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TENDER OFFER DEVELOPMENTS IN 1980

A. *SEC v. Texas International Co.*

The popularity of tender offers as a means of corporate acquisition[1] has resulted in judicial and legislative definition of tender offers.[2] Generally, a tender offer consists of a public invitation by one company to purchase a fixed amount of another company's stock at a premium price.[3] Since a company makes an offer as part of a takeover attempt, the offeror may condition its obligation to purchase shares upon a sufficient number of shares being tendered.[4] In addition, the offer is usually available for only a limited period of time.[5] Prior to Congress' enactment of the Williams Act (Act),[6] target shareholders were pressured into making hasty and uninformed decisions because the offeror had no obligation to disclose its methods or intentions.[7] Congress promulgated the Williams Act as an amendment to the Securities Exchange Act of 1934

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[1] *See* Austin, *Tender Offer Update: 1978-1979*, 15 MERGERS & ACQUISITIONS 13, 23-24 (1980). Over 80% of all takeover attempts by tender offer are successful. *Id.* at 23. In 1979, there were as many as 114 tender offers despite increased economic uncertainty and strong defense tactics by targets. *Id.* at 13 n.1 & 23. In the mid-1970's, tender offers averaged 160 per year. *See id.* at 13.

[2] Courts have defined tender offers expansively by examining the substance rather than the form of unconventional transactions. In Cattlemen's Investment Co. v. Fears, 343 F. Supp. 1248 (W.D. Okla. 1972), a federal district court held that a widespread but private solicitation of a corporation's shares was a tender offer, notwithstanding that shareholders are solicited publicly in conventional tender offers. *Id.* at 1251-52; *see* text accompanying note 3 *infra*. In Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195 (2d Cir. 1978), however, the court refused to find a tender offer because the transaction was not sufficiently similar to a conventional tender offer. *Id.* at 1206. While courts have been formulating various tender offer definitions, the Securities and Exchange Commission (SEC) has proposed its own tender offer definition. *See* 44 Fed. Reg. 70,349 (Dec. 6, 1979). The SEC proposed a two-tiered test for defining a tender offer. SEC Securities Exchange Act Release No. 34-16385 (Nov. 29, 1979), *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374, at 82,603. The first tier defines a tender offer as an invitation directed to more than ten shareholders to acquire more than 5% of a security class within 45 days. *Id.* The second tier defines a tender offer as a public invitation to purchase stock at a premium price without negotiation on price or terms. *Id.* at 82,604-05. If an acquisition plan conforms to either definition, the substantive and disclosure provisions of the Williams Act apply. *Id.* at 82,603.

[3] *See* Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1250-51 (1973) [hereinafter cited as *Developing Meaning*].

[4] *Id.* at 1252.

[5] *See id.*

[6] 15 U.S.C. ¶¶ 78m(d)-(e), 78n(d)-(f) (1976 & Supp. III 1979), *amending* Securities Exchange Act of 1934 ('34 Act), 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979).

[7] *See* H.R. REP. No. 1711, 90th Cong., 2d Sess. 2, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2811, 2813; Note, *Defining Tender Offers: Resolving a Decade of Dilemma*, 54 ST. JOHN'S L. REV. 520, 520-21 & n.4-6 (1980) [hereinafter cited as *Decade of Dilemma*].

('34 Act) to alleviate these shareholder pressures and to aid shareholders in making an informed decision.[8] Section 14(d) of the Act requires tender offerors to file certain information with the Securities and Exchange Commission (SEC).[9] The filing requirements of section 14(d) apply only to tender offers for equity securities that are registered under section 12(g) of the '34 Act.[10] The fraud prohibitions of section 14(e) apply to all misrepresentations in connection with the tender offer.[11] These anti-fraud provisions attempt to ensure that target shareholders have complete and accurate information when making a decision on an offer.[12] Despite the purpose of the Act to provide adequate information to target shareholders,[13] the SEC has not promulgated a definition of tender offers.[14] Until the SEC adopts a comprehensive definition, judicial

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[8] 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979); *see* H.R. REP. No. 1711, 90th Cong. 2d Sess. 2, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2811, 2811-13. In Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977), the Supreme Court concluded that the purpose of the Williams Act is to provide adequate information to shareholders confronted by a tender offer. *Id.* at 35.

