EXECUTIVE COMPENSATION IN THE CONTEXT OF TENDER OFFERS

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Recent case law has raised significant issues as to whether the payment or grant of executive compensation by a target company in connection with a tender offer constitutes disparate treatment of shareholders in violation of Rule 14d-10. Rule 14d-10, sometimes referred to as the "all-holder, best-price" rule, provides that all shareholders tendering shares during a tender offer must receive the same consideration.[1] In the last year or so, three courts have held that certain payments or grants to executives in connection with a tender offer may violate Rule 14d-10 (even if actually agreed to and made outside the tender offer period).[2] Although two other courts have more recently held that executive payments paid outside a tender offer period did not violate Rule 14d-10 as a matter of law,[3] in one of these decisions there may be a negative implication that such payments would be violative if not made pursuant to a pre-existing duty.

In light of certain courts' continuing expansion of Rule 14d-10, a decision to grant or approve additional executive compensation, including even standard golden parachutes and retention agreements, in connection with a tender offer should be undertaken with caution. The risk that extra executive compensation can be recharacterized as a payment to certain shareholders in violation of Rule 14d-10 creates significant settlement value as a result of the potential damages. In order to avoid the issue entirely, the parties can structure the transaction as a one-step merger. Alternatively, if a one-step merger were impracticable, the parties should

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1 17 C.F.R. § 240.14d-10. Rule 14d-10, promulgated by the Securities and Exchange Commission under the authority of the Securities Exchange Act of 1934, provides in part that "[n]o bidder shall make a tender offer unless . . . [t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."

2 *Millionerrors Inv. Club v. General Elec. Co.*, No. CIV. A. 99-781, 2000 WL 1288333 (W.D. Pa. Mar. 21, 2000); *Katt v. Titan Acquisitions, Ltd.*, 133 F. Supp. 2d 632 (M.D. Tenn. Nov. 17, 2000); *Maxick v. Cadence Design Sys., Inc.*, No. C-00-0658-PJH, 2000 WL 33174386 (N.D. Cal. Sept. 21, 2000) (declining to dismiss a Rule 14d-10 claim despite the defendants' argument that the "retention bonuses" at issue were paid outside the tender offer period). The brief opinion in *Maxick* is not otherwise discussed herein because it does not describe the facts underlying the Rule 14d-10 claim and provides little guidance for evaluating the legal sufficiency of such claims in other cases.

3 *McMichael v. United States Filter Corp.*, No. EDCV 99-182 VAP (Mcx), 2001 U.S. Dist. LEXIS 3918 (C.D. Cal. Feb. 22, 2001); *Walker v. Shield Acquisition Corp.*, No. CIV. A. 1:00CV0481ODE, 2001 WL 431465 (N.D. Ga. Mar. 30, 2001).

maintain a careful record to demonstrate that the executive compensation cannot fairly be characterized as an inducement to support the offer and tender shares.

Rule 14d-10 and Executive Compensation

Disparate Approaches in the Case Law

The expansion of Rule 14d-10 began with the Ninth Circuit's decision in *Epstein v. MCA, Inc.*, which arose out of Matsushita Electrical Co. Ltd.'s 1990 acquisition by tender offer of MCA, Inc. ("MCA").[4] A class of MCA shareholders sued and alleged, among other matters, that an MCA executive had received a payment of $21 million in order to induce this executive to support the offer and tender shares. On appeal, the Ninth Circuit considered whether Rule 14d-10 applies to compensation paid outside the formal tender offer period. Notwithstanding that the payment was agreed to prior to the commencement of the tender offer period and paid after its conclusion, the Ninth Circuit concluded that the payment could be considered paid during the offer period because it was otherwise "an integral part of [the] tender offer."[5] The Ninth Circuit adopted this functional analysis to extend the plain language of the statute based upon the "remedial" nature of the securities laws.[6] The Ninth Circuit conceded, however, that the grant of the options would not raise a Rule 14d-10 issue if granted pursuant to a pre-existing duty.[7]

