24th Australian Legal Convention September 20-25, 1987 — Perth, Western Australia

"Business Law: Litigation in Contested Takeovers" An American Perspective

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Tuesday, September 22, 1987

Introduction

The purpose of this paper is to provide an American perspective on the role of litigation in contested takeovers. It will necessarily focus and reflect on the American experience with contested takeovers, but it will endeavour to do so comparatively — in a manner which may suggest considerations relevant to the Australian takeover environment.

A Note of Context

Before turning to the subject at hand it may help to provide an element of comparative context by noting certain dominant characteristics of the American takeover environment that may distinguish it somewhat from the Australian environment. First would be the size and importance of risk arbitrage activity in the U.S. contested takeovers. Although it is difficult to determine with precision, it is estimated that the total amount of arbitrage portfolios invested at any one time is up to U.S. $50 billion. In the typical unsolicited takeover bid situation, it is not uncommon to see 30 to 50% of the target company's shares acquired by risk arbitrager portfolios within two weeks of the bid announcement. Thus, to oversimplify for example, suppose a company trading at $20 receives a bid of $35 and two or three weeks later 40% of its shares have been acquired by entities which bought them at 30 for the exclusive purpose of reselling them to the bidder two weeks later at the bid price of 35. The impact of this market phenomenon on the conduct of takeover strategy in the U.S. — including the use of litigation — cannot be underestimated.

A second important feature of the U.S. takeover environment is the flexibility — as well as the imperative — that flows from the ability of a U.S. company to purchase its own shares directly. Here again a simple hypothetical serves to illustrate the general principle. Suppose the target company's shares trade in the market in the $15-20 range. The bidder sees values justifying a $30 share price and believes those values could be unlocked through sale of certain non-performing assets, achievement of certain cost cutting efficiencies and maximisation of cash flow through various means, including reduction of capital spending. In the face of a $25 bid, one option available to the target is to implement the business plan which will maximise values and to recapitalise itself by acquiring a substantial number of its own shares — for cash or debt or both. As a consequence, the target is able to compete with the hostile bidder and may defeat the contested bid on economic terms. However, these share repurchase transactions — leveraged buyouts, self tender offers, market purchase programs and recapitalisations — involve the direct or indirect purchase by the company of its own shares — presumably in a manner that would conflict with Section 129 of the Companies Code if it were attempted by an Australian company.

A third major feature of U.S. takeovers is the obsolescence of the partial bid, despite Mr Pickens efforts to revitalise it in the Newmont Mining situation. Because of the importance of arbitrage activities, the target company's capacity to implement self-help economic defences and the advent of various other defensive tactics — the poison pill, supermajority voting provisions, lock-up options and the like — the partial bid has become extremely rare. Virtually every unsolicited bid for a U.S. company to be credible and have a chance of succeeding will be a cash bid for all the shares. Thus, the principal issue for consideration — both by the target's directors and shareholders — is the attractiveness of the price since a cash bid for all shares eliminates any issue regarding the value of a continuing investment in the target.

Finally, the discipline of a market place in which the vast majority of the funds invested are managed by or on behalf of fiduciaries and institutional investors* typically demands a competitive economic response to an unsolicited takeover bid, not an attempt to persuade the market that the bid should be rejected by shareholders or an effort to defeat the bid through the use of litigation. Indeed, the conventional wisdom is that a bid exceeding the market price will get all the shares it seeks unless there is either a superior economic alternative to the bid or a legal prohibition against it.

What all this means is that for practical reasons (and for legal reasons — as will be discussed below) in a contested U.S. takeover a target company's board of directors will be under heavy pressure to pursue an economic strategy — that is seeking economic alternatives to the unsolicited bid — rather than relying primarily on a litigation or public relations attempt to defeat the bid. In a practical effect, this means the board must give serious consideration to pursuing a sale of the target in one manner or another. Thus, a contested takeover attempt frequently transforms the role of the target company's board of directors into that of an entity charged with obtaining the best possible price for the shareholders in a prudent and impartial fashion — *i.e.* it ceases its managerial oversight functions and it becomes an impartial auctioneer. In very simple terms this is the doctrine of the so-called "level playing field."