[9] 15 U.S.C. § 78n(d) (1976). Pursuant to § 14(d) of the '34 Act offerors must file with the SEC copies of the tender offer invitation and any other information the Commission may require. *Id.*

[10] *Id.* Section 14(d) requires an offeror to file only if consummation of the tender offer would give the offeror beneficial ownership of more than 5% of a class of equity securities. *Id.*

[11] 15 U.S.C. § 78n(e) (1976). Section 14(e) of the '34 Act prohibits fraud, deception and material misrepresentations in connection with a tender offer. *Id.*; *see Lewis* discussion part B *infra*. Pursuant to § 14(e), the SEC has promulgated two rules directed at preventing fraud in connection with a tender offer. *See* 17 C.F.R. § 240.14e-1, -2 (1980). Rule 14e-1 imposes timing and disclosure requirements on offerors. *Id.* § 240.14e-1 (1980); *see McDermott* discussion part C *infra*. Rule 14e-2 requires target companies to inform shareholders of its evaluation of prospective tender offers. 17 C.F.R. § 240.14e-1 (1980).

[12] *See* 44 Fed. Reg. 70,348 (Dec. 6, 1979).

[13] *See* note 8 *supra*.

[14] For over a decade, the SEC left the responsibility for definition of tender offers with the courts, theorizing that courts would then have greater flexibility in applying the SEC's tender offer regulations to the varied methods of corporate acquisition. *See* SEC Securities Exchange Act Release No.34-12676 (August 2, 1976), *reprinted in* [1975-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,659, at 86,895-96. The SEC specifically declined to propose a tender offer definition by reasoning that the dynamic nature of stock acquisition transactions renders a definition inappropriate and unnecessary. *Id.* Lacking regulatory guidance, courts constructed tender offer definitions on a case-by-case basis. *See, e.g.*, Smallwood v. Pearl Brewing Co., 489 F.2d 579, 596-98 (5th Cir. 1974); Wellman v. Dickinson, 475 F. Supp. 783, 826 (S.D.N.Y. 1979) (secret acquisition of stock from 39 solicitees at large premium is tender offer); S-G Securities, Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114, 1126-27 (D. Mass. 1978) (public announcement of intention to gain control through stock acquisition with subsequent rapid acquisition of large block constitutes tender offer); Cattlemen's Inv. Co. v. Fears, 343 F. Supp. 1248, 1252 (W.D. Okla. 1972), *vacated per stipulation*, No. 72-152 (W.D. Okla. May 8, 1972) (solicitation of stock through telephone calls, letters, and visits is tender offer); *see Decade of Dilemma*, *supra* note 7, at 522. The court's varied definitions, however resulted in such an excessive degree of diversity that the SEC recently proposed its own tender offer definition. *See* 44 Fed. Reg. 70,349 (Dec. 6, 1979) (proposed rule 14d-1(b)(1); Note, *What is a Tender Offer?*, 37 WASH. & LEE L. REV. 906, 906 (1979) [hereinafter cited as *Tender Offer*]; note 2 *supra*.

attempts at definition of tender offers will determine the scope of the Williams Act.[15]

In *SEC v. Texas International Co.*,[16] a federal district court recently extended the scope of the Williams Act by holding that an offer to purchase creditors' claims in bankruptcy that are convertible to securities is a tender offer subject to the Williams Act.[17] King Resources Corporation (KRC), an involuntarily bankrupt company, structured a corporate reorganization plan that would allow its business to continue relatively debt-free as the new Phoenix Resources Company.[18] KRC would discharge over ninety percent of its debts by issuing stock in the new company, Phoenix, to KRC's creditors.[19] After KRC's shareholders approved the reorganization plan, Texas International Company (TI) decided to acquire Phoenix by purchasing the claims of certain KRC creditors.[20]

TI's offer contained several characteristics of conventional tender offers.[21] TI made a public invitation to purchase claims of over 20,000 solicitees.[22] Additionally, the offer contained a two-week time limit that could pressure the solicitees into making a hasty decision.[23] TI provided the targeted creditors with information on the terms of the offers and also disclosed its objective to gain control of KRC-Phoenix.[24] As a result of its offer, TI acquired claims equivalent to slightly less than a majority ownership of KRC-Phoenix.[25] The SEC subsequently filed suit for injunctive relief against TI and alleged that TI's bid for KRC's creditors' claims was a tender offer and, therefore, that TI violated section 14(d) of the Williams Act by not filing a disclosure report to the SEC about its acquisition of KRC-Phoenix.[26] The SEC also alleged that some of TI's

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[15] *See* Note, *Expansion of the Williams Act: Tender Offer Regulation for Nonconventional Purchases*, 11 LOY. U. (CHI.) L. J. 277, 281 (1980).