The Seventh Circuit declined to adopt the Ninth Circuit's functional test when addressing Rule 14d-10 in *Lerro v. Quaker Oats Co.*, which arose from Quaker Oats' 1994 acquisition of Snapple Beverage Corporation.[8] Addressing a claim of extra compensation in the form of a lucrative distribution contract, the Seventh Circuit held that the challenged contract was signed before the tender offer period began and thus was not consideration paid "during such tender offer." The Seventh Circuit expressly adopted a bright line rule that Rule 14d-10 is violated only if allegedly extra compensation is paid during the tender offer period.[9]

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4 50 F.3d 644 (9th Cir. 1995).

5 *Id.* at 655.

6 *Id.*

7 *Id.* at 656-57. The plaintiffs in *Epstein* also challenged a swap transaction pursuant to which another MCA executive tendered his shares in MCA in exchange for preferred stock in a subsidiary of Matsushita. *Id.* at 648. The court found that arrangement to violate Rule 14d-10 as a matter of law even though the agreement was entered into before the tender offer commenced and was consummated after the tender offer was completed. *Id.* at 657.

8 *Lerro v. Quaker Oats Co.*, 84 F.3d 239 (7th Cir. 1996).

9 *Id.* at 242-43.

Recently, district courts in Pennsylvania and Tennessee have followed the Ninth Circuit's functional analysis and held that executive compensation paid outside the tender offer period may constitute additional payment to selected shareholders in violation of Rule 14d-10.[10] In *Millionerrors Investment Club v. General Electric Co.*, the court denied a motion to dismiss Rule 14d-10 claims based on 1.3 million stock options granted to eight executives of a company acquired by tender offer.[11] In that case, the options were granted shortly before the tender offer period commenced and were cashed out in their entirety as soon as the tender offer was completed.[12] Similarly, in *Katt v. Titan Acquisitions, Ltd.*, the court denied a motion to dismiss Rule 14d-10 claims based on golden parachute payments, "sign-on" bonuses, and accelerated performance awards.[13] This decision is particularly troubling to the extent that it suggests that standard golden parachutes and retention agreements are problematic. The transaction was, however, more vulnerable to challenge under Rule 14d-10 because some accelerated performance awards were conditioned on the tender of shares. Although the payments were made by the target, the court nonetheless found that payments made by the target should be treated as paid by the bidder if induced by the bidder.

Two other district courts have recently granted motions to dismiss Rule 14d-10 claims where the alleged additional compensation was paid outside the tender offer period. In *McMichael v. United States Filter Corp.*, the court held that golden parachutes, if pre-existing, do not violate Rule 14d-10 as a matter of law.[14] In *McMichael*, decided by a district court in the Ninth Circuit, the court noted that the extra compensation was paid pursuant to change-of-control provisions that were present in previous versions of the executives' employment contracts.[15] The court also noted that the employment agreements were fully disclosed and that the payments came from the target corporation rather than the bidder.[16] Although the decision could be viewed as encouraging for prospective bidders, the problematic aspect of the decision

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[10] *Millionerrors*, 2000 WL 1288333; *Katt*, 133 F. Supp. 2d 632.

[11] 2000 WL 1288333, at *5.

[12] *Id.* at *1. Plaintiffs alleged that the options were issued with the sole objective of providing management with windfall profits from the anticipated cash-out of the options upon the sale of the target.

[13] 133 F. Supp. 2d at 636-37. According to the plaintiffs in *Katt*, the accelerated performance awards were contingent on the executives' tender of shares pursuant to the tender offer, as well as negotiation and consummation of the tender offer. *Id.* at 637.

[14] *McMichael*, 2001 U.S. Dist. LEXIS 3918.

[15] *See id.* at *17-18.

[16] *See id.* at *19-20.

is the extent to which it implicitly suggests that the payments would have been improper if they had not been made pursuant to a pre-existing duty.

