MEMORANDUM

DATE: January 4, 2006

FROM: Jason A. Gonzalez

Subj: Amendments to the Tender Offer Best-Price Rule

RESPONSES TO SELECTED QUESTIONS

1. **How does the term "for securities tendered" impact the rule?**

Under the new safe-harbor, it would appear that if the compensation package is not approved by the appropriate committee, the bidder may be able to avoid the rule altogether by simply encouraging the employee not to tender. This result is acceptable because the purpose of the best-price rule is to ensure that everyone receives the same amount of money for their shares. In this example, the employee/director has made an informed decision to receive nothing in exchange for his or her shares. Surely, no other shareholder can complain about that nor can the employee/director be forced to tender because this would also violate yet another important principle of the purpose of the rule; the fundamental right for each shareholder to refuse the offer.

2. **If an officer/director recommended that the shareholders tender, but nevertheless retained his or her shares, could this result in a breach of fiduciary duty?**

In this case, a colorable argument can be made that the officer/director has breached his or her fiduciary duty. In some states (i.e. Delaware) there is an affirmative duty to disclose "material" information. Certainly, if the director stands to receive a financial gain or other benefit from the tender offer, that information is indeed material and needs to be disclosed. If a director lobbies in favor of the transaction without disclosing this information, this conduct could be viewed as: (1) failure to disclose "material" information or simply self-dealing.

What's not clear, however, is how the director's breach of fiduciary duty will impact the transaction. Will the breach result in a loss of the safe-harbor or perhaps a loss in the tender offer as a whole? If the safe harbor is lost, is there any way to cure the situation?

There is another variation of these facts that is also worth considering. Suppose the interested officer/director beneficially owns a large stake in the target company and refuses to tender (simply as a means of avoiding the best-price rule altogether or because the compensation committee has refused to grant the necessary approval) and his failure to tender causes the tender offer to be undersubscribed and thereby fail. Could this potentially be viewed as self-dealing or a violation of the duty of loyalty? (Of course, this would only affect employees/directors who own or control a significant portion of the company's shares).

In each scenario described above, the alleged breach of fiduciary duty resulted from the director's conduct; <u>not because the new rule is somehow flawed</u>. In both cases, the director's failure to disclose caused the breach.

3. **Why are issuer tenders offers not included in the compensation safe-harbor?**

Wouldn't this impede the company's ability to conduct a corporate "makeover"? It's not hard to imagine a situation where the company has decided to repurchase its own shares via a tender offer and cut management at the same time. Employment Agreements are instrumental in these situations and there is no reason why the safe harbor should not apply.

4. **Should the new rule define what an employee benefit arrangement is?**

Probably. Since the new safe-harbor does not apply to commercial arrangements, it's possible that Plaintiffs will argue that certain employee benefit agreements (e.g. consulting or independent contractor arrangements) fall outside of the scope of the safe-harbor and thus subject the tender offer to legal challenges. It's not clear what the term "commercial arrangements" means and there is no indication that it is limited to contracts for the sale of goods. "Commercial arrangements" could potentially include certain types of services. At a minimum the ambiguity gives Plaintiffs an argument that would create a question of fact sufficient to withstand summary judgment. It may be best to draw a line between agreements that make the person a permanent employee of the company (e.g. the new CEO) or completely sever that relationship (e.g. non-compete agreements).

5. **Should the rule include a list of non-exclusive factors to assist in determining whether an employee benefit arrangement falls within the exemption?**

Non-exclusivity is a good idea, but one would expect that many securities lawyers will want specific guidance when drafting these agreements. As a practical matter, company employees/directors who stand to benefit from these types of arrangements (and the bidders offering these agreements) are likely to be indifferent as to whether they are required to accept payment during a certain period or refrain from endorsing the tender offer. One would further assume that these individuals simply want the agreement to be insulated from legal challenges and one that is easy for the compensation committee to approve.