[16] 498 F. Supp. 1231 (N.D. Ill. 1980).

[17] *Id.* at 1240.

[18] *Id.* at 1236. *See generally* Mitchell, *Securities Regulation in Bankruptcy Reorganizations*, 54 BANKR. L. J. 101 (1980).

[19] 498 F. Supp. at 1236. King Resources Corporation (KRC) paid in full the claims that were not discharged by the issuance of new stock. *Id.* KRC's trustee in bankruptcy divided the new stock into two classes and issued the shares according to the creditors' priorities. *Id.* at 1237. One group of shareholders, referred to as the Dietrich class, obtained unsecured creditor status by settling a class action lawsuit in which they charged KRC with fraudulent securities transactions. *Id.* The Dietrich class was instrumental to the fraud claims in the instant case because they were shareholders at the time of TI's alleged misrepresentations. *Id.* at 1238; *see* text accompanying notes 42-48 *infra*.

[20] 498 F. Supp. at 1237. The court commented that Texas International was "acquisition-minded" in the field of oil and gas exploration and production. *Id.*

[21] *See id.* at 1240; text accompanying notes 3-5 *supra*.

[22] 498 F. Supp. at 1240. The court stated that because TI's offer was directed to over 20,000 solicitees, the offer had a widespread impact on the investing public. *Id.*

[23] *Id.*

[24] *Id.* at 1237.

[25] *Id.* at 1238. Although TI's purchased claims amounted to less than one-third of KRC's total claims, those purchases converted into 44% of Phoenix stock. *Id.*; *see id.* at n.1.

[26] *Id.* at 1238. In order to invoke the tender offer disclosure requirements of § 14(d), the SEC had to prove that the claims of KRC's creditors amounted to equity securities under §

materials contained material misrepresentations in violation of section 14(e) of the Williams Act.[27]

To determine whether section 14(d) applied to TI, the court considered whether TI made a tender offer for a class of equity securities registered under section 12(g) of the '34 Act.[28] The district court held that in light of the purposes of the Williams Act, TI's bid constituted a tender offer.[29] The court reasoned that TI's bid possessed many of the characteristics of conventional tender offers, and that the bid presented the potential problems that the Williams Act was designed to prevent.[30] The court next found that TI's offer was for an equity security because TI purchased creditors' claims that were readily exchangeable into Phoenix equity securities.[31] Reasoning that substance and not form should control, the court held that the creditors' claims, although not securities themselves, were so closely related to the Phoenix stock that TI's offer was made for equity securities.[32]

The final consideration under section 14(d) was whether TI's offer concerned securities that were registered under section 12(g) of the '34 Act.[33] Although the targeted Phoenix stock was not registered during

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12(g) of the '34 Act. *Id.* Equity securities are defined as any stock or similar security that reflects an interest in a corporation. *See* 15 U.S.C. § 78c(a)(11) (1976). The SEC claimed that § 12(g) should apply to TI's offer because the claims were readily exchangeable into shares of Phoenix stock. 498 F. Supp. at 1238; *see* text accompanying notes 28-32 *infra.*

[27] 498 F. Supp. at 1238; *see* 15 U.S.C. §§ 78j(b) & 78n(e) (1976); 17 C.F.R. §§ 240.10b-5 & 14(e) (1980).

[28] 498 F. Supp. at 1238; *see* text accompanying notes 9 & 10 *supra.*

[29] 498 F. Supp. at 1240.

[30] *Id.* The tender offer characteristics that TI's bid possessed included a public invitation, a limited period of time for target shareholders to respond, an offer to over 20,000 solicitees, and an overt intention to gain control through the purchase. *Id.*; *see* text accompanying notes 3-5, 21-23 *supra.* The court concluded that the large number of solicitees and the two-week time limit placed pressure on the shareholders. *Id.*; *see* text accompanying notes 22 & 23 *supra.*

[31] 498 F. Supp. at 1240-41; *see* note 26 *supra.* In finding that TI's offer was for equity securities, the court emphasized that consummation of the reorganization plan was quite probable and, therefore, that TI was contemplating receiving Phoenix stock, not merely creditors' claims. *Id.*

[32] *Id.*; *see* note 31 *supra.* The *Texas International* court supported its broad use of the term "equity security" by relying on SEC v. Howey, 328 U.S. 293 (1946). In *Howey,* the Supreme Court held that definitions under the securities laws are based on flexible, not narrow principles. *Id.* at 299. In *Texas International,* the court also reasoned that the practical economic reality was that TI purchased equity securities. 498 F. Supp. at 1241.

