20% of the stock of target the right to vote, unless the acquirer obtains shareholder agreement granting such rights. Also included are moratorium or business combination statutes, which prohibit a hostile acquirer that acquires more than a certain percentage of the target's stock from completing a second-step merger for a fixed period of time after the acquisition.

Such statutes may permit the second-step transaction to occur if certain conditions are satisfied, such as the approval of the disinterested directors and shareholders, as provided in section 203 of the Delaware General Business Corporation Law. In the alternative, such statutes may absolutely prohibit a second-step merger for a specified period as is the case with the Wisconsin statute that was held to be constitutional and

41. Neff, *State Statutes*, *supra* note 9.

not preempted by the Williams Act in *Amanda Acquisition Corp. v. Universal Foods Corp.*⁴² Other statutes specifically reject the enhanced scrutiny test in Delaware which was adopted by *Unocal*. Mr. Neff also points out that several states have adopted constituency statutes which authorize the board to consider the effects of the proposed takeover on the company's employees, consumers, and other constituencies.

Contrasting the approach in Delaware with the approach taken in certain other states, Mr. Neff discusses the Fourth Circuit's decision in *WLR Foods, Inc. v. Tyson Foods, Inc.*,⁴³ which interprets the Virginia Business Corporation Statute in the context of defensive measures taken by a target corporation. The Virginia statute specifically does not permit any inquiry into the reasonableness of the directors' actions but focuses solely on whether the directors acted in good faith. Under this statute, the court held that the acquirer was only entitled to discovery with regard to certain procedural issues that bear on the factors of good faith.

Mr. Neff also discusses the Pennsylvania federal district court's decision in the *Conrail* case, where the court said that *Unocal* and *Revlon* are "myopic" and specifically do not apply under the Pennsylvania statute. This *Conrail* case is addressed in detail in an article by Vince Garrity and Mark Morton, which is introduced below.

Mr. Neff then turns to continuing director provisions which provide that a share purchase plan (i.e., poison pill) can only be redeemed by a majority of continuing directors, that is those directors who held office before the battle commenced. Mr. Neff goes on to discuss *Bank of New York Co. v. Irving Bank Corp.*,⁴⁴ which he says is the only case that has directly addressed the validity of a continuing director provision. This case held that such a provision was not permissible under New York law. Although the Delaware courts have not directly addressed the issue, he does, however, discuss several Delaware cases that bear on this issue. Finally, Mr. Neff points out that for states other than Delaware that have specific statutory provisions authorizing poison pills even if the statutes do not deal directly with the continuing director issue, the statute may be interpreted to have implicitly sanctioned such provisions.

In the final article dealing with the law governing the target's directors, Vince Garrity and Mark Morton consider whether the Delaware courts would have reached the same conclusion that was reached under Pennsylvania law in the CSX/Conrail transaction, which involved the use of various lock-up devices. In this transaction, CSX Corporation, the acquirer and largest U.S. railroad, and Conrail, Inc., the target and

42. 877 F.2d 496 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

43. 65 F.3d 1172 (4th Cir. 1995).

44. 528 N.Y.S.2d 482 (Sup. Ct. 1988).

fifth largest railroad, entered into a merger agreement pursuant to which CSX would have acquired Conrail in a multi-step transaction for, in essence, \$92.50 per share. Norfolk Southern Corporation (Norfolk) also a railroad company, made a competing bid for Conrail at \$100 per share, which was later raised to \$115 per share. Norfolk challenged the CSX/Conrail merger, and since Conrail is a Pennsylvania corporation, Pennsylvania law applied. The article, which is entitled *Would the CSX/Conrail Express Have Derailed in Delaware? A Comparative Analysis of Lock-Up Provisions Under Delaware and Pennsylvania Law*,⁴⁵ starts out by discussing the various lock-up provisions employed in the merger agreement between CSX and Conrail.⁴⁶

First, the agreement contained a break-up or termination fee of \$300 million, which represented 3% of the transaction price at the time the deal was first struck.⁴⁷ Second, the merger agreement contained a stock option, which granted CSX the right to acquire 10% of Conrail's shares for \$92.50, the price to be paid by CSX in the acquisition.⁴⁸ There was no cap on the benefit that CSX could realized upon exercise of the option. Third, the agreement contained a no-shop clause which, subject to certain exceptions, prohibited Conrail's directors from (i) soliciting or participating in negotiations concerning another takeover proposal, (ii) approving or recommending another takeover proposal, or (iii) withdrawing or modifying their recommendation of the CSX acquisition for a period of 180 days.⁴⁹ This black-out period was later extended to 720 days (i.e., from December 19, 1996 to December 31, 1998).⁵⁰ Fourth, Conrail agreed that, except with regard to the CSX acquisition, it would not amend its poison pill without the consent of CSX or take any action with respect to its poison pill to facilitate any other offer.⁵¹

The authors discuss the three preliminary injunction hearings in this case in which the district court, ruling from the bench, rejected Norfolk's challenge to these lock-ups. In the first opinion, the court pointed out that section 1715 of the Pennsylvania Business Corporation Law (PBCL) permits directors in rendering decisions to consider constituencies other than shareholders and to consider both short and long-term interest of the corporation.⁵² The court also pointed out that section

45. Garrity, *The CSX/Conrail Express*, *supra* note 10.

46. *See id.* at Part II.

47. *See id.*

48. *See id.*

49. *See id.*

50. *See id.* at Part II.G.

51. *See id.*

52. *See id.* at Part II.C.

1715(c) of the PBCL provides that the fiduciary duties of directors do not require them to redeem or modify any poison pill,⁵³ and that Section 1715(d) provides that if a board's action is approved by a majority of disinterested directors, the plaintiff has the burden of establishing that the board did not render its decision in good faith after reasonable investigation.⁵⁴ In finding that Norfolk failed to meet this burden, the court said that these provisions of the PBCL specifically reject such Delaware cases as *Unocal* and *Revlon*.⁵⁵

In the third preliminary injunction hearing, the district court specifically approved the 720 day no-shop clause, reasoning that there is "no principled reason" why the lock-out cannot extend for the full period of the merger contract.⁵⁶

In turning to Delaware law, the authors first point out that lock-ups are not considered *per se* illegal,⁵⁷ and that in negotiated transactions the standard of review in examining the use by a target's board of lock-ups is the standard business judgment rule.⁵⁸ In hostile transactions, however, the *Unocal* enhanced business judgment standard applies,⁵⁹ unless the *Revlon* duty to auction rule applies because there is a change of control of the target.⁶⁰ The authors then discuss a series of Delaware cases that have dealt with lock-ups in a variety of contexts.⁶¹

Finally, the authors apply the law of Delaware to the facts in the CSX/Conrail transaction.⁶² The authors conclude that while the standard business judgment rule may have applied to the lock-up provisions of the initial merger agreement, the *Unocal* enhanced business judgment rule would apply to the 720 day extension of the no-shop clause, and that the extension would be found to be preclusive under *Unitrin*.⁶³ The authors further conclude that since 40% of the consideration to be paid by CSX is cash and only 60% is stock of CSX, a change of control of Conrail has occurred and *Revlon*, therefore applies. The authors argue that the exception to *Revlon* for transactions in which the target's shareholders receive stock of the acquirer and after the merger the stock of the acquirer is held by a "fluid aggregation" of shareholders, should not apply in this case because of the large cash component of the transac-

53. *See id.*

54. *See id.*

55. *See id.*

56. *See id.* at Part II.H.

57. *See id.* at Part III.

58. *See id.* at Part III.A.

59. *See id.*

60. *See id.*

61. *See id.* at Parts III.B.-D.

62. *See id.* at Part IV.

63. *See id.* at Part IV.A.

tion.⁶⁴ The authors, therefore, conclude that, under both *Unocal* and *Revlon*, each of the lock-ups—the termination fee, the stock option, the no-shop clause, and the limitations on the poison pill—would be invalid and unenforceable.

III. VALUATION OF THE TARGET

As explained at the Institute by Bob Lovejoy, the primary methods of valuing a target are (1) the comparable companies trading analysis, (2) the comparable transactions analysis, and (3) the discounted cash flow (DCF) analysis.⁶⁵ Both comparable companies and the comparable transactions approaches are based on the principle that the value of an asset (i.e., a target) may be determined by referring to the value of comparable assets (i.e., a comparable company) recently sold by a reasonably informed seller to a reasonably informed purchaser.⁶⁶ Professor Cornell refers to these two methods as direct comparison approaches to valuation.⁶⁷

The DCF approach to valuation involves a four step process. First, the analyst estimates the amount and timing of the free cash flows expected to be generated by the target over a forecast period during which the target is expected to grow.⁶⁸ Second, the analyst estimates the expected value of the target at the end of the forecast period, this is referred to as the terminal value.⁶⁹ Third, the analyst determines the appropriate discount rate to be utilized in discounting the target's free cash flows and terminal value. If the target is engaged in different lines of business, separate discount rates may have to be determined for each business, taking into account the risk associated with the particular business. Probably the most used tool for determining the discount rate is the Capital Asset Pricing Model.⁷⁰ If the target is engaged in one line of business it may be appropriate to use the weighted average cost of capital in determining the discount rate.⁷¹

Fourth, the target's free cash flows and terminal values are discounted to present value at the applicable discount rate using the DCF

64. See *id.* at Part IV.C.

65. Each of these methods is explored in detail in Samuel C. Thompson, Jr., *A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions*, 21 J. CORP. L. 456 (1996) [hereinafter Thompson, *Modern Valuation*] and in THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at ch. 7.