** According to Federal Reserve Board statistics, the aggregate amount of pension fund investments alone in U.S. equities represent more than 50% of the total amount invested in U.S. equities.*

Based on the foregoing considerations, in the U.S. today litigation would almost never play a decisive role in defeating an unsolicited takeover bid where the result is that the bid is withdrawn and the target company remains independent. Similarly, while there are limited recent examples of the contrary, it would be an unusual case today if through litigation the original unsolicited bidder were prevented altogether from pursuing his bid while a white knight succeeded in acquiring the target. In this sense, strategic litigation in U.S. contested takeovers has virtually disappeared. As will be seen below, however, the tactical use of litigation in the same context has become more important — principally by the bidder to ensure the existence of a level playing field.

An Historical Note

After the enactment of the principal U.S. legislation governing tender offers, the principal ground for litigation in contested U.S. takeovers involved the adequacy of disclosure furnished to shareholders in the offering circular (the U.S. analogue to the Part A) and in the target's recommendation document (the U.S. analogue to the Part B), the legality of the offer under the antitrust and other applicable regulatory schemes and the legality of the target board's specific activities in opposition to the offer under applicable fiduciary principles of law. Throughout the decade of the 1970's the defensive strategy of targets of unsolicited bids invariably included and generally depended upon an all-out litigation attack on the offer — both substantively and from a disclosure point of view in the federal as well as state courts. Similarly, unsolicited bidders routinely sought to enjoin virtually every act of the target board of directors taken in response to the takeover bid. Frequently the outcome of the outcome of the takeover contest would depend upon the outcome of the litigation. It is perhaps not an overstatement to say that litigation was certainly the strategy of first choice and often was the determinative strategic initiative.

A number of developments, however, began to reduce very sharply the strategic efficacy of litigation by a takeover target against the bidder. The first was the establishment of the general principle that the appropriate judicial remedy for the failure of a bidder to make full and accurate disclosure concerning the offer was not to enjoin the offer. Rather it was simply to require a correction or supplement to cure the disclosure defect. Thus, a target could, at most, expect to buy itself some time by attacking the adequacy of disclosure surrounding an offer — a modest tactical advantage in some circumstances but not especially significant from a strategic point of view.

Second, until relatively recently a number of regulated U.S. industries required compliance with an elaborate approval procedure — with substantial attendant delays — prior to a change of control of a company in the industry. Examples included communications, commercial aviation, railroads, trucking and shipping. Over the past several years, however, as deregulation generally has gained momentum, the agencies charged with the administration of those regulatory schemes have developed procedures to enable a bidder to purchase shares in the tender offer first and then complete the approval process. For example, it has become in the communications and transportation industries to place shares of the regulated companies in a voting trust following consummation of the acquisition and prior to receipt of regulatory approval. This has effectively eliminated the ability of a target to utilise the delay and substantive obstacles associated with the regulated approval procedure to defeat a tender offer.

Third, if the claim could be made with any credibility, a major focus of attack on an unsolicited offer was its invalidity under the antitrust laws. Two developments have substantially reduced this strategem's efficacy as well. First, under the current presidential administration (in office since 1981) there has been a substantial relaxation of enforcement policy from what prevailed before it. Second, with the enactment of the Hart-Scott-Rodino Act a process of governmental antitrust review has been instituted and refined which is designed to ensure adequate scrutiny by the government on a prompt basis before a transaction is consummated. Thus, if an antitrust attack is to be mounted against a bid — whether by the target company or a third party competitor — to which the government has failed to object during the applicable Hart-Scott-Rodino review period the attack begins with the disadvantage of needing to explain the absence of the government from the attack. Alternatively, should the government take an interest in the acquisition the offeror's bid may well be forestalled until such time as the government and the bidder are able to agree on a satisfactory resolution of potential anticompetitive business arrangements which could result from the acquisition. Clearly in the hostile context, any such challenge may well result in the offer being defeated — due to both timing and substantive disadvantages. While the government and the offeror are attempting to reach a meeting of the minds, the target company is likely to be structuring economic alternatives to the hostile offer. Moreover, the

governmental requirements for withdrawal of their objections may be too costly to make the acquisition feasible from a financial point of view.

To sum up — the U.S. takeover environment has moved away from litigation as a prime strategy, although it can still play an important role in the overall mix of takeover tactics.