[33] *Id.* Section 12(g) of the '34 Act requires issuers to file a registration statement with the SEC if the issuer deals in interstate commerce, has assets exceeding $1,000,000 and has a class of equity securities held by more than 500 persons. 15 U.S.C. § 781(g)(1)(B) (1976). KRC was registered under § 12(g) until bankruptcy proceedings began. 498 F. Supp. at 1241. Due to the bankruptcy proceedings and filings required thereunder, Phoenix was exempt from the registration requirements until trading in Phoenix shares began. *See id.* at 1242. Once trading began, however, Phoenix had all the characterisitcs that require registration under § 12(g). *Id.* TI's tender offer occurred before § 12(g) applied to the Phoenix shares. *Id.*

the offer, KRC stock was registered until the reorganization plan went into effect.[34] The court acknowledged that the Phoenix stock could not be deemed continuously registered through its contention to KRC because the Phoenix stock arose from creditor's claims, not from KRC stock.[35] Reasoning that Phoenix Stock had the characteristics of securities subject to section 12(g), however, the court concluded that Phoenix stock should be considered registered in order to comport with the protective purposes of the '34 Act.[36] In addition, the court found support for its decision in rule 12g-3(a) of the '34 Act, which creates a continuity of registration for securities issued by companies undergoing fundamental business changes.[37] Conceding that KRC's reorganization was not a merger or an exchange of assets to which rule 12g-3(a) refers, the court nonetheless concluded that the rule applied to KRC because KRC was indeed undergoing a fundamental business change.[38] The court reasoned that to deny the rule's application to KRC would subvert the protective purposes of the '34 Act.[39] Since TI's bid constituted a tender offer for equity securities registered under section 12(g), the court found that section 14(d) applied to TI's offer to KRC creditors.[40] Accordingly, the court held that TI violated section 14(d) by not filing the appropriate materials with the SEC as required.[41]

Regarding the SEC's section 14(e) charge that TI's offer contained material misrepresentations, the court determined that the allegation was sufficiently material to survive TI's motion for summary judgment.[42] TI contended, however, that in addition to materiality, the SEC must establish that TI's misrepresentations were made with scienter.[43] TI

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[34] *Id.* at 1341-42. *See* note 33 *supra.*

[35] 498 F. Supp. at 1243.

[36] *Id.* The court reasoned that Congress added § 12(g) to the '34 Act in order to extend the Act's disclosure obligations to a wider class of securities. *Id.*; *see* 109 CONG. REC. 13725-26 (1963); 10 CONG. REC. 17916, 17921 (1964). Phoenix was not registered during TI's offer because of the bankruptcy proceedings despite the fact that Phoenix had all of the necessary characteristics to be subject to the registration requirements. 498 F. Supp. at 1243.

[37] *See* 17 C.F.R. § 240.12g-3(a) (1980). Rule 12b-3(a) states that securities will be deemed registered in connection with mergers, exchanges of assets, or other corporate successions if the new securities are issued to the holders of another issuer's securities that are registered under § 12(g). *Id.*

[38] 498 F. Supp. at 1244.

[39] *Id.*

[40] *Id.* at 1245. The *Texas International* court found that TI owned, as a result of the offer, over 5% of Phoenix securities, a final requirement of § 14(d). *Id.*; *see* note 10 *supra.*

[41] 498 F. Supp. at 1245. The court did not grant the SEC a permanent injunction against TI because the SEC had not shown sufficient cause for the injunction. *Id.* at 1254. Reasoning that TI had in good faith attempted to comply with the federal statutes, the court concluded that TI's erroneous construction of the law could not justify a permanent injunction. *Id.*

[42] *Id.* at 1251. The SEC made four allegations of material misrepresentation, but only one contention survived a motion for summary judgment. *See id.* at 1246.