66. See Thompson, *Modern Valuation*, *supra* note 65.

67. See BRADFORD CORNELL, *CORPORATE VALUATION: TOOLS FOR EFFECTIVE APPRAISAL AND DECISION MAKING* (1993).

68. See Thompson, *Modern Valuation*, *supra* note 65, at 481-89.

69. See *id.* at 481-500.

70. See *id.* at 501-21.

71. See *id.* at 521-25.

model. This gives an estimate of today's value of the target's expected cash flows.

An investment in a target should only be undertaken if the transaction produces a positive net present value, which means that the cost of acquiring the target is less than the present value of the target's free cash flows and terminal value.⁷²

Each of these methods (comparable companies, comparable transaction and DCF) will generally be used by investment bankers in valuing a target. For example, in Time, Inc.'s acquisition of Warner Communications, Inc., the investment bankers for both Time and Warner used all three techniques in valuing Warner.⁷³

A recent study of several leverage buyouts found "evidence that discounted cash flow valuation methods provide reliable estimates of market value."⁷⁴

IV. ANTITRUST AND PRE-MERGER NOTIFICATION

A. *Substantive Antitrust*

As indicted by the FTC's recent decision to oppose the merger of two office supply discounters, Staples, Inc. and Office Depot, Inc., even though the companies planned substantial divestitures,⁷⁵ the antitrust authorities may be taking a more aggressive approach to merger enforcement. At the federal level, the antitrust aspects of a merger generally will be examined by either the FTC or the Antitrust Division of the Department of Justice (DOJ). Also, other federal regulatory agencies, such as the Federal Reserve Board, may have a role in antitrust enforcement for a particular industry. In addition, the State Attorneys General may enforce the federal or state antitrust statutes.

The principal federal antitrust statute governing mergers and acquisitions is section 7 of the Clayton Act, which prohibits certain acquisitions "where in any line of commerce [i.e., in the relevant product market] . . . in any section of the country [i.e., in the relevant geographic market], the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

In 1992, the DOJ and FTC jointly published Horizontal Merger Guidelines, and as indicated below, the section of these guidelines dealing with efficiencies was revised in April 1997. These 1992 DOJ/FTC

72. See *id.* at 471-73.

73. See *id.* at apps. A through D.

74. Steven N. Kaplan & Richard S. Ruback, *The Valuation of Cash Flow Forecasts*, 50 J. OF FIN. 1059, 1091 (1995).

75. See John M. Broder, *FTC Rejects Deal to Join Two Giants of Office Supplies*, N.Y. TIMES, Apr. 5, 1997, at A1.

Guidelines replaced the provisions of the DOJ's 1984 Merger Guidelines dealing with horizontal mergers. The provisions of the 1984 Guidelines dealing with conglomerate and vertical mergers continue to be in effect. Also, in 1993, the National Association of Attorneys General promulgated Horizontal Merger Guidelines, which set forth the general enforcement policy of the state attorneys general.

This section briefly outlines the approach taken in the 1992 DOJ/FTC Guidelines, which sets out a five step analytical process the DOJ and FTC follow in determining whether a merger will likely enhance market power or facilitate its exercise and therefore, should be prohibited.⁷⁶

First step. The first step is to determine whether the merger would significantly increase concentration and result in a concentrated market, properly defined. Thus, the starting point is the definition of the market and the determination of concentration levels in the market.

The relevant market is determined by applying a formula that is premised on the microeconomic concept of cross elasticity of demand. Thus, market definition under the 1992 DOJ/FTC Guidelines focuses on the demand side of the market.

After determining the relevant market, the final part of the first step is to determine the level of concentration in the market. This involves an analysis of the productive capacities of both actual competitors and certain potential competitors (i.e., "uncommitted entrants"). Uncommitted entrants are firms that could begin producing in the relevant market quickly without incurring significant "sunk" costs of entry or exit. Thus, these are the "hit and run" potential entrants of the contestable market theory.

Second step. The second step in the 1992 DOJ/FTC Guidelines is to determine whether, in view of market concentration and numerous other factors, the merger raises concerns about potential anticompetitive effects. Thus, in ascertaining whether there is any anticompetitive effect, consideration is given both to the concentration level in the market and to an examination of market structure to determine whether the market is likely to be characterized by either coordinated interactions or unilateral anticompetitive effects.

The guidelines divide markets into three concentration levels

76. See generally PHILIP AREEDA & DONALD F. TURNER, ANTITRUST LAW, chs. 9, 10, and 11 (1978); CORPORATE COUNSEL'S GUIDE, MERGER ANALYSIS UNDER THE ANTITRUST LAWS (1996); HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE (1994); THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at ch. 8; and SAMUEL C. THOMPSON, JR. A PRACTITIONER'S GUIDE TO THE ECONOMICS OF THE ANTITRUST MERGER GUIDELINES (forthcoming 1997).

depending on the post-merger Herfindahl-Hirschman Index (HHI). The HHI is determined by squaring the market shares of the firms in the market. Thus, if one firm has 100% of a market, the HHI is 10,000, indicating a monopoly, and if each of 100 firms in a market has 1% of the market, the HHI is 100, indicating a competitive market.

The tentative enforcement decision depends on both the total post-merger HHI for the market and the increase in the HHI resulting from the merger. Markets with a post-merger, HHI of 1000, which corresponds roughly to a 4-firm concentration level of 40%, are considered unconcentrated, and mergers in this range are rarely challenged. Markets with a post-merger HHI between 1000 and 1800, which corresponds roughly to a four firm concentration level of 70%, are considered moderately concentrated. Mergers, in this range, producing substantial increases in concentration may be challenged depending on an analysis of (1) coordinated and unilateral effects, (2) entry conditions (*see* Third Step), (3) efficiencies (*see* Fourth Step) and (4) the failing firm doctrine (*see* Fifth Step).

Markets with an HHI above 1800 are considered highly concentrated, and mergers in this range producing moderate increases in concentration may be challenged depending upon an analysis of the above mentioned four factors.

In summary, the second step involves a determination of whether the post-merger concentration levels in the market and the increase in concentration resulting from the merger provide a basis for competitive concern. If so, then the second step proceeds to an analysis of whether the merger is likely to lead to coordinated interactions or unilateral anticompetitive effects. If after an analysis of these three oligopoly factors (concentration, coordinated interactions, and unilateral effects) it is tentatively decided to challenge the merger, the analysis proceeds to the third step.

Third step. The third step is to determine whether entry into the market by "committed entrants" would be timely, likely and sufficient to deconcentrate the market. Committed entrants are those potential entrants that could enter only by incurring significant sunk costs.

Even if the merger appears to be anticompetitive after an analysis of concentration levels and the other oligopoly factors, it may not be challenged if the possibility of new entry by committed entrants would prevent the exercise of market power.

Fourth step. If after considering entry the decision to challenge still holds, then the analysis proceeds to the fourth step: determining whether there are any efficiency gains that cannot be attained otherwise. Thus, the presence of efficiencies may lead to the decision not to chal-

lenge a merger. On April 8, 1997, the DOJ and the FTC issued a revision of section 4 of the 1992 DOJ/FTC Guidelines, which addresses efficiencies. Under this revision, "merger specific" efficiencies that have been verified and that do not arise from anticompetitive reductions in output or service are treated as "cognizable efficiencies." Under the enforcement standard, the agencies "will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market."

Fifth step. If after going through the first four steps, a decision to challenge the merger is made, then the analysis turns to the fifth step: determining whether the failing firm exception applies.

B. Pre-Merger Notification

As pointed out at the Institute by Mr. Whitener, the parties to a merger or acquisition will generally have to file notification with the FTC and DOJ under the Hart-Scott-Rodino Pre-Merger Notification law (HSR) if the deal has a value of \$15 million or more and one of the companies has sales or assets of \$100 million and the other has sales or assets of \$10 million.⁷⁷ This summary captures several concepts embodied in HSR and in the rules.⁷⁸

To be subject to HSR three tests must be satisfied: (1) The *Commerce* test,⁷⁹ which will be satisfied in virtually every acquisition, (2) the *Size of Person* test,⁸⁰ and (3) the *Size of Transaction* test.⁸¹

The first step in determining whether HSR applies is to identify the "Acquiring Person" and "Acquired Person."⁸² Under the rules, the Acquiring Person is basically defined as the "ultimate parent entity" (UPE), that is, a non-controlled parent, and all of its controlled subsidiaries that hold stock or assets of the Acquired Person as a result of the acquisition.⁸³ The Acquired Person is basically defined as the UPE and controlled subsidiaries of the target company.⁸⁴

The *Size of Person* test is generally satisfied if either the Acquiring

77. See 15 U.S.C. § 18a (1994). See generally, STEPHEN M. AXINN ET AL., ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENT ACT (revised Edition, 1984); SECTION OF ANTITRUST LAW, AMERICAN BAR ASSOCIATION, THE MERGER REVIEW PROCESS (1995); and Thompson, BUSINESS PLANNING FOR M & A, *supra* note 1, at ch. 9.

78. The rules are contained in Rules, Regulations, Statements and Interpretations Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 16 C.F.R. § 801 (1996).