The Current Environment

General

The role of litigation in contested U.S. takovers today is primarily tactical. With few exceptions, litigation simply has not been outcome determinative of recent takeover contests in the U.S. What it has been is an important device which is utilised to achieve specific objectives or advantages in the overall contest. These would include the achievement of a timing advantage (e.g. a delay permitting a target additional time to find a "white knight" at a higher price), obtaining access to the opponent's documents and witnesses through discovery and generally creating an environment in which the opponent's decision-making process is subject to the twin pressures of time urgency and the possibility of judicial scrutiny. However, this type of tactical use of litigation is generally a hand maiden to the bidder's market and economic strategy, and its success frequently depends upon the strength of the latter strategy. Thus, for example, the ability of a bidder to obtain judicial assistance to remove obstacles to his offer (e.g. a poison pill) and to enforce a level of playing field may depend upon the strength and credibility of the bid itself. Similarly, the success of a target's efforts to derail or delay a bid in the courthouse can often depend on the credibility of its efforts to achieve a superior result for shareholders through alternatives to the contested bid.

Defensive Litigation by the Target

It is always open to a U.S. takeover target to attack the bidder's disclosure materials under the applicable federal securities laws. In addition to the requirements of disclosing material facts and avoiding false and misleading statements, the bidder is subject to a myriad of required disclosures relating to its financing, its future business plans for the issuer, its prior dealings with the issuer and many other similar matters. These will generally provide ample basis for developing some colorable claim of the bidder's lack of complete candour in the information contained in the offering circular distributed to the target shareholders. Typically, claims of this nature will not have a decisive effect on the outcome of the takeover attempt. They can, however, afford the target additional time and possibly a tilting of the playing field somewhat in the target's direction.

There is one unusual but important exception to this general rule of thumb. That is the case of the fatal disclosure flaw — i.e. where the disclosure correction required is so unpalatable that the bidder would prefer to drop the bid. This occurred, for example, in the 1983 takeover battle between Smith and Gearheart — two oil field service companies. There a Texas judge found that the bidder — Smith — had failed to make proper disclosures relating to an ongoing litigation with serious liability implications for Smith. However, the same description was also in Smith's regular public reports to the SEC and its shareholders which had been public for some time. Smith found itself with the dilemma of correcting the disclosure in its offering materials and thereby acknowledging the inadequacy of the same disclosure in its regular public reports (with the attendant risk of liability) or withdrawing the offer. It chose the latter course. Similar dilemmas have been created for hostile bidders through attacks directly on the adequacy of their regular public reports in the area of environment and other contingent liabilities. Yet a third focus of such efforts to find and exploit a fatal disclosure flaw has been the financial position and statements of the bidder. Here a private or a foreign bidder may be reluctant or unwilling to comply with the full array of required financial disclosure, particularly if the disclosure would contradict a position previously taken. For example, a foreign bidder might be unwilling to permit public disclosure of the effect on its financial statements of the required reconciliations to United States generally accepted accounting principles. Similarly, a private individual might be unwilling or unable to provide the kind of financial disclosure typically provided only on behalf of a corporation or partnership.

Since the advent of the insider trading scandal on Wall Street last year, in certain circumstances it has become virtually automatic for a target company to bring suit claiming the bidder leaked its intentions to make a bid, thereby causing the share market to be destabilised and the company to be put "into play." This claim was a centrepiece of Safeway's defence against the Dart takeover bid in 1986 although the company ultimately was acquired by Kohlberg, Kravis, Roberts & Co. in a leveraged buyout transaction. Similarly, Gillette defended against the Revlon takeover attempt last winter on the ground that the arbitragers and other market players had been tipped by Revlon of its planned bid and had then acquired large blocks of stock for resale to Revlon. The litigation was settled when Revlon terminated its offer and sold its 14% block back to Gillette.

One other type of claim has been somewhat successful in recent cases, although it may be somewhat unique to the specific circumstances in which it has been brought. When Dominion Textile and Asher Edelman joined forces to attempt to take over the giant textile company Burlington Inc. earlier this year, they were assisted by a former Burlington executive. This proved unfortunate. A federal court and a federal appellate court held the assistance to have involved an improper disclosure of material inside information to the bidders and enjoined the tender offer. In effect, this case suggests that it is difficult for anyone who stood in a fiduciary relationship with a target to assist third parties in attempting to take over that target.