6. **Should the safe-harbor be made available to employees/directors of the bidder?**

Probably. It's possible that an employee/director of the bidder may already hold a stake in the target company (e.g. a partially-owned subsidiary). Take, for example, the situation where the same person or control group holds a large stake in two separate companies (company A and B) and then wishes to consolidate these interests for some legitimate business purpose. The best course of action may be for company A to purchase company B using a tender offer and, at the same time, consolidate management. The rule, as written, doesn't make the safe-harbor available. It's also not clear how the safe-harbor would apply if the bidder was the holding company of the target.

7. **Should we address specifically the timing of the approval of the compensation committee or arrangements for the purposes of the safe harbor?**

Drawing a line with respect to when a compensation agreement must be approved can have drastic implications. Consider the following scenarios:

a. **Scenario 1:** If the safe-harbor states that the compensation committee must approve the compensation agreement after the tender offer has closed, then the employee is stuck with his or her decision to tender. In other words, if the committee ultimately disapproves of the compensation agreement, the bidder has no way of eliminating its exposure to liability since the decision to tender has already been made. (Of course, this assumes that failure to tender will avoid the rule altogether).

b. **Scenario 2:** If the new rule states that the compensation agreement must be approved during the tender offer, it is more likely that bidders will abuse the rule by waiting to see whether the offer is sufficiently subscribed before deciding how much to offer the director/employee. If the tender offer is undersubscribed, for instance, the bidder may find it advantageous to increase the compensation amount or offer additional compensation arrangements to those employees/directors who hold a large percentage of the target's shares, but have failed to tender. If the target's Board has already endorsed/recommended the tender offer to the shareholders, the Compensation Committee may feel pressured to approve these last minute deals out of fear that the tender offer will ultimately fail. This result would circumvent the spirit of 14d-10.

c. **Scenario 3:** If the new rules were to state that the compensation agreement must be approved before the tender offer has commenced, it would give both the bidder and the target a tremendous amount of flexibility. Both parties would then enter the tender offer period knowing precisely what the landscape is with respect to these compensation agreements. They know who is being asked to stay or leave and can make a better decision as to whether the tender offer should be endorsed or recommended.

8. **If the proposal is adopted, should the safe harbor have retroactive applicability?**

No. With respect to those tender offers that have already been commenced, providing retroactive applicability would give class-action lawyers more ammunition to argue that the compensation agreement was inappropriate. It is unlikely that any company followed the requirements of the newly proposed 14d-10 safeharbor carefully enough to avoid a question of fact that would warrant summary judgment. However, for tender offers that have not "commenced" as of the date the new rules are adopted, a retroactivity clause would allow targets to go out and get committee approval.

9. If a member of the compensation committee is a party to the employment compensation agreement, should the safeharbor still be available?

This question demonstrates the importance of adopting an "independence" requirement. It will certainly be difficult for a director in this situation to demonstrate that he or she is truly independent. A similar situation could arise if a Plaintiff's lawyer successfully shows that two directors acted *quid pro quo* in approving each other's compensation agreements while recusing themselves from the vote that involved their own. The solution to both of these problems is: (1) disclosure, (2) independence and, when necessary, (3) complete recusal.

The decision to recuse oneself from this particular vote appears to be one of those things that's just common sense and should otherwise fall into the category of "best practices." The SEC is probably better off allowing compensation committees to decide when recusal is appropriate in these situations since any litigation that arises as a result will likely be resolved by deciding whether the board can avail itself of the business judgment rule.

10. Should approval that a court determines violates a fiduciary duty result in a loss of the safe harbor?

Yes. If a court determines that the fiduciary duty violation constitutes a failure to achieve "independence" within the meaning of the applicable listing standards, the safe harbor should be lost. It's still not clear, however, how losing the safe harbor will impact the entire tender offer. Is there any way to cure this situation without putting the whole offer at risk? Could the bidder make the offer subject to compensation committee approval and later withdraw the offer if approval is not obtained?