79. See 15 U.S.C. § 18a(a)(1) (1994).

80. See 15 U.S.C. § 18a(a)(2) (1994).

81. See 15 U.S.C. § 18a(a)(3) (1994).

82. See 16 C.F.R. § 801.2 (1996); THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1 at § 9.4.B.2.

83. See 16 C.F.R. § 801.2(a).

84. See 16 C.F.R. § 801.2(b).

Person or Acquired Person has at least \$100 million in sales or assets, and the other has at least \$10 million in sales or assets.⁸⁵

Under section 18a(a)(3), the *Size of Transaction* test is satisfied if the Acquiring Person acquires either 15% or \$15 million of the Acquired Person's asset or voting securities (stock). This statutory test is modified by the minimum dollar exemption of section 802.20. Under this exemption, the *Size of Transaction* test is satisfied in an asset acquisition if more than \$15 million of the Acquired Person's assets are acquired. In a stock acquisition, if more than 15% but less than 50% of the Acquired Person's stock is acquired, the *Size of Transaction* test is satisfied if more than \$15 million of stock is acquired. If 50% or more of the Acquired Person's stock is acquired the *Size of Transaction* test is satisfied if either (1) more than \$15 million of stock is acquired, or (2) less than \$15 million of stock is acquired and the Acquired Person has assets or sales of at least \$25 million. In each of these cases, the Acquired Person must have sales or assets of at least \$10 million or the *Size of Person* test will not be satisfied.

In summary, the *Size of Transaction* test as modified by the minimum dollar exemption is met if:

- (1) The Acquired Person would hold more than \$15 million of the Acquire Person's assets or stock;
- (2) The Acquired Person would hold at least 15% but not more than 50% of the Acquired Person's stock and such stock has value of more than \$15 million dollars;
- (3) The Acquired Person would hold 50% or more of the Acquired Person's stock and such stock has a value of more than \$15 million dollars; and
- (4) The Acquiring Person would hold 50% or more of the Acquired Person's stock, such stock does not have a value of more than \$15 million, but the target has annual net sales or assets of \$25 million or more.⁸⁶

In a negotiated merger there is a thirty day waiting period before the parties can complete the transaction, and the waiting period does not start until both the Acquiring Person and the Acquired Person file.⁸⁷ In a cash tender offer the waiting period is fifteen days after the Acquiring Person files,⁸⁸ and the Acquired Person must file ten days after the Acquiring Person files.⁸⁹ These waiting periods may be shortened by

85. See 15 U.S.C. § 18a(a)(2) (1994). See generally, THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at § 9.4.B.4.

86. THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at 9.4.B.5.

87. See 16 C.F.R. §§ 803.10(a), 803.10(b).

88. See 16 C.F.R. § 803.10(a)(1).

89. See 16 C.F.R. § 803.30(b)(2).

receipt of an early termination notice or lengthened if the applicable agency files a second request for information.⁹⁰

In conducting the review of the transaction, the applicable agency will give close scrutiny to internal documents concerning the transaction filed pursuant to section 4(c) of the Pre-Merger Report Form, which requires that the parties file "all studies, surveys, analyses and reports which were prepared by or for any officer(s) or director(s) . . . for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets."

Under section 18a(g)(1), the penalty for non-compliance with HSR is \$10,000 for each day the required filing is not made.

V. STATE CORPORATE LAW ASPECTS IN STRUCTURING THE NEGOTIATED MERGER OR ACQUISITION

A. *Introduction*

This section addresses a variety of state corporate law issues that can arise in structuring a negotiated merger or acquisition. Subsequent sections address other state issues in greater detail, including the law governing successor liability in asset acquisitions.

B. *Confidentiality Agreements and Letters of Intent*

As pointed out at the Institute by Mr. Garrity, before reaching agreement on a merger or acquisition, the parties may exchange confidential information and such an exchange should be governed by a confidentiality agreement.

The seller should draft its own confidentiality agreement, and the agreement should be binding and in appropriate cases reciprocal. Each party should keep a log of all information turned over to the other and there should be a method for determining that all documents are returned.⁹¹

Turning to letters of intent, which Mr. Garrity refers to as the "devil's work," particular attention should be given in deciding whether to use them. As illustrated in *Texaco, Inc. v. Pennzoil, Co.*,⁹² a letter of intent or an agreement in principle may in certain circumstances be interpreted as a binding contract and a breaching party or third party

90. See generally THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at § 9.4.D.

91. For general discussions of confidentiality agreements see KLING, NEGOTIATED ACQUISITIONS, *supra* note 1, at ch. 9; THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at ch. 10. For a sample confidentiality agreement with commentary see, MODEL STOCK PURCHASE AGREEMENT, *supra* note 2, at 327.

92. 729 S.W. 2d 768 (Tex. App. 1987), *cert. dismissed*, 485 U.S. 994 (1988), *appeal dismissed on agreement of the parties*, 748 S.W. 2d 631 (Tex. App. 1988).

interloper may be liable for significant damages.⁹³

Mr. Garrity gives the following reasons for using a letter of intent: (1) the lender for the buyer might require a letter of intent for financing; (2) a letter of intent may be used to start the clock running for Hart-Scott-Rodino purposes; (3) a letter of intent focuses the seller and buyer on the essential economic terms of the deal; and (4) some parties feel a "moral" commitment to a deal after signing a letter of intent.

Mr. Garrity gives the following reasons for not using a letter of intent: (1) the letter of intent might end up in court as evidence of a deal; (2) a letter of intent can be legally binding; (3) a letter of intent might create an implied duty to negotiate in good faith; (4) the seller might be viewed as damaged goods if the seller signs a letter of intent and the deal subsequently falls through; and (5) a letter of intent might increase the obligation of a public company to announce the deal. Mr. Garrity prefers using term sheets which enunciate the economics of a deal, using bullet points, but which is not legally binding.

C. *Director Exculpation Provisions*

Both the target's and the acquirer's directors will generally be protected from possible personal liability for a breach of the duty of care by an exculpation provision like section 102(b)(7) of the Delaware General Corporation Law.⁹⁴

D. *Shareholders' Right to Vote and to Dissent*

1. INTRODUCTION

In structuring any type of merger or acquisition it is important to ascertain whether the shareholders of the acquirer and the target have the right to vote and the right to dissent and have their share appraised. This will involve an examination of the particular state corporate laws governing the acquirer and the target. Also, if the acquirer is publicly-traded, consideration will have to be given to the exchange rules governing the acquirer. The discussion here focuses on the following two types of transactions under the Delaware General Corporation Law, the Revised Model Business Corporation Act, and the California Corporation Code:⁹⁵

93. For a general discussion of letters of intent, see KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at ch. 6; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at ch. 10.

94. See EDWARD P. WELCH & ANDREW J. TUREZYN, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW, FUNDAMENTALS*, 15 (1996) [hereinafter *FOLK, DELAWARE LAW*].

95. For a general discussion of corporate law issues involving shareholders' rights to vote and dissent, see KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at ch. 1 and § 4.08; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at ch. 3.

(1) A direct merger of the target into the acquirer with the target's shareholders receiving in the alternative stock of the acquirer and cash, and

(2) a reverse triangular merger in which a wholly-owned subsidiary of the acquirer merges into target with (a) the target's shareholders receiving, in the alternative, stock of the acquirer or cash, and (b) acquirer ending up as the owner of all of the target's outstanding shares. The approaches taken by these three statutes provide a good illustration of the different approaches states take to these issues.

2. DIRECT MERGER

The direct merger of a target into acquirer is governed by sections 251 and 262 of Delaware law. Under section 251(c) the target's shareholders have the right to vote on the transaction, without regard to the consideration paid. Under sections 251(c) and (f), the acquirer's shareholders have the right to vote on the transaction, unless the consideration paid is less than 20% of the acquirer's stock outstanding immediately before the acquisition.⁹⁶ Thus, if the consideration is cash, the acquirer's shareholders do not vote. The same rules generally apply under both the Revised Model Business Corporation Act⁹⁷ and the California Corporations Code.⁹⁸ The exception from the voting rule in section 1201(b) of the California Corporations Code provides that the acquirer's shareholders do not vote as long as they own immediately after the merger equity securities possessing more than five-sixths of the voting power of acquirer. This five-sixths rule is the economic equivalent of the rules under Delaware law and the Revised Model Business Corporation Act, which provide that there is no vote unless more than 20% of the outstanding equity securities of the acquirer are issued on the merger.

Under section 262, if the shareholders of the target and the shareholders of the acquirer have the right to vote, then the shareholders also have the right to dissent and have their shares appraised, subject to the market out exception of section 262(b). Under this exception, if the acquirer is publicly traded, the acquirer's shareholders have no appraisal rights, and if the target is publicly traded, its shareholders have no appraisal rights if, *inter alia*, the consideration they received is stock of the acquirer.⁹⁹

There is no market out exception under the Revised Model Busi-

96. See DEL. CODE ANN. tit. 8 § 251(f) (1991).

97. See REVISED MODEL BUS. CORP. ACT § 11.03 (1984).

98. See CAL. CORP. CODE §§ 1200, 1201 (Deering 1997).

99. See DEL. CODE ANN. tit. 8 § 262(b)(2)(a) (1991).

ness Corporation Act. Consequently, the shareholders of the target have the right to dissent in all events,¹⁰⁰ and, if the shareholders of the acquirer have the right to vote, they also have the right to dissent.¹⁰¹

California has a market-out exception, which applies if the stock of the corporation (either the target or acquirer) is publicly traded and less than 5% of the shareholders demand appraisal.¹⁰²

3. REVERSE TRIANGULAR MERGER

In a reverse triangular merger under Delaware law, the target's shareholders have the right to vote in all events. The same is true under section 11.03 of the Revised Model Business Corporation Act and section 1201 of the California Corporations Code.

