SEC PROPOSES AMENDMENTS TO BEST-PRICE RULE TO ELIMINATE BIAS AGAINST TENDER OFFERS

On December 16, 2005, the Securities and Exchange Commission (the "SEC") published long-awaited proposals to amend its "best-price rule."[1] Comments on the proposed rule amendments are due on February 21, 2005.

I. Background

The best-price rule was adopted in 1986 to ensure equal treatment of shareholders by requiring that the consideration paid to any security holder in a tender offer be the highest consideration paid to any other security holder in the offer. However, application of the rule has not been as simple as its concept. In a number of cases, shareholders have challenged tender offers in the federal courts, complaining that employment, severance, noncompete and other payments to target insiders have in reality been hidden payments of additional consideration for the insiders' shares. The plaintiffs have alleged, often successfully, that the best-price rule requires the per share amount represented by these "side" payments to be paid as well to all other shareholders who participated in the tender offer.

To complicate matters, the federal courts have disagreed on the proper interpretation of the best-price rule and the circumstances under which "side" payments should be considered additional consideration for tendered stock. The confusion engendered by these decisions has raised the concern that legitimate payments to target insiders – often a commercial necessity – could be recharacterized by the courts and that acquirors would be forced to pay substantial additional consideration after an acquisition has closed. This concern has often led acquirors to favor merger structures, to which the best-price rule does not apply, and has discouraged the use of tender offers, even when a tender offer might otherwise be preferable. For some time now, practitioners have been looking to the SEC to offer guidelines on when payments to target company executives trigger the rule.

II. The SEC's Approach to the Best-Price Rule

The federal courts have developed two principal approaches to the best-price rule. One, referred to as the "integral parts" test, holds that the best-price rule applies to all integral parts of a tender offer and seeks to determine whether a particular payment is an integral part of the tender offer that should be recast as tender offer consideration. The other approach is a bright-line test that holds that the best-price rule applies to all arrangements executed or implemented between commencement and completion of the tender offer.

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[1] The "best-price rule" is actually two rules – one for third-party tender offers (Rule 14d-10(a)(2)) and another for issuer tender offers (Rule 13e-4(f)(8)(ii)). Amendments have been proposed to both rules, which we collectively refer to as the "best-price rule."

The SEC's proposed amendments find fault with both of these judicial approaches and are based instead on the view that the best-price rule generally should not apply to employment compensation, severance and other employee benefit arrangements. The SEC concluded that these arrangements, whether they are made before or during the pendency of a tender offer, often are integral to an acquisition, but that in most cases they should not be recast as tender offer consideration unless they are based on the shareholdings of the insiders who benefit from them.

To implement its approach, the SEC has taken three separate tacks: clarifying that the best-price rule applies only with respect to the consideration paid for tendered securities; exempting certain compensation, severance and benefit arrangements from the best-price rule; and creating a safe harbor for these arrangements when they are approved by an independent compensation committee.

III. Specifics of the SEC's Proposals

A. Clarification of the Best-Price Rule

The first proposal revises the language of the rule to make it clear that its scope is limited to payments "for securities tendered in the tender offer" rather than the looser language that now exists in the rule. Although helpful and certainly an improvement, this proposal alone is unlikely to satisfy the current concerns with the rule because it may not prevent courts from concluding, as they have done in the past, that "side" payments are in fact disguised consideration for insiders' shares.

B. Exemption for Certain Employment Compensation, Severance and Other Employee Benefit Arrangements

The second proposal specifically exempts from the third-party best-price rule (but not from the best-price rule applicable to tender offers by issuers):

> the negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such arrangements, with respect to employees and directors of the subject company, where the amount payable under the arrangement: (i) relates solely to past services performed or future services to be performed or refrained from performing, by the employee or director (and matters incidental thereto), and (ii) is not based on the number of securities the employee or director owns or tenders.

The SEC has not proposed to extend this exemption to issuers because it does not believe that issuers have the same need to enter into or revise compensatory arrangements when they structure and commence tender offers. However, the limitation of this exemption to third-party tender offers is a topic on which the SEC has specifically solicited comment, and it is possible that issuers will have the benefit of this exemption in the final rule. The SEC is undoubtedly right that the best-price rule is much less of an issue in issuer tender offers, but certainly there can be situations where an issuer that has revised its management compensation will have to consider delaying or forgoing a contemporaneous tender offer that otherwise would be attractive to shareholders.

C. Safe Harbor for Certain Employment Compensation, Severance and Other Employee Benefit Arrangements

The final proposal is a non-exclusive safe harbor that would apply only to third-party tender offers. The safe harbor would deem any arrangement to be "an employment compensation, severance or other employee benefit arrangement" within the meaning of the exemption described above if the relevant compensation committee approves the arrangement as meeting the requirements of the exemption that the arrangement (i) relates solely to past services performed or future services to be performed or refrained from performing, by the employee or director (and matters incidental thereto) and (ii) is not based on the number of securities the employee or director owns or tenders.

The relevant compensation committee is either the compensation committee of the bidder or of the target company, depending on which company the arrangement is made with. In all cases, the safe harbor applies only if the compensation committee that approves the arrangement is comprised solely of independent directors. For this purpose, independence is determined by the relevant listing standards for listed companies (*e.g.*, NYSE or NASDAQ rules) and by the listing standards of any national securities exchange or national securities association for non-listed companies (so long as the non-listed company uses the same standard for all committee members).

IV. Commentary

The SEC's proposed amendments to the best-price rule will bring a welcome change and will once again allow acquirors to readily consider structuring transactions to include a tender offer. The safe harbor is a particularly welcome proposal because it will allow the parties to a transaction to eliminate interpretive uncertainty surrounding payments to employees and directors that are made or committed to during or around the time of a tender offer.

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If you have any questions about the proposed revisions to the tender offer rules, or would like further information, please call Michael A. Schwartz at (212) 728-8267, Steven J. Gartner at (212) 728-8222, John S. D'Alimonte at (212) 728-8212 or the corporate partner with whom you regularly work.

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