[43] *Id.* The SEC relied on Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), which held

relied on *Aaron v. SEC*,[44] which held that the scienter requirement is applicable to injunctive actions under section 10(b).[45] The court in *Texas International*, following *Aaron*, determined that the similarity between the antifraud provisions of section 10(b) and section 14(e) justifies use of the scienter requirement in section 14(e) actions.[46] Although the *Texas International* court found no scienter by TI,[47] the court nonetheless extended the scienter requirement of section 10(b) injunctive actions to section 14(e) injunctive actions.[48]

The *Texas International* court's application of sections 14(d) and 14(e) to TI's offer appropriately promotes the policies underlying the Williams Act. Although TI's offer to purchase KRC's creditors' claims was an unconventional method of corporate acquisition, the court recognized that the offer contained many of the elements of conventional tender offers and introduced many of the dangers that the Williams Act seeks to prevent.[49] In finding that TI's offer amounted to a tender offer under the Williams Act, the court properly emphasized the pressure factors on the target creditors that are identical to shareholder pressure factors in conventional tender offers.[50] Since TI's offer also contained conventional tender offer solicitation characteristics such as a large number of solicitees,[51] the court's finding of a tender offer was correct. The court also correctly construed the Williams Act to find that TI's tender offer

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that scienter is an essential element of a private fraud action for damages under § 10(b). 498 F. Supp. at 1251; *see* 425 U.S. at 193 n.12.

[44] 446 U.S. 680 (1980).

[45] *Id.* at 695. In *Aaron*, the SEC filed an injunctive suit against a managerial employee of a securities broker and alleged that the employee had violated § 17(a) of the Securities Act of 1933 ('33 Act) and § 10(b) of the '34 Act by fraudulently conducting a sales campaign for certain securities. *Id.* at 682-84. The Court reversed the court of appeals ruling that proof of negligence is sufficient to find a violation of § 10(b) of the '34 Act in civil injunctive proceedings. *Id.* at 702. *Aaron's* requirement of scienter may have a spillover effect on other fraud provisions of the securities laws. *See* Steinberg, Aaron's *Unanswered Questions*, 4 CORP. L. REV. 166, 168-69 (1981).

[46] *Id.* at 1252. Lower courts have required scienter in private actions under § 14(e). *See, e.g.*, Lowenschuss v. Kane, 520 F.2d 255, 268 n.10 (2d Cir. 1975) (knowledge or reckless disregard required, but not mere negligence); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir. 1974) (some culpability beyond mere negligence required); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362-63 (2d Cir. 1973) (knowing or reckless failure to discharge obligation required).

[47] 498 F. Supp. at 1253. The *Texas International* court applied Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), to find that TI's misrepresentations were neither knowingly nor recklessly made. 498 F. Supp. at 1252-53. The court relied on *Ernst & Ernst* rather than *Aaron* to examine the elements of scienter because *Ernst & Ernst* provided the more precise definition of scienter. *Id.* at 1252.

[48] *Id.*

[49] *Id.* at 1240; *see* note 30 *supra*.

[50] 498 F. Supp. at 1240; *see Tender Offer*, *supra* note 13, at 693-95; text accompanying notes 3-7; 22-23 *supra*.

[51] *See* text accompanying note 22 *supra*.

was for a class of equity securities registered under the '34 Act.[52] TI's offer failed technically to be for equity securities because TI bought creditors' claims, not stock.[53] TI's offer also was not for registered stock, because KRC's registration was cancelled and Phoenix had not yet registered.[54] The court overcame these technical deficiencies by examining the purposes of the Williams Act. Concluding that congressional intent to provide full disclosure to investors would be thwarted if TI's offer could escape scrutiny under the Act, the court applied section 14(d) to TI's offer.[55] Since the Act is directed to full disclosure in the securities markets and since TI's offer possessed many of the characteristics of transactions covered by the Act, the court correctly refused to permit the unorthodox nature of the reorganization plan to allow TI to avoid liability under section 14(d).[56]

The *Texas International* court's extension of the scienter requirement to injunctive action under section 14(e) also comports with the purposes of the Williams Act and with judicial precedent.[57] Both section 10(b) and section 14(e) are designed to prevent fraud and deception in the securities markets.[58] Several federal courts have favored a culpability standard such as the scienter requirement to private fraud actions under section 14(e).[59] Since tender offer fraud and general securities fraud are substantially similar, no reason exists to depart from the guidance of the Supreme Court with regard to scienter in fraud actions under the '34 Act.[60]

B. *Lewis v. McGraw-Hill*

Section 14(e) of the Williams Act[1] prohibits material misrepresentations and fraudulent practices in connection with a tender offer.[2]

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[52] *See* text accompanying notes 31 & 32 *supra*. *Cf.* E.H.I. of Florida, Inc. v. Insurance Co. of North America, 499 F. Supp. 1053, 1064 (1980) (offer to purchase corporation's assets from bondholders not offer for equity securities since no ownership interest involved).