Under Delaware law, the shareholders of the acquirer do not have the right to vote because the acquirer is not a "constituent" corporation under section 251(c). The same is true under section 11.03 of the Revised Model Business Corporation Act because the acquirer is not a "party to the merger." However, under sections 1200 and 1201 of the California Code, the acquirer's shareholders have the right to vote, unless the consideration paid by the acquirer is its voting stock amounting to more than 20% of its voting stock before the transaction. Thus, if the consideration paid by the acquirer is cash, the acquirer's shareholders have no vote. Also, they have no vote if the acquirer issues its voting stock in the merger and such voting stock is less than 20% of the acquirer's voting stock immediately before the transaction.

Even though under Delaware law and the Revised Model Business Corporation Act the shareholders of the acquiring parent do not have the right to vote in a triangular merger, if the acquiring parent is publicly-traded then the shareholders are given the right to vote under the rules of the New York Stock Exchange,¹⁰³ the American Stock Exchange,¹⁰⁴ or the National Association of Securities Dealers,¹⁰⁵ whichever is applicable, if the acquiring parent issues its stock in the merger amounting to more than 20% of its outstanding stock immediately before the merger.

Under section 262 of Delaware law, the target's shareholders have the right to dissent, unless the target is publicly traded and in the merger the target's shareholders receive publicly traded stock of the acquirer.¹⁰⁶

100. See REVISED MODEL BUS. CORP. ACT § 13.02 (1984).

101. See *id.* § 13.02.

102. See CAL. CORP. CODE § 1300(b)(1) (Deering 1997).

103. See NEW YORK STOCK EXCHANGE MANUAL § 312.00.

104. See AMERICAN STOCK EXCHANGE MANUAL § 712.

105. See NATIONAL ASS'N OF SEC. DEALERS (NASD) MANUAL, SCHEDULE D TO BYLAWS, § 5(i).

106. DEL. CODE ANN. tit. 8 § 262(b)(2)b (1991).

Since the acquirer's shareholder do not have the right to vote under Delaware law (even if they have the right to vote under an exchange rule), they do not have a right to dissent under section 262.

Under section 13.02 of the Revised Model Business Corporation Act, the shareholders of the target have the right to dissent in all events, and since the acquiring parent's shareholders do not have the right to vote (even though they may have a right to vote under an exchange rule), they do not have the right to dissent.

Under section 1300 of California law, the target's shareholders have the right to dissent, unless the target's shares as publicly traded, and less than 5% of the of the target's shareholders' dissent. Also, if the acquirer's shareholders have the right to vote under section 1201, they have the right to dissent under section 1300, unless the acquirer's shares are publicly traded and less than 5% of its shareholders' dissent.

E. *Purchase and Sale of a Controlling Stock Interest*

The purchase or sale of a controlling stock interest can give rise to such issues as (1) whether a control premium received by the selling stockholder must be shared with the non-selling shareholders, (2) whether the selling shareholders are liable if the purchaser loots the company, and (3) whether the non-selling shareholders have any rights under the Federal securities laws?¹⁰⁷ The answers to these questions are generally: (1) no, the control premium does not have to be shared;¹⁰⁸ (2) maybe, the selling shareholders may be liable for sale to a known looter if the selling shareholder failed to properly investigate;¹⁰⁹ and (3) no, the nonselling shareholders have no rights under Rule 10b-5 because they are not purchasers or sellers.¹¹⁰

VI. FEDERAL SECURITIES LAW ISSUES IN NEGOTIATED ACQUISITIONS

A. *Introduction*

This section deals with the following issues that can arise under the federal securities laws in the acquisition of a publicly held target corporation in a negotiated acquisition.

107. For a general discussion of these issues, see KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at section 4.11; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at ch. 11.

108. *See, e.g.,* *Zetlin v. Hanson Holding, Inc.* 48 N.Y.2d 684 (N.Y. 1979).

109. *See, e.g.,* *Gerdes v. Reynolds*, 29 N.Y.S.2d 622 (N.Y. Sup. Ct. 1941). *But see* *Swinney v. Keebler*, 480 F.2d 573 (4th Cir. 1973).

110. *See* *Blue Chip Stamps v. Marion Drug Stores*, 421 U.S. 723 (1975).

B. *Preparation of the Proxy Statement and Registration Statement Under the Federal Securities Law*

If a publicly traded target that is subject to registration under the 34 Act¹¹¹ is to be acquired in a merger, a proxy statement will have to be prepared in accordance with Rules 14a-1 and Schedule 14A under the 34 Act. If a publicly traded acquirer is issuing in the merger stock amounting to 20% or more of its outstanding stock before the merger, the acquirer's shareholders will have the right to vote under state law or under the exchange voting rule or both, and consequently, a proxy statement will have to be prepared for the acquirer's shareholders. In addition, since the acquirer is issuing stock in the acquisition of a public target, the acquirer is required by Rule 145 under the 33 Act to register the stock. Thus, this type of acquisition of a publicly held target by a publicly held acquirer involves the preparation of two proxy statements under section 14 of the 34 Act and one registration statement under the 33 Act. These proxy statements and the registration statement can be jointly filed on Form S-4,¹¹² and the disclosure document that is distributed to shareholders will be a joint acquirer and target proxy statement and acquirer prospectus.¹¹³

Rule 145(b) sets forth the information that can be included in a press release announcing the deal prior to the filing of the S-4 registration statement without engaging in gun jumping under section 5 of the 33 Act. Rule 145(c) and (d) deal with the resale of registered securities received in a Rule 145 transaction. Basically a target shareholder that is not an affiliate can sell without restriction, but there are limitations on the ability of an affiliate to resell.

Rule 14a-9 of the proxy rules is a general antifraud provision similar to Rule 10b-5, and shareholders have a private right of action to enforce the rule.¹¹⁴ The standard for determining whether an inaccuracy in a proxy statement is "material" and, therefore, actionable is governed by the Supreme Court's decision in *TSC Industries, Inc. v. Northway, Inc.*,¹¹⁵ where the Court held that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."¹¹⁶

111. The reference hereinafter to a publicly traded corporation is to a corporation which is required to register under section 12(g) of the 34 Act, which applies to corporations with 500 shareholders and \$10 million in assets. See Rule 12g-1.

112. See General Instruction E of Form S-4.

113. See, e.g., KLING, *NEGOTIATED ACQUISITION*, *supra* note 1, at § 5.02; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at § 13.10.

114. See *J.I. Case Company v. Borak*, 377 U.S. 426 (1964).

115. 426 U.S. 438 (1976).

116. *Id.* at 439.

The circuit courts are split on the question of whether scienter is a requirement under Rule 14a-9.¹¹⁷ In *Virginia Bankshares, Inc., v. Sandberg*,¹¹⁸ the Supreme Court held that in order to be actionable under Rule 14a-9, a proxy statement must be an "essential link" in the accomplishment of the merger.

Under Delaware law a party issuing a proxy statement has a duty of candor¹¹⁹ with respect to all material facts, and the test for materiality is the same as the test under Federal law.¹²⁰

C. *The Plain English Initiative*

In his article in this Symposium entitled *Plain English—Changing the Corporate Culture*,¹²¹ Securities Exchange Commissioner Isaac C. Hunt, Jr. addresses the SEC's plain English initiative and explains that the SEC is seeking comments on its proposed Plain English Handbook, which has recently been released. Commissioner Hunt emphasizes that it is particularly important that proxy statements for mergers and acquisitions be written in plain English, and he applauded the lawyers who drafted the proxy statement in the Bell/NYNEX merger for their success in drafting that major document in plain English. He also addresses the question of whether compliance with the plain English rule will subject issuers to greater liability and concluded that this will not be the case. In this regard, he says that he knows of "no case that has held anyone liable for clearly and accurately disclosing material information to investors."¹²²

D. *Disclosure of Merger Negotiations*

Under the rules of *Basic v. Levinson*¹²³ and *In re The Matter of Carnation Company*,¹²⁴ if a company chooses to make a disclosure concerning a merger negotiation, the company must speak truthfully, assuming the subject matter of the disclosure is material. In determining whether merger negotiations are material, *Basic* applies a probability-magnitude test. The best practice for a company to follow in responding

117. Compare *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976) (only negligence required), with *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1976) (scienter required).

118. 501 U.S. 1083 (1991).

119. See, e.g., *In re Genetech, Inc. Shareholders Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 95,317 (Del. Ch. 1990).

120. See, e.g., *Zirn v. VLI Corporation*, Fed. Sec. L. Rep. (CCH) ¶ 97,722 (Del. 1993).

121. Hunt, *Plain English*, *supra* note 11.

122. *Id.* at 717.

123. 485 U.S. 224 (1988).

124. Exchange Act Rel. No. 22214 (July 8, 1985).

to inquire about possible mergers is to respond with "no comment."¹²⁵

E. *Impact of Section 16(b)*

Liability under section 16(b) under the 34 Act for certain 10% shareholders may arise in a takeover context if, for example, a potential acquirer who after exceeding the 10% threshold buys and sells within six months. If, however, the potential acquirer has its stock in the acquirer converted to merger consideration as a result of the acquisition by another party of the target, the transaction should be exempt from section 16(b) liability as an unorthodox transaction under *Kern County Land Co. v. Occidental Petroleum Corp.*¹²⁶ This exception does not apply if the potential acquirer sells the target's stock back to the target.¹²⁷

VII. FEDERAL INCOME TAX AND ACCOUNTING ASPECTS OF MERGERS AND ACQUISITIONS

A. *Introduction*

This section briefly outlines the tax and accounting treatment of certain basic acquisition transactions.¹²⁸ Also, the section briefly addresses some of the tax and non-tax aspects of spinoffs.¹²⁹

This section focuses on the tax and accounting aspects of the seven transactions set out in the following three paragraphs:

(1) *Mergers*. The acquisition of a target in a merger of the target into the acquirer (i.e., a direct merger), or in a merger of a subsidiary of the acquirer (acquiring sub) into the target (i.e., a reverse subsidiary merger), or in a merger of the target into acquiring subsidiary (i.e., a forward subsidiary merger).