In a related vein, serious issues have been raised in several recent bids, including a contested offer for GenCorp, concerning the propriety of an investment banker working against its former client. The GenCorp deal suggests that a merchant banker should, at a minimum, wait some modest period of time before attempting to work against a former client. In GenCorp the failure to observe an appropriate waiting period proved a serious and unexpected difficulty for the offeror client for whom the banker was working, and the target company was able to develop a substantial tactical litigation advantage as a result.

Offensive Litigation by the Bidder

As stated above, in a contested U.S. takeover economics is likely to control the outcome of the bidding contest. As a result, litigation commenced by the bidder is often designed to assure that it will have a "level playing field" on which to present its bid to the target's shareholders. Generally, and depending on the location of both the bidder and the target company, a bidder may initiate litigation upon commencement of its tender offer in order to set the litigation stage in a jurisdiction which is receptive to notions of procedural fairness designed to maximise shareholder value.

Once the appropriate forum has been selected, there are four primary areas in which the bidder seeks help from the courts. First, the bidder will seek to invalidate or prohibit the target company from invoking various defensive measures. For example, more than 400 publicly traded American corporations have adopted "poison pills." Without detailing the various intricacies of a "poison pill" rights plan, it is both difficult and costly, if not impossible, for a hostile bidder to acquire a company which has such a rights plan in place. Accordingly, unsolicited offers are generally conditioned upon the target company's board redeeming the rights plan or the rights plan othewise being invalidated. Therefore, in the first instance, the acquiror will demand that the target company's board redeem the rights and at the same time seek to have a court enjoin the plan or othewise invalidate it.

Other defensive measures often used by a target company include issuing a controlling block of securities which may possess multiple voting rights per share, entering into a preferential acquisition agreement with a third party or management which contains a lock-up stock option, "crown jewel" asset option or a provision for the payment of substantial liquidated damages in the event the alternative transaction is not completed. As a general matter, discriminatory voting securities issued in the hostile acquisition context have been invalidated by the courts on state corporate law grounds prohibiting discrimination among shareholders of the same class of securities. Lock-up stock options, "crown jewel' asset options and break-up fees have been considered by many courts and are analysed on a case-by-case basis. Other than asset options granted at less than fair value, these measures, if reasonable under the circumstances, are usually permitted by courts provided they have been granted on a level playing field and have not had a chilling effect on the bidding process.

The second area for offensive litigation by a bidder, which has become increasingly more important to bidders since the *Revlon* decision, is the enforcement of the "level playing field" concept. Once a board of directors has determined to maximise economic value for its shareholders, the courts will require that the board act as an impartial auctioneer of the company. As an impartial auctioneer the board must provide equal access to company information to all interested bidders, and the board must establish fair bidding procedures to permit an equal opportunity to all bidders to bid for the company, and rebid if appropriate. As a result of the recent development of this body of common law, a bidder is likely to seek court relief preventing the target's board from chilling the bidding process by favouring one bidder, such as management, over the others.

The third context for litigation in the contested takeover area is the target company's disclosure obligations under the U.S. securities laws. Following the commencement of a tender offer, the federal securities laws require that the target company publish its recommendation concerning the unsolicited offer within ten business days. Among other things, the target company is obligated to make a recommendation to shareholders as to whether they should tender their shares in the offer and identify the factors underlying its recommendation. In addition, the target company is obligated to state whether or not any negotiations are underway between the company and others which would result in an acquisition transaction, thereby defeating the unsolicited offer. The SEC has taken an active role in enforcing these disclosure obligations, particularly those concerning negotiations in light of the *Revlon* line of cases obligating the board to conduct a fair auction on a level playing field. The disclosure obligations imposed on a target company thus provide two grounds for litigation by the bidder — first, that the target company has failed to comply with the technical disclosure requirements of the securities laws; and second, that the failure to make adequate disclosure of the negotiations is causing an unfair auction process.

Finally, the last area providing a basis for litigation by an offeror is an economic one centering on employee benefits. Often the board of a target company will authorise special employee benefits which are paid following a change of control of the company. These benefits frequently would result in the payment of significant sums of money in the event employees are terminated following a change in the control. While arrangements of this nature have generally been upheld by the courts, claims are often brought against the board for breach of its fiduciary duty and waste of corporate assets in the granting and payment of these benefits.