[53] *See* text accompanying note 20 *supra*.

[54] *See* text acommpanying notes 34 & 35 *supra*.

[55] 498 F. Supp. at 1245; *see* text accompanying notes 36-39 *supra*.

[56] 498 F. Supp. at 1243.

[57] *See* text accompanying notes 8-12 *supra*.

[58] *See* discussion of similarity of § 10(b) & § 14(e) in *Lewis*, part B *infra*.

[59] *See* note 46 *supra*.

[60] *See* text accompanying note 45 *supra*.

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[1] 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976 & Supp. III 1979), *amending* Securities Exchange Act of 1934, 15 U.S.C § 78a-78kk (1976 & Supp. III 1979). Congress promulgated the Williams Act to alleviate pressure on target shareholders by requiring the offeror to disclose fully information pertinent to the tender offer. *See* H.R. REP. No. 1711, 90th Cong., 2d Sess. 2, *reprinted in* [1968] U.S. CODE CONG & AD. NEWS 2811, 2813. *See generally* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977).

[2] 15 U.S.C. § 78n(e) (1976). Section 14(e) prohibits "any untrue statement [or omission] of any material fact [that is] misleading, or . . . any fraudulent, deceptive, or manipulative

Although section 14(e) parallels the general securities fraud prohibition in section 10(b) of the '34 Act,[3] the two provisions differ in one respect. Section 10(b) prohibits fraudulent conduct in connection with an actual purchase or sale of a security.[4] Section 14(e), however, does not contain a purchase or sale limitation and thus permits nonpurchasing or nonselling parties who otherwise have standing to challenge all misrepresentations in connection with a tender offer.[5] Accordingly, courts have permitted non-tendering shareholders to sue for damages under section 14(e), provided that the transaction giving rise to the misrepresentations actually constitutes a tender offer.[6] The question remains whether a party can sue for damages under section 14(e) for misrepresentations in connection with an unrealized or proposed tender offer.[7]

In *Lewis v. McGraw-Hill*,[8] the Second Circuit determined that when a proposed tender offer has never become effective and target shareholders have never detrimentally relied on management's alleged misstatements, the shareholders have no section 14(e) damages claim against management.[9] In *Lewis*, the American Express Company

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acts or practices, in connection with any tender offer." A tender offer consists of an invitation by one company to purchase a significant amount of another company's stock at a premium price. *See* Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1250-51 (1973). Tender offers are usually a part of a takeover attempt. *See id.* at 1253.

[3] *See* 15 U.S.C. § 78j(b) (1976). Section 10(b) and rule 10b-5 prohibit fraudulent or misleading acts in connection with the purchase or sale of any security. *Id.*; 17 C.F.R. § 240 10b-5 (1980); *see* note 2 *supra*.

[4] *See* 15 U.S.C. § 78j(b) (1976); 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD, § 8.8 (1979); note 3 *supra*. Several courts have denied potential plaintiffs standing to sue under § 10(b) because the plaintiffs were not defrauded purchasers or sellers. *See, e.g.*, Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970) (tender offeror did not rely on target management's misstatements); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967) (target company has no claim against fraudulent offeror); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) (nontendering shareholders have no claim against offeror).

[5] *See* note 2 *supra*. *See also* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 116-17 (1973) [hereinafter cited as ARANOW & EINHORN]. Private litigants must prove that § 14(e) permits an implied private right of action in order to have standing to sue. *See generally*, Maher, *Implied Private Rights of Action and the Federal Securities Laws: A Historical Perspective*, 37 WASH & LEE L. REV. 783 (1980).

[6] *See, e.g.*, Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc., 307 F. Supp. 910 (S.D.N.Y. 1969), *aff'd*, 425 F.2d 842 (2d Cir. 1970); Electronic Speciality Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969); Neuman v. Elec. Specialty Co., [1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,591, at 98,705 (N.D. Ill. 1969).