(2) *Stock Acquisitions*. An acquisition by an acquirer of all of the stock of a target (i.e., a direct stock acquisition), or an acquisition by

125. See generally KLING, *Negotiated Acquisitions*, *supra* note 1, at ch. 7; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at § 13.7.

126. 411 U.S. 582 (1973).

127. See *Colan v. Mesa Petroleum Co.*, 941 F.2d 933 (9th Cir. 1991). For a general discussion of section 16(b) in the merger and acquisition context see KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at § 5.03[4]; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at § 13.16.

128. See generally MARTIN GINSBURG & JACK LEVIN, *MERGERS, ACQUISITIONS AND BUYOUTS* (1995); BORRIS BITTKER & JAMES EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (6th ed. (1994)); SAMUEL C. THOMPSON, JR., *TAXABLE AND TAX-FREE CORPORATE MERGERS, ACQUISITIONS AND LBOs* (1994); KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at ch. 3; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at chs. 5 (tax), 6 (accounting).

129. See generally THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at ch. 25 (spinoffs).

acquiring subsidiary of all of the stock of target (a triangular stock acquisition).

(3) *Asset Acquisitions*. An acquisition of substantially all of the assets of a target (i.e., a direct asset acquisition), or the acquisition by acquiring subsidiary of substantially all of target's assets (i.e., a triangular asset acquisition), with the target liquidating in both cases.

To summarize the seven transactions are: (1) a direct merger, (2) a reverse subsidiary merger, (3) a forward subsidiary merger, (4) a direct stock acquisition, (5) a triangular stock acquisition, (6) a direct asset acquisition, and (7) a triangular asset acquisition. In each transaction the consideration used is in the alternative cash and voting stock of the acquirer, and the target is in the alternative a stand alone corporation, (i.e., not a subsidiary) and a wholly-owned subsidiary of the target's parent (target parent).

The fact patterns involved in an acquisition are unlimited, but many of the tax and accounting principles can be illustrated by these seven transactions.

Each of these seven transactions can be structured either as a reorganization under section 368 of the Internal Revenue Code (the Code) in which case the parties will receive tax-free or partially tax-free treatment¹³⁰ or the transaction can be structured as a taxable acquisition. The first question to ask is whether the transaction constitutes a reorganization under section 368, because if it does not constitute a reorganization, the transaction will be taxable.

Each of the above transactions will be treated for accounting purposes as either a pooling of interest or a purchase, and the acquirer will have one consolidated balance sheet even if after the acquisition the target is held as a subsidiary. In a pooling, the historic balance sheets and income statements of the acquirer and target are merely added up and in a purchase the assets and liabilities of the target are included on the acquirer's balance sheet at fair market value and the acquirer's income statement reflects these new amounts.

To qualify as a pooling, the transaction must satisfy all of the conditions of Accounting Principles Board Opinion No. 16 (APB Opinion No. 16.), otherwise the transaction is treated as a purchase.

To qualify as a pooling, the transaction must satisfy three broad sets of requirements. First, under paragraph 46 of APB Opinion No. 16, relating to the characteristics of the *Combining Companies*, the companies must be autonomous (i.e., not a subsidiary) and independent (i.e., no intercorporate investment in excess of 10%). Second, under para-

130. See I.R.C. §§ 354-62 (1994).

graph 47, relating to the *Combining Interest*, (1) the combination must be effectuated in a single transaction, (2) 90% of the consideration paid must be underlying voting common stock of the acquirer and any non-voting stock consideration must not be distributed pro rata, (3) repurchases of shares by both companies are restricted, (4) the shareholders of the two companies must maintain the same proportionate interest, (5) voting rights must be unrestricted, and (6) no contingent consideration can be used. Third, under paragraph 48, relating to an *Absence of Planned Transactions*, (1) there can be no changes in the common stock issued, (2) there can be no side deals with shareholders, and (3) the acquirer cannot make any significant disposition.

In addition to the above rules, the SEC also requires as a condition of pooling that there be "risk-sharing." This requires that "no affiliate of either company reduces his risk relative to any common shares received in the business combination until publication of financial results covering at least thirty days of post-merger combined operations."¹³¹ Also, in 1996 the SEC ruled that the intention by an acquirer to reacquire treasury stock after the acquisition precludes accounting for the combination as a pooling.¹³²

If the transaction is treated as a purchase, then under Accounting Principles Board Opinion No. 17 (APB Opinion No. 17), any goodwill arising from the acquisition of the target's assets must be written-off over a period of not more than 40 years.

B. *The Direct Merger*

1. TAX TREATMENT. THE (A) REORGANIZATION

The direct merger of a stand-alone target into the acquirer with the target's shareholders receiving stock of the acquirer will constitute a reorganization under section 368(a)(1)(A) of the Code, provided the continuity of interest requirement is satisfied (i.e., a minimum amount of the consideration must be stock and the stock received is not immediately resold), the continuity of business enterprise requirement is satisfied (i.e., the target's business or a substantial portion thereof is continued), and there is a business purpose for the transaction. This is referred to as an A reorganization. The stock consideration in a direct merger could be as low as 40% (for IRS ruling purposes, 50%),¹³³ and the transaction could still qualify as an A reorganization; however, the target's shareholders who receive non-stock consideration (i.e., boot) will be subject to tax.

131. SEC STAFF ACCOUNTING BULLETIN TOPIC 2: BUSINESS COMBINATIONS (1996).

132. See SEC STAFF ACCOUNTING BULLETIN, No. 96 (Mar. 19, 1996).

133. See Revenue Proc. 77-37, 1977-2 C.B. 569, § 3.02.

If the target is a subsidiary, the target parent will not be able to distribute the acquirer stock it receives in the merger to its shareholders in a tax-free transaction. Thus, to avoid tax, the target parent would have to continue to own the acquirer's stock. In any event, subsidiaries are generally not acquired in a merger transaction. Rather, subsidiaries are generally acquired in either a stock purchase as discussed in Section VII.E. or in an asset acquisition as discussed in section VII.G.

If the consideration is all cash, the merger will be treated as a taxable sale by target of its assets to acquirer followed by a taxable liquidating distribution of the cash to the target's shareholders. Thus, there would be a double tax, one at the target level and one at the shareholder level.¹³⁴ In most cases the parties will want to avoid this result.

2. ACCOUNTING TREATMENT

If the consideration paid in the merger is at least 90% voting stock of the acquirer and any boot is not distributed pro-rata to the target's shareholders (i.e., the 90% voting stock requirement), and the other conditions for a pooling are satisfied, the transaction will be treated as a pooling of interests for accounting purposes.¹³⁵ Otherwise, the transaction will be accounted for as a purchase.

If target is a subsidiary the transaction cannot be accounted for as a pooling because one of the conditions for a pooling is that the target be autonomous, that is, not a subsidiary.¹³⁶

C. *The Reverse Subsidiary Merger*

1. TAX TREATMENT

The reverse subsidiary merger of an acquiring subsidiary into a stand-alone target, with the target's shareholders receiving stock of the acquirer will be treated as a reorganization under section 369(a)(2)(E), provided (1) the consideration is at least 80% voting stock of acquirer, (2) the continuity of interest requirement is otherwise satisfied, (3) the continuity of business enterprises requirement is satisfied, and (4) there is a business purpose for the transaction. Conditions (2) through (4) are hereinafter referred to as the "other reorganization conditions."

If cash is the consideration in the merger, the transaction will be treated as a taxable acquisition of the target's stock.¹³⁷ The target is not subject to tax, unless an election under section 338 is filed as discussed below in Section VII.E. Since the reverse subsidiary cash merger pro-

134. See, e.g., *West Shore Fuel, Inc. v. United States*, 598 F.2d 1236 (2d Cir. 1979).

135. See APB Opinion No. 16, ¶¶ 45-49.

136. See *id.* at ¶ 46(a).

137. See Rev. Rul. 90-95, 1990-2 C.B. 67.

duces only one level of tax and the target's assets and liabilities stay within the target, which becomes a subsidiary of the acquirer, this is one of the preferred forms of taxable acquisition.

2. ACCOUNTING TREATMENT

If the consideration paid in the merger satisfies the 90% voting stock requirement, the transaction will be treated as a pooling. Otherwise it will be treated as a purchase.

D. *Forward Subsidiary Merger*

1. TAX TREATMENT

The forward subsidiary merger of a stand-alone target into an acquiring subsidiary, with the target's shareholders receiving stock of the acquirer will be treated as a reorganization under section 368(a)(2)(D), provided (1) the consideration paid is at least 40% (50% for IRS ruling purposes) stock of the acquirer,¹³⁸ and (2) the other reorganization conditions are satisfied.

If the consideration is cash or the merger does not otherwise qualify as a reorganization, the transaction is treated as a taxable purchase of the target's assets followed by a taxable acquisition of the stock of the target's shareholders.¹³⁹ This generally should be avoided.

2. ACCOUNTING TREATMENT

If the consideration paid in the merger satisfies the 90% voting stock requirement, the transaction will be treated as a pooling. Otherwise, it will be treated as a purchase. Thus, for example, if the consideration paid is 50% stock of the acquirer, the transaction will be a reorganization for tax purposes but a purchase for accounting purposes.

