

## **Online Appendix for “How do Acquirers Choose between Mergers and Tender Offers?”**

### **Brief History of the Best Price Rule (SEC Rule 14d-10)**

The regulatory environment for tender offers has been in flux in the United States for many years. In 1986, the SEC adopted Rule 14d-10, otherwise known as the “Best Price Rule.” This regulation specified that, “the 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.” In other words, all investors holding the same class of securities had to be paid the same amount per share in a tender offer. The wording of the rule was not clear about whether executive compensation triggered by the tender offer was included in the definition of “consideration,” so it was left to the courts to decide. Beginning in 1995, the courts ruled that executive compensation contingent on the change-in-control could be part of the consideration paid to the executives for their shares.<sup>1</sup> From 1995 to 2002, the 2<sup>nd</sup>, 7<sup>th</sup>, and 9<sup>th</sup> U.S. Circuit Courts of Appeals made conflicting rulings about the applicability of executive compensation to the definition of consideration. Although tender offers did not disappear during this time, there was uncertainty as to whether a buyer might have to go back after completing the deal and pay the non-executive target shareholders additional compensation to make them whole.

The uncertainty about Rule 14d-10 peaked following the resolution of the case of *Gerber v. Computer Associates International (CA)* from the Second Circuit of the U.S. Court of Appeals.<sup>2</sup> In that case, a jury awarded shareholders an additional \$5.7 million after finding that a \$5 million non-compete payment to the CEO was consideration in the tender offer under Rule

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<sup>1</sup> See, for example, *Epstein v. MCA, Inc.*, 50 F.3d 644 (9th Cir. 1995)

<sup>2</sup> *Gerber vs. Computer Assocs. Int'l, Inc.*, 303 F.3d 126 (2d Cir. 2002).

14d-10. Given that CA paid \$120 million for the target, the judgment added 4.75% to their costs, not including the costs of litigating the case for nearly 11 years.

The September, 2002 decision in *Gerber v. CA* in particular made it extremely risky for a target firm to make payments to executives that were contingent upon a change in control. Based on this ruling, acquiring firms in tender offers were exposed to substantial liability if the target firm made payments to any executive via golden parachute, retention agreement, accelerated vesting, or consulting agreement, as all could be included as consideration in the tender offer. Motivated by this decision, the SEC chose to clarify that its intention with the best price rule was to exclude executive compensation. As a result, Rule 14d-10 was amended effective December 8, 2006 to require that, “the consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer.” In other words, compensation payments are excluded from the new version of the best price rule.

There is anecdotal evidence that the court rulings from 1995 to 2002, and specifically in the *Gerber v. CA* case, skewed the takeover markets away from tender offers until the revision of Rule 14d-10 in 2006. In a joint letter submitted to the SEC in 2005 upon its request for comments on the proposed changes to the rule, several top law firms noted that:

Given the current disarray among courts with respect to the proper interpretation of Rule 14d-10 under the Securities Exchange Act of 1934 (the “Exchange Act”) — and the significant litigation risks entailed in the tender offer process because of these court interpretations — most law firms are advising their clients not to commence tender offers if other acquisition structures are available that do not have the possible adverse consequences of the best-price rule — even if such

other structures may be less economically efficient for companies and their shareholders.<sup>3</sup>

Similar sentiment can be observed in newsletters that law firms sent to their clients after Rule 14d-10 was revised. For instance, in November, 2006, the law firm Morrison Foerster alerted its clients, “We anticipate that with the amendments (to Rule 14d-10) companies will use tender offers more frequently...”<sup>4</sup> Later, in guidance to clients of the law firm Skadden Arps Slate Meagher & Flom, Ward et al. (2011) note that, “This resurgence (in tender offers) is largely due to the U.S. Securities and Exchange Commission’s 2006 clarification to the all holders/best price rule regarding the treatment of employee compensation in tender offers.” Given that Offenberg and Officer (2014) find that most firms now have substantial change-in-control compensation contracts, there is reason to believe that acquiring firms were actively avoiding tenders from 2003 through 2006 so as to avoid the corresponding liability. As a result, there should have been an increase in tender offers after 2006.

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<sup>3</sup> Letter to the SEC regarding File No: S7-11-05; Release Nos. 34-52968; IC-27193 Amendments to the Tender Offer Best-Price Rule (the “Release”), sent February 21, 2006 by Cravath, Swaine & Moore LLP; Davis Polk & Wardwell; Latham & Watkins, LLP; Simpson Thacher & Bartlett LLP; Skadden, Arps, Slate, Meagher & Flom LLP; and Sullivan & Cromwell LLP.

<sup>4</sup> Morrison Foerster Client Alert, “SEC Amends Tender Offer ‘Best Price’ Rule,” 11/6/2006, retrieved from: <http://www.mofo.com/pubs/xpqPublicationDetail.aspx%3fpxST%3dPubDetail%26pub%3d7260>

The impact of the Gerber decision appears obvious in the data. Tender offers represent 14.2% of deals in 2002, but only 3.2% in 2006 (untabulated). The market for tender offers rebounds quickly after 2006, with 20% of deals executed as tenders in 2008 & 2009. Any empirical study on the choice of method must account for the legal ambiguity in the tender offer rules, particularly from 2002 through 2006. Given that the tender offer market was so skewed by the ambiguous interpretations of Rule 14d-10 and other legal changes, we focus our empirical analysis on deals initiated after 2006.

## **References**

Offenberg, D., Officer, M.S., 2014. The totality of change-in-control payments, *Journal of Corporate Finance*, forthcoming.