[7] In Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971), a shareholder brought an action for damages under § 14(e) against the issuer for announcing a tender offer that it never intended to make. The district court dismissed the case because no tender offer was made. *See id.* at 335. On appeal, the Second Circuit dismissed the case on other grounds, but commented that the district court's reading of § 14(e) may have been too restrictive. *See id.*

[8] 619 F.2d 192 (2d Cir. 1980).

[9] *Id.* at 193, 195-96. The court in *Lewis* noted that the shareholders could recast their claims as state law actions for the directors' breach of fiduciary duty. *Id.* at 195; *see* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

(AMEXCO) made two tender offer proposals to McGraw-Hill, Inc.[10] McGraw-Hill's board of directors opposed the first proposal despite the premium price that AMEXCO offered.[11] The McGraw-Hill directors characterized AMEXCO's initial offer as reckless, illegal, and improper.[12] AMEXCO withdrew that proposal before the offer became effective and submitted a second proposal at a higher premium expressly contingent upon the approval of McGraw-Hill's management.[13] The McGraw-Hill board rejected AMEXCO's second proposal as inadequate, and the proposed offer expired without ever becoming effective.[14]

McGraw-Hill's shareholders brought suit for damages in federal district court against McGraw-Hill and its directors by alleging that the directors made material, false statements in violation of section 14(e).[15] McGraw-Hill moved to dismiss the complaint for lack of subject matter jurisdiction.[16] To address McGraw-Hill's motion, the district court considered whether the shareholders had alleged that management's conduct was "in connection with" a tender offer under section 14(e),[17] and if so, whether the shareholders relied on and were injured by management's conduct.[18] The court concluded that the McGraw-Hill shareholders' claim was within section 14(e) because AMEXCO had made a public announcement of the proposed tender offer and had established a clear intent to make the offer.[19] Nevertheless, the court determined that

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[10] 619 F.2d at 194. AMEXCO initially offered to purchase 49% of McGraw-Hill's shares for $34 each. *Id.* At the time of AMEXCO's announcement, the market price of McGraw-Hill's securities was $26 per share. *Id.* AMEXCO's second offer was at a price of $40 per share, and AMEXCO offered to buy all of the McGraw-Hill shares. *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.* AMEXCO's second offer would not become effective unless McGraw-Hill promised not to oppose the offer by "propaganda, lobbying, or litigation." *Id.*

[14] *Id.*

[15] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 96,566 (S.D.N.Y. 1979). The plaintiff shareholders in *Lewis* alleged that the defendants wrongfully described AMEXCO's offer as inadequate despite their knowledge that the offer price was fair. *Id.* at 96,567. Plaintiffs further contended that the defendants had sullied the integrity of AMEXCO through various spurious allegations. *Id.* Finally, plaintiffs contended that the director's characterization of the initial offer as improper was false because earlier, McGraw-Hill had described AMEXCO as a proper and desirable merger partner. *Id.*

[16] *Id.*; *see* FED. R. CIV. P. 12. McGraw-Hill claimed that no § 14(e) damages claim could arise because no tender offer ever existed. *See* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 96,568.

[17] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 96,568; *see* note 2 *supra.*

[18] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 96,570. The district court in *Lewis* also considered defendant's argument that plaintiffs had alleged merely breaches of fiduciary duty which are not actionable under § 14(e). *Id.* at 96,569. The court concluded that plaintiffs alleged both nondisclosure and misleading disclosure, which can be viewed as manipulative or deceptive acts under § 14(e). *Id.* Accordingly, the court refused to dismiss the claim for lack of alleged deception. *Id.*

[19] *Id.* at 96,568. The district court in *Lewis* relied on two cases that permitted § 14(e) injunctive actions for proposed tender offers. *See id.*; Reserve Management Corp. v. Anchor Daily Income Fund, Inc., 459 F. Supp. 597, 608 (S.D.N.Y. 1978); Applied Digital Data Sys.,

the complaint lacked the requisite showing of reliance and causation since the shareholders were never in a position to make a decision that would have caused them any loss.[20] Finding reliance impossible, the district court granted McGraw-Hill's motion and dismissed the shareholder's claim.[21]