E. *Direct Stock Acquisition*

1. TAX TREATMENT. THE (B) REORGANIZATION

The acquisition of the target's shares directly from the target's shareholders in exchange solely for voting stock of the acquirer will be treated as a reorganization under section 368(a)(1)(B), provided (1) the acquirer acquires at least 80% of the target's stock, and (2) the other reorganization conditions are satisfied. There can be no boot consideration. This is referred to as the B reorganization.

If the acquisition is for cash or the acquisition does not otherwise

138. Rev. Proc. 77-37, 1977-2 C.B. 569, § 3.02.

139. See, e.g., *West Shore Fuel, Inc. v. United States*, 598 F.2d 1236 (2d Cir. 1979).

qualify as a reorganization, the transaction is treated as a taxable purchase of the target's stock and the target is not subject to tax, unless a section 338 election is made to treat the target as if it sold and then repurchased its assets. A section 338 election generally will not be filed because the parties will want to avoid a tax at the target level. The taxable stock acquisition is the preferred form of taxable acquisition.

If the target is a subsidiary, and the stock acquisition is taxable (i.e., not a B reorganization), the target parent and the acquirer may jointly file a section 338 election. In such case, the target parent is subject to only one level of tax. A joint section 338 election is generally filed in a stock acquisition of a subsidiary, because the target gets a stepped-up basis and the target parent is only subject to one level of tax, which would also be the case even if the parent did not join in filing under section 338.

2. ACCOUNTING TREATMENT

In the acquisition of a stand-alone target, if the consideration paid satisfies the 90% voting stock requirement, the transaction will be treated as a pooling. Otherwise the transaction will be treated as a purchase.

To qualify as a reorganization for tax purposes, the consideration must be solely voting stock. Thus, for example, if the consideration paid by the acquirer is 90% voting stock and 10% cash the transaction will be taxable, but as long as the cash is not distributed pro rata, the transaction will be treated as a pooling for accounting purposes.

F. *Triangular Stock Acquisition*

The results are essentially the same as in the direct stock acquisition, except the acquirer is the acquiring subsidiary.

G. *Direct Asset Acquisition*

1. TAX TREATMENT. THE (C) REORGANIZATION

The acquisition by acquirer of substantially all of the target's assets in exchange solely for voting stock of the acquirer will be treated as a reorganization under section 368(a)(1)(C), provided the target is liquidated and the other reorganization requirements are satisfied. This is referred to as a C reorganization. In certain cases, acquirer may be able to pay up to 20% boot.

If the acquisition is for cash (or the transaction does not otherwise qualify as a reorganization) and the target is liquidated, there will be two

levels of tax on the transaction.¹⁴⁰ Normally this should be avoided, unless the target has net operating losses or is an S corporation.

If the target is a subsidiary, the asset acquisition will produce one level of tax for the target parent because the subsequent liquidation of the target will be tax-free to the parent under section 332.

2. ACCOUNTING TREATMENT

In the acquisition of the assets of a stand-alone target, if the consideration paid satisfies the 90% voting stock requirement and the target is liquidated, the transaction will be treated as a pooling. Otherwise, the transaction will be treated as a purchase.

H. *Triangular Asset Acquisition*

The results are essentially the same as in the direct asset acquisition, except the acquirer is the acquiring subsidiary.

I. *Possible Use of Section 351*

If an acquisition cannot qualify as a reorganization, it may still be possible to give some of the target's shareholders tax-free treatment through the use of section 351. For example, assume that individual A owns 15% of the stock of a target company, and the public owns the balance of target's stock. Acquiring corporation wants to acquire target in a transaction in which A receives tax-free treatment and the public shareholders of target receive cash. Acquirer and A jointly form a holding company (HC) with acquirer contributing cash in an amount equal to the purchase price of the target stock held by the public and A contributing his 15% stock interest. Acquirer receives 85% of HC's stock and A receives 15%. HC then forms a subsidiary and transfers the cash to the subsidiary. The subsidiary merges into target in a reverse subsidiary merger in which target's public shareholders receive cash for their shares and target becomes a wholly-owned subsidiary of acquirer. The Internal Revenue Service has ruled that the formation of HC is a tax-free transaction to A under section 351 even though 85% of the stock of the target is acquired for cash.¹⁴¹

J. *Spinoffs*

Spinoffs are transactions in which a parent corporation distributes the stock of a subsidiary to the parent's shareholders. If certain conditions set out in Code section 355 are satisfied, spinoffs can be effect-

140. See *id.*

141. See Rev. Rul. 84-71, 1984-2 C.B. 106.

ated on a tax-free basis to both the distributing corporation and its shareholders.¹⁴²

In general, to qualify under section 355, both the distributing corporation and the subsidiary that is spun off must hold active businesses that have been conducted for at least five years, the distributing corporation must distribute at least 80% of the subsidiary's stock, there must be a good business purpose for the transaction, and the distribution cannot be used as a device for the distribution of earning and profits. The subsidiary can be either newly formed in a reorganization under section 368(a)(1)(D) or previously existing.

A spinoff may in certain cases precede an acquisitive reorganization as was the situation in *Commissioner v. Morris Trust*.¹⁴³ There a target distributed to its shareholders the stock of an unwanted subsidiary, and the target was then acquired in a stock merger. The court held that the distribution qualified as a tax-free spinoff under section 355 and the merger qualified as a tax-free reorganization. The Clinton administration has proposed legislation that would significantly restrict the ability to structure *Morris Trust* type spinoffs followed by acquisitive reorganizations.¹⁴⁴

A host of non-tax issues can arise in a spinoff such as compliance with the dividend provisions of the state business corporation law because the spinoff is a distribution, and compliance with various SEC rules even though a registration statement under the 33 Act is not required.¹⁴⁵

VIII. DUE DILIGENCE AND SELECTED RISK ISSUES

The due diligence investigation in a merger or acquisition will begin during the process of the identification of the target and continue through the closing of the acquisition agreement.¹⁴⁶ The purpose of the due diligence investigation is to ensure that the acquirer has all relevant and material information concerning the target. If the acquirer is issuing stock, the target and its shareholders will conduct a similar due diligence investigation of the acquirer.

One of the principal functions of the due diligence process is to

142. See generally THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at ch. 25.

143. 367 F.2d 794 (4th Cir. 1966).

144. See generally JOINT COMM. ON TAXATION, *Description and Analysis of Certain Revenue-Raising Provisions Contained in President Clinton's Fiscal 1998 Budget Proposal*, prepared for House Ways and Means Committee, § II.B.6. (JCX-10-97, Mar. 11, 1997).

145. See generally THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at ch. 25.

146. See generally KLING, NEGOTIATED ACQUISITIONS, *supra* note 1, at ch. 8; SECTION OF BUSINESS LAW, AMERICAN BAR ASSOCIATION, MANUAL ON ACQUISITION REVIEW (1995); THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at § 15.17.

identify the risk associated with the target. In the article in this Symposium entitled *Selected Risk Issues In Merger and Acquisition Transactions*,¹⁴⁷ Howard Shecter addresses the following broad risk topics, (1) successor product liability issues, (2) employee benefits issues, (3) environmental issues, (4) labor and employment law issues, and (5) intellectual property issues.

In addressing the issues of successor product liability, Mr. Shecter first outlines the traditional rule which holds that an acquiring party is only liable for the specific liabilities assumed in an asset acquisition. He then discusses several cases that have rejected the traditional rule in favor of imposing liability on the acquiring party. In *Knapp v. North American Rockwell Corp.*,¹⁴⁸ the court held that an acquiring corporation was liable under strict product liability principles for injury for a defective product manufactured by the predecessor corporation. The principle in *Knapp* was expanded in *Ray v. Alad Corp.*,¹⁴⁹ where the California court enunciated a product line exception to the general rule of non-liability. Under this exception an acquiring person is liable if it continues the line of products that were manufactured by the target. This principle also has been adopted in New Jersey in *Ramirez v. Amsted Indus., Inc.*¹⁵⁰

Mr. Shecter says that notwithstanding the liberal approach taken in *Knapp*, *Ray*, and *Ramirez*, other states, such as Florida,¹⁵¹ have not followed along this line.

In a very important section of the paper entitled "Practical Suggestions,"¹⁵² Mr. Shecter discusses practical ways of dealing with the possibility of successor product liability. First, he suggests that where there is a risk of successor liability, the acquisition may be made by a special subsidiary that is well capitalized to avoid piercing of the corporate veil. Second, the acquirer may seek a "sleep easy" insurance policy which would protect its investment against potential loss associated with defective products manufactured by the target corporation.

With regard to employee benefit plans, the acquirer must first ascertain the legal exposure to which it may become subject by reason of the purchase and then assess the financial risk associated with the plans that have been identified. The parties should negotiate regarding who will bear the cost and risk associated with any of the plans. He sets out sample representations of warranties relating to benefit plans.

147. Shecter, *Selected Risk Issues*, *supra* note 12.

148. 506 F.2d 361 (3d Cir. 1974), *cert. denied*, 421 U.S. 965 (1975).

149. 560 P.2d 3 (Cal. 1977).

150. 431 A.2d 811 (N.J. 1981).

151. *See Bernard v. Kee Mfg. Co.*, 409 So. 2d 1047 (Fla. 1982).