Offensive litigation by an offeror in a contest for control is rarely determinative of the outcome. In today's

acquisition environment, economics controls the marketplace. Accordingly, while tactical litigation can be helpful to the bidder in order to maximise the likelihood that the bidder will be entitled to present fairly a bid to the target company's shareholders, litigation commenced by the offeror is not likely to be outcome determinative.

Stockholder Derivative Litigation

One other type of litigation plays a role in the American acquisition environment — albeit a minor one — stockholder derivative litigation or the plaintiffs' bar. In virtually every acquisition, whether friendly or unfriendly, derivative litigation is brought by a nominal stockholder on behalf of the corporation. As a general matter, suits of this nature which are brought against a negotiated acquisition result in the payment of attorneys' fees for the plaintiffs' lawyers and sometimes a slightly increased price to all stockholders in transactions involving either management or affiliated entities.

These suits are commenced against management and the board of directors promptly following the announcement of a transaction. In a contested situation, the plaintiffs seek relief from any defensive action taken by the target company, and they may seek to prevent the board from invoking defensive measures which currently exist, such as the poison pill.

The theory behind the plaintiffs' bar in a contested situation is to prevent management from discouraging a bidder from presenting its best bid to shareholders. In friendly transactions which involve management, such as leveraged buyouts or leveraged recapitalisations, the plaintiffs' bar generally claims that the price be paid to shareholders is not adequate and that there has been a lack of procedural fairness in structuring the transaction. Whether the transaction is hostile or friendly, these suits have a minimal effect, if any, on the outcome of the transaction. Typically in a contested acquisition the stockholder's derivative action follows and takes second seat to the litigation being conducted by the offeror. To the extent the offeror does not pursue vigorously its claims the plaintiffs' bar is not likely to pursue theirs. Generally in a negotiated acquisition, management will factor into the economics of its transaction the likelihood of plaintiffs' suits and thus will save some value with which to settle these suits and to pay attorneys' fees.

Conclusion

Litigation has receded in importance as a strategic element in U.S. contested takeovers. It has retained substantial tactical significance, principally as an adjunct to the matter of principal importance in a takeover — the economics of the transaction. As such it probably serves a useful and appropriate economic purpose — facilitation of a liquid takeover market.

Customs Law Committee

Note for Australian Business Lawyer on the Committee's Activities during 1987 and to date

The Customs Law Committee for 1987 comprised Keith Steele (Chairman), Alan Limbury, Philip Sacks, David Fairlie, Professor Colin Phegan, Charles Sweeney, John Griffiths, Leslie Katz and Jeff Waincymer. It was assisted by Minutes Secretaries Axel Rasmussen and latterly, Aldo Nicotra.

In the course of 1987 the Committee contributed to the Business Law Section submissions which were subsequently lodged by the Law Council with the Federal Government in relation to the following matters:

1. The proposed anti-dumping tribunal and the proposed sunset provisions for the review of the Customs Tariff (Anti-Dumping) Act, 1975 following the release of the Gruen Report in March 1986 and the Government's subsequent announcements in relation to its implication.

2. The Administrative Decisions (Judicial Review) Bill 1986.

3. An interim submission on the Customs and Excise Legislation Amendment Bill (No. 2) 1987.

The Committee most recently has contributed a comprehensive submission which has now been lodged with the Federal Government on the Customs and Excise Legislation Amendment Bill (No. 2) 1987.

The submission in relation to the review of the anti-dumping laws represents a continuation of the Committee's participation and involvement in the review which was triggered by the February 1986 reference to Professor Gruen by the Federal Government. The Committee consulted with and made submissions to Professor Gruen in the course of his inquiry leading to his report. Subsequent to the release of the report the Committee made a submission on its recommendations to the Minister for Industry Technology and Commerce on 31 July, 1986. In that submission, lodged through the Law Council, the Committee substantially agreed with the central thrust of the Gruen recommendations. However, the Committee recommended, inter alia, that the final determination and recommending function traditionally exercised by the Australian Customs Service in assisting the Minister to exercise his powers under the Anti-Dumping Act should be placed in the hands of an independent body which would operate in the same way as the Administrative Appeals Tribunal.

Subsequently the Government announced in October 1986 that it proposed to implement the central recom-