Most recently, the court in *Walker v. Shield Acquisition Corp.* held that executive bonus payments conditioned on change-of-control provisions did not violate Rule 14d-10 where the payments were made pursuant to a merger agreement executed prior to the commencement of the tender offer and paid following its expiration and the subsequent merger.[17] The court distinguished *Epstein* on the ground that *Epstein* involved only a tender offer, while the acquisition at issue in *Walker* involved both a tender offer and merger.[18] In addition, the court rejected *Epstein's* functional approach and adopted the Seventh Circuit's bright-line rule as more consistent with the language and purpose of Rule 14d-10.[19]

General Rules

While the disparate holdings of these cases reflect a lack of consensus on the application of Rule 14d-10 to executive compensation outside the tender offer period, certain general rules have emerged:

- Where a payment is based on a pre-existing duty, defendants have an excellent argument that there is no Rule 14d-10 violation and may succeed in having the claims dismissed on the face of the complaint.

- If there is no pre-existing duty to make a payment, then a defendant may face allegations that the payment is in fact a covert premium to the executive to support the offer and tender shares. While the Seventh Circuit will be receptive to a motion to dismiss based on the timing of the payment, the Ninth Circuit will examine whether the payments were "an integral part of [the] tender offer" to determine whether there is a violation. While many federal appeals and district courts have not yet addressed the application of Rule 14d-10 to executive compensation, there is negative precedent for defendants in certain Tennessee and Pennsylvania district courts and favorable precedent in a Georgia district court. There can be, of course, no assurance as to where a case will be filed.

- The case law is pernicious because the ability of a plaintiff to resist a motion to dismiss puts tremendous pressure on the bidder to settle, given the huge damages if the executive compensation payments are found to be additional

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[17] *Walker*, 2001 WL 431465, *8.

[18] *Id.* at *7. This effort to distinguish *Epstein* was not fully persuasive because, among other reasons, *Epstein* did involve a short-form statutory merger.

[19] *Id.* at *13-14

consideration. The remedy for a Rule 14d-10 violation is payment to every security holder of the same consideration paid to the highest-compensated security holder. Even if the evidence suggests that the payments are for employment services (and not related to the tender of shares), the possible exposure could provide the plaintiff with significant leverage in settlement negotiations.

- While appropriately structured and motivated retention payments should not be problematic, litigation may arise if such payments could be recharacterized as an inducement to support the offer and tender shares in the "guise" of retention payments.

Recommendations

To the extent that the grant of additional compensation in connection with a business combination is necessary or desirable, Rule 14d-10 can be sidestepped by structuring the transaction as a one-step merger. If this were not a practical alternative and the bidder is prepared to accept the litigation risk associated with executive compensation being recharacterized as a payment for shares, then we recommend that a company considering paying additional executive compensation near the time of a tender offer take precautions to build a proper record that the payments are for employment services. For example, no documents should include language providing that the compensation paid to the officers is conditioned on the officers' tender of shares or support of the tender offer or otherwise tied to the officers' activity in connection with the tender offer. The amount of any additional compensation should be reasonable and commensurate with the officers' prior salary and bonuses. Retention of an expert to determine the appropriate market price for such compensation may be regarded favorably for defendants. If the compensation includes a retention bonus, the required period of retention should be reasonable. Change-of-control payments that are not conditioned on continued employment should be initiated by the target for bona fide corporate purposes and should be commercially reasonable. Finally, the compensation should preferably be contingent on completion of the merger, as opposed to contingent on completion of the tender offer, and the compensation should be fully disclosed in the tender offer documents.

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If you have any questions concerning the executive compensation issues created by Rule 14d-10, please do not hesitate to contact John Finley (at 212-455-2583; j_finley@stblaw.com), Rob Spatt (at 212-455-2685; r_spatt@stblaw.com) or David Sorkin (at 212-455-3387; d_sorkin@stblaw.com).

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