152. Shecter, *Selected Risk Issues*, *supra* note 12, at 736-40.

Turning to environmental issues, Mr. Shecter points out that there are two types of environmental problems: first, problems arising from a target's current operation, and second, problems resulting from prior releases of hazardous or toxic materials. Mr. Shecter indicates that, in general, environmental liabilities may not be avoided even in asset acquisitions because the courts may apply a successor liability rule, such as the "substantial continuity" test which was adopted in *B.F. Goodrich v. Betkoski*.¹⁵³ Mr. Shecter then discusses the importance of Phase I and Phase II environmental investigations.

Turning to labor and employment law issues, Mr. Shecter deals with three broad areas. First, he discusses the successor corporation's obligation to give notice under the Worker Adjustment and Retraining Act (WARN) of any planned plant closings, mass lay-offs or actual employment terminations. Second, he addresses the applicability of the "successorship doctrine," a judicially developed doctrine that effectively transfers certain labor-related obligations from the target to the acquirer if the employees are represented by a union. Here the initial inquiry is to determine whether the acquirer is a "successor" under the National Labor Relations Act (NLRA), which is a question that is to be answered on a case by case basis. If the successorship doctrine applies, then the acquirer has certain related duties, such as the duty to arbitrate and the duty to bargain. Also, the successor may have liability for the predecessor's unfair labor practices or civil rights violations.

Mr. Shecter then turns to the issue of the assignability of individual employment agreements and covenants not to compete, and concludes that the issue must be resolved by reference to the applicable state law. The general rule, however, seems to be that such contracts are enforceable by a transferee, in the absence of a specific provision in the contract providing otherwise.

The final topic addressed by Mr. Shecter deals with intellectual property issues in acquisition transactions. He points out that this should be a four-step process. First, the acquirer should evaluate the intellectual property rights of the target through a proper due diligence investigation. Second, the acquirer should take steps to correct any defects in the intellectual property prior to closing. Third, the acquirer should insure that it obtains valid title. Fourth, the acquirer should proceed to perfect that title.

The issues addressed by Mr. Shecter are just some of the many risk issues that can arise in an acquisition. It is important that the acquirer

153. 99 F.3d 505 (2d Cir. 1996).

conduct a proper due diligence investigation to identify the specific risk that the acquirer is undertaking.

In dealing with each of the risks addressed by Mr. Shecter, there seems to be a fundamental four-step approach. First, the basic risk must be identified; second, the particular risk must be properly investigated to ascertain the scope of the risk; third, steps must be taken to minimize the risk; and fourth, the parties must negotiate over who will bear the ultimate risk assuming that the risk is not eliminated.

IX. DRAFTING THE ACQUISITION AGREEMENT AND THE TREATMENT OF FIDUCIARY OUTS

Lou Kling and his co-authors provide a guide to the drafting of acquisition agreements in their article entitled, *Summary of Acquisition Agreements*.¹⁵⁴ In his article entitled *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*¹⁵⁵ Gil Sparks addresses the difficult question of whether the target's directors have the right to walk from an acquisition agreement that they no longer like.

As Lou Kling and his co-authors point out, there is usually a gap between the signing of an acquisition agreement and the closing.¹⁵⁶ In addition to addressing the stock or assets to be sold and the consideration to be paid, the typical acquisition agreement will contain (1) representations and warranties of the parties dealing with the state of the parties as of the signing,¹⁵⁷ (2) covenants dealing with the conduct of matters between the signing and the closing,¹⁵⁸ (3) conditions dealing with the preconditions to the obligation of each party to close,¹⁵⁹ and (4) termination provisions dealing with the rights of the parties to walk from the transaction.¹⁶⁰

These various provisions are inter-related. For example, the "bring down" in the conditions portion of the agreement will generally require that a party's representations and warranties be true and correct at the time of signing as well as at the time of the closing.¹⁶¹ Acquisition agreements involving the acquisition of privately-held corporations, subsidiaries or divisions may also contain indemnification provisions, pur-

154. Kling, *Acquisition Agreements*, *supra* note 13. See generally KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at chs. 10-15; MODEL STOCK PURCHASE AGREEMENT, *supra* note 2; THOMPSON, *BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS*, *supra* note 1, at ch. 15.

155. Sparks, *Fiduciary Outs*, *supra* note 14.

156. KLING, *Acquisition Agreements*, *supra* note 13, at Part II.

157. See *id.* at Parts III, IV.

158. See *id.* at Part VI.

159. See *id.* at Part VII.

160. See *id.* at Part IX.

161. See *id.* at Part II.

suant to which the parties agree to indemnify each other if it turns out that a party's representations and warranties are untrue. Thus, in a private deal, the representations and warranties generally survive the closing, whereas in a public acquisition they generally do not survive.

In drafting the representations and warranties, care must be given to the structuring of "knowledge" and "materiality" qualifications.¹⁶² The parties should be cognizant of the possibility of double materiality, which can arise when a representation and warranty that is subject to a materiality qualification is again materially qualified in the conditions to closing.¹⁶³ As explained by Lou Kling, double materiality occurs quite often in public deals.¹⁶⁴

Mr. Kling also discusses acquisitions of publicly-held firms and indicates that many such transactions may involve multiple steps, such as a purchase of stock from a major shareholder, followed by a tender offer and then a second step freeze-out merger.¹⁶⁵

In addition, the authors discuss acquisition agreements for LBOs and the importance of a representation concerning the solvency of the target in order to avoid a fraudulent transfer.¹⁶⁶ In this regard, consideration should be given to *Munford Inc. v. Valuation Research Corporation*.¹⁶⁷ There the court implicitly found that even though there was a solvency representation in the LBO merger agreement, a fraudulent conveyance may have occurred. Also, in another case dealing with the same transaction, the court held that under the Georgia Business Corporation Law, an LBO was a distribution. This could expose the target's directors to personal liability if the distribution was illegal because the target was insolvent.¹⁶⁸

These are just some of the issues that can arise in drafting an acquisition agreement.

Finally, in his article dealing with the ability of a target's board to walk from a transaction, Gil Sparks demonstrates that the law in this area is unsettled and that the parties need to give close consideration to the preparation of fiduciary-outs provisions of an acquisition agreement. In particular, attention should be given to *Paramount Communications, Inc. v. QVC Network, Inc.*,¹⁶⁹ which held that a merger agreement did

162. See *id.* at Part IV.

163. See *id.* at Part IV.B.

164. See *id.*

165. See *id.* at Part XI.A.

166. For a discussion of LBOs see KLING, NEGOTIATED ACQUISITION, *supra* note 1, at ch. 20; THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at ch. 14.

167. 98 F.3d 604 (11th Cir. 1996).

168. See *In re Munford Inc. v. Valuation Research Corporation*, 97 F.3d 456 (11th Cir. 1996).

169. 637 A.2d 34 (Del. 1994).

not create "vested rights" in the acquirer and that under the circumstances the target's directors had an obligation to consider other offers.

X. OUTLINE OF IMPACT OF WILLIAMS ACT PROVISIONS OF THE 34 ACT

This section briefly outlines the Williams Act provisions of the 34 Act, which are principally contained in sections 13(d) and (e) and 14(d) and (e).¹⁷⁰ These provisions govern certain wanted and unwanted accumulations of the stock of publicly traded targets.

Section 13(d) deals with open market purchases of the stock of a publicly held corporation. Section 13(e) authorizes the SEC to promulgate rules governing the purchase of the stock of a publicly held corporation by such corporation or an affiliate. Under this provision, the SEC has promulgated Rule 13e-3, which deals with certain going private transactions and Rule 13e-4, which deals with issuer tender offers.

Section 14(d) deals with third party tender offers and section 14(e) prohibits certain fraudulent acts or nondisclosures in connection with a tender offer. The SEC has promulgated an elaborate set of rules under sections 14(d) and (e). These provisions are also addressed on a comparative basis in section XI and in Ed Greene's article on international acquisitions.¹⁷¹

Under section 13(d), if a person or group acquires more than 5% of the stock of a publicly held corporation, such person or group is required to file a Schedule 13-D within ten days of crossing the 5% threshold. This schedule requires certain information, including the reasons for the acquisition. The purpose of section 13(d) is to apprise the market of any significant purchases of a publicly held corporation's shares.

The rules under sections 14(d) and (e) set out a variety of requirements relating to a tender offer. Most of the rules govern the bidder, but some rules also govern the target and trading by investors in the shares of the target. Rules 14d-1 through 14d-6 and Schedule 14-D set out elaborate disclosure rules for tender offers. Also, under Rule 14e-1(a), a tender offer must remain open for at least twenty business days. Rule 14d-7 allows a tendering shareholder to withdraw any tendered securities during the period the tender offer remains open. Under Rule 14d-8, if a partial tender offer is over subscribed, the shares must be purchased on a *pro rata* basis. Under the all holders, best price provisions of Rule 14d-10, a tender offer must be open to all shareholders of the class of

170. See generally KLING, *NEGOTIATED ACQUISITIONS*, *supra* note 1, at § 5.03[3]; LIPTON, *TAKEOVERS*, *supra* note 1; THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at chs. 16-21, 24.

171. See Greene, *Cross Border Takeover Regulations*, *supra* note 15.

shares subject to the tender offer, and the consideration paid to any shareholder must be the highest consideration paid in the tender offer. Also, Rule 10b-13 prohibits the bidder from purchasing any of the target's shares outside of the tender offer.

Rule 14e-2 requires the target's board to advise the target's shareholders of the position the board takes on the tender offer. This requirement is implemented by Rule 14d-9 and Schedule 14D-9.

Turning to investors, Rule 14e-3 prohibits trading in the stock of a target of a tender offer on the basis of material non-public information. Although several courts have found that the SEC has the authority to issue the rule,¹⁷² the Eighth Circuit found that the rule is beyond the scope of the SEC's authority in *United States v. O'Hagan*.¹⁷³

XI. INTERNATIONAL ACQUISITIONS

The level of cross border merger and acquisition activity has been increasing dramatically.¹⁷⁴ From the U.S. perspective this activity may be divided into inbound transactions in which a foreign acquirer acquires a U.S. target and outbound activity in which a U.S. acquirer acquires a foreign target.¹⁷⁵

The principal concern of U.S. lawyers involved in inbound transactions will be compliance with various U.S. corporate, securities, tax, antitrust, and other laws such as the Exon-Florio Act, which authorizes the President to block the acquisition by a foreign person of a U.S. target if the acquisition could have an adverse effect on national security.¹⁷⁶

In outbound transactions, the U.S. lawyer will also help guide the client through the maze of foreign laws that the U.S. acquirer will face in the applicable foreign country. This could include, for example, anti-trust enforcement in the European Community under its Merger Control Regulation.¹⁷⁷

Obviously, international acquisitions can provide a number of challenging legal issues and in their article in this Symposium entitled *Toward a Cohesive International Approach to Cross Border Takeover Regulation*,¹⁷⁸ Ed Greene and his co-authors address the absence of a "consistent and cohesive" approach to the regulation of mergers and acquisitions in which "(i) the bidder and target are each organized under

172. See, e.g., *Securities Exchange Commission v. Peters*, 978 F.2d 1162 (8th Cir. 1997).

173. 92 F.3d 612 (8th Cir. 1996), *cert granted*, 117 S. Ct. 759 (1997).

174. See generally, Greene, *Cross Border Takeover Regulation*, *supra* note 15, at Part I.

175. See generally THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at ch. 26, which provides an introduction to international acquisitions.

176. See *id.* at ch. 26, Part II.

177. See *id.* Part III.

178. Greene, *Cross-Border Takeover Regulations*, *supra* note 15.

the laws of different countries and/or (ii) the target's shareholders are located in more than one country."¹⁷⁹ The authors first review the background of this problem and of various policy responses such as the SEC's 1991 International Tender Offer Proposal¹⁸⁰ and the European Community's proposed Directive 13 on Takeover Bids.¹⁸¹ The authors then set forth a proposal for SEC action to minimize tension between U.S. takeover rules and those of other countries with a view to eliminating the strong incentive for parties making a tender offer for a foreign target to exclude the target's U.S. shareholders from the tender offer.¹⁸² The authors also propose an international accord on takeover regulation. Their proposal is based on the assumption that the regulatory approach should be similar to that in the United Kingdom, which through its *City Code on Takeovers and Mergers*¹⁸³ is administered by the Panel on Takeovers and Mergers, which consists of market participants who rely on the threat of non-legal sanctions for enforcement purposes. The *City Code* sets out ten general principles governing takeover bids.¹⁸⁴ One of the principles requires that all shareholders of the same class be treated the same, which is similar to the general approach of the Williams Act.¹⁸⁵ Another principle requires that the target's directors take no action to frustrate an offer unless they get the approval of the target's shareholders, which is inconsistent with the general approach of state law in the U.S.¹⁸⁶

The authors also specifically propose that cash-only tender offers be regulated based on the tender offer rules in the target's country of organizations, and they address the problem with cross border exchange offers.

In addition to discussing the operation of *City Code*, the authors also discuss the statutory approach to takeover regulation in France and the non-statutory approach followed in Germany.¹⁸⁷ They illustrate how

179. *Id.* at 824 n.1.

180. See International Tender and Exchange Offers, Exchange Act Release No. 34-29275, available in 1991 SEC Lexis 1026, at *4 (June 5, 1991) [hereinafter SEC International Tender Offer Proposal].

181. See COMMISSION OF THE EUROPEAN COMMUNITIES, PROPOSAL FOR A 13TH EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE ON COMPANY LAW CONCERNING TAKEOVER BIDS, EUR. PARL. DOC.(COM 95) 655 (Feb. 2, 1996) [hereinafter EC Directive 13 on Takeover Bids]; see also THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, which discusses the SEC Tender Offer Proposal at § 26.12.B.2 and the EC Directive 13 on Takeover Bids at § 26.8.C.

182. Greene, *Cross Border Takeover Regulation*, *supra* note 15, at Part IV.

183. THE CITY CODE ON TAKEOVERS AND MERGERS and THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES (9th ed. 1996) [hereinafter CITY CODE ON TAKEOVERS AND MERGERS].

184. See Greene, *Cross Border Takeover Regulation*, *supra* note 15.

185. See *id.* at Part X.

186. See *id.* at Part II.

187. See Greene, *Cross Border Takeover Regulation*, *supra* note 15, at § II. See generally

a tender offer by a French acquirer for the stock of a U.K. based target with international shareholders may be subject to conflicting regulation in France, the U.K., Germany, and the U.S. The conflicts arise with respect to such items as (1) the requirement for the acquirer in certain cases to make a mandatory offer, (2) the manner of commencing an offer, (3) the minimum period during which an offer must remain open, (4) withdrawal rights, (5) purchases outside the bid, (6) defensive tactics, and (7) disclosure requirements.¹⁸⁸ Under the mandatory offer provisions of Rule 9.1 of the *City Code*, an acquirer cannot pass the 30% ownership threshold without undertaking a bid for all of the target's shares. Thus, partial tender offers cannot be made for more than 30% of a target's stock.

The authors illustrate, *inter alia*, how conflicting regulation between the U.K. and the U.S. regarding the all-holders, best price rule under Rule 14d-10 was resolved by the SEC in Ford's 1989 tender offer for Jaguar, a U.K. public limited company, which had a substantial number of its shares traded through American Depositary Shares in the U.S.¹⁸⁹ After examining these various approaches the authors conclude that the different "regulatory systems have, while seeking what are essentially similar protections, created incompatibilities that hinder cross-border transactions."¹⁹⁰

The authors next turn to a discussion of various proposals for remedying this problem, including the SEC's 1990 Concept Release on Multinational Tender and Exchange Offers (the Multinational Concept Release)¹⁹¹ and the SEC's 1991 proposal on International Tender Offers.¹⁹² The latter release proposed that if 10% or less of a non-U.S. target's shares are held by U.S. persons, a cash tender offer made by an acquirer would generally be exempt from the Williams Act. The propo-

THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at §§ 26.11 (French Statute), 26.10 (German Statute).

188. *See id.* at Part II.

189. *See In re Ford Motor Company Limited Offer to Purchase the Ordinary Shares and American Depositary Receipts of Jaguar PLC*, Exchange Act Release No. 34-27425, *available in* 1989 SEC LEXIS 2346 (Oct. 18, 1991); *see also In re Hanson PLC & HB Acquisitions PLC Offers to Purchase the Ordinary Shares and American Depositary Receipts of Beazer P.L.C.*, Exchange Act Release No. 34-29835, *available in* 1991 SEC LEXIS 2346 (Oct. 18, 1991).

190. Greene, *Cross Border Takeover Regulation*, *supra* note 15, at 855.

191. Concept Release on Multinational Tender and Exchange Offers, SEC Release Nos. 33-6866, 34-28093, *available in* 1990 SEC LEXIS 1139 (June 6, 1990). *See* Greene, *Cross Border Takeover Regulation*, *supra* note 15, at Part III; THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, at § 26.12.B.

192. SEC International Tender Offer Proposal, *supra* note 180. *See* Greene, *Cross Border Takeover Regulation*, *supra* note 15, at Part III; THOMPSON, BUSINESS PLANNING FOR M & A, *supra* note 1, and § 26.12.B.

sal would not, however, exempt such transactions from the antifraud provisions of Federal securities laws.

The authors also discuss suggestions in the International Tender Offer Proposal for an exemption for international exchange offers in which not more than \$5 million of a foreign acquirer's securities are offered in the U.S. and a simplified registration form for such exchange offers where not more than 5% of a foreign target's shares are traded in the U.S.¹⁹³ These proposals have not been adopted.

Further, the authors discuss the proposed EC Directive on Takeover Bids,¹⁹⁴ which sets out certain general principles regarding takeovers that are to apply throughout the European Union, such as a prohibition on frustrating actions without shareholder approval and protection of minority shareholders through mandatory bids. The authors explain that the directive in essence sets out a residency test for determining which member state should oversee a bid.

The authors finally propose that the SEC restart its efforts to include U.S. shareholders in tender offers for non-U.S. targets and that efforts be made through the International Organization of Securities Councils (IOSCO) to develop minimum standards for takeover regulation that participating countries would agree, through the use of the "memorandum of understanding" (MOV) procedure, to follow.¹⁹⁵

They propose, *inter alia*, that the SEC adopt a presumption that any tender offer for a class of securities of which more than 5% are held by U.S. persons have "significant effects" in the U.S. and, therefore, are subject to the Williams Act.¹⁹⁶ They also propose that IOSCO establish a working party to study international takeover regulations and to formulate a set of non-binding recommendations regarding such items as methods for determining which country's rules apply in an international tender offer.¹⁹⁷

XII. CONCLUSION

The merger and acquisition landscape is full of obstacles and pitfalls. Hopefully, this Article and Symposium will assist the reader in successfully traversing the field.

193. See Greene, *Cross Border Takeover Regulations*, *supra* note 15, at Part III.A.1.

194. See *id.* at Part III.B; see also THOMPSON, *BUSINESS PLANNING FOR M & A*, *supra* note 1, at § 26.8.C.

195. See *id.* at Part IV.

196. See *id.* at Part IV.A.

197. See *id.* at Part IV.B.