On appeal, the Second Circuit held that the shareholders' complaint against McGraw-Hill was properly dismissed.[22] The court based its holding on the absence of detrimental reliance by the shareholders.[23] While acknowledging that reliance may be presumed from the materiality of the alleged misstatements,[24] the court declined to make that presumption in *Lewis*.[25] The court reasoned that reliance was impossible because the shareholders never had an opportunity to tender their shares.[26] In contrast to the district court, the Second Circuit did not specifically address the issue whether the McGraw-Hill shareholders had alleged conduct in connection with a tender offer under section 14(e).[27]

The Second Circuit evaded the crucial issue that *Lewis* presents. The court failed to consider whether a damages claim can arise from section 14(e) where the tender offer never materializes.[28] The district court,

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Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1155 (S.D.N.Y. 1977). *Reserve Management* interpreted *Applied Digital* as allowing § 14(e) actions only where the offer has been publicly announced and the offeror has established a clear intent to make the offer. 459 F. Supp. at 608. The district court in *Lewis* rejected defendant's suggestion that *Applied Digital* pertains only to injunctive actions and could not be used as precedent for *Lewis*, a damages action. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 97,568. The court reasoned that *Applied Digital* did not so limit its reasoning and that to preclude an action for damages under § 14 would be inconsistent with the purpose of § 14. *Id.*; *see* text accompanying notes 29-36 *infra*.

[20] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 97,570. The district court in *Lewis* explained that plaintiffs alleged that the defendants frustrated consummation of the proposed tender offer, but that plaintiffs alleged no reliance by shareholders or AMEXCO. *Id.* Frustration of a tender offer alone will not create a § 14(e) action. *See* Rediker v. Geon Indus., Inc., 464 F. Supp. 73, 82 (S.D.N.Y. 1978).

[21] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 97,570-71.

[22] 619 F.2d at 195.

[23] *See id.* The *Lewis* court stated that an element of a cause of action under § 14(e) is a showing of reliance by shareholders on the alleged misrepresentation. *Id.* (citing Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973)).

[24] 619 F.2d at 195; *see* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970) (reliance presumable from materiality where too burdensome to prove otherwise); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 375 (2d Cir. 1973) (reliance presumable only when logical).

[25] 619 F.2d at 195.

[26] *Id.* The McGraw-Hill shareholders were never given an opportunity to tender their shares. Rather, they received information which caused them to anticipate having the opportunity to tender. *See id.*

[27] *Compare* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 97,568 *with* 619 F.2d at 195. The *Lewis* court obliquely noted that statements may be in connection with a tender offer only if reliance can be presumed and the tender offer becomes effective. 619 F.2d at 195; *see* note 44 *infra*.

[28] 619 F.2d at 193-96. The appeals court in *Lewis* correctly characterized the issue as whether the shareholders could maintain an action for damages under § 14(e) where no

however, did address the issue directly and held that a damages claims under section 14(e) for statements about a proposed tender offer should be permitted.[29] In so finding, the district court relied on two cases that permitted injunctive relief for proposed tender offers to address the *Lewis* question of monetary relief.[30] These courts permitted injunctive actions under section 14(e) so long as the proposed offer was publicized and the offeror exhibited a definite intent to make the offer.[31] The courts stated that if these two criteria are met, then the plainiff will have alleged conduct "in connection with" a tender offer that is actionable under section 14(e).[32]

The rationale that has supported injunctive actions for proposed tender offers is equally applicable to damages actions for ineffective tender offers.[33] Courts have held that the public announcement of a proposed tender offer presents the dangers of misrepresentation that section 14(e) was designed to prevent.[34] In situations where the damage is already done, injunctive relief would be pointless. As the district court in *Lewis* correctly concluded, if damages claims under section 14(e) for proposed tender offers are prohibited, then target companies would have a safe harbor from liability if they successfully used deception to thwart a proposed tender offer.[35] The broad remedial purposes of section 14(e) mandate that material misrepresentations in connection with proposed tender offers be subject to effective challenge.[36] In the future,

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tender offer had been made, but the court addressed only the question of the shareholder's reliance. *Id.* at 193.

[29] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 97,568; *see* text accompanying notes 17-19 *supra.*

[30] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,195, at 97,568. *See, e.g.*, Reserve Management Corp. v. Anchor Daily Income Fund, Inc., 459 F. Supp. 597, 608 (S.D.N.Y. 1978); Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1155 (S.D.N.Y. 1977). *See also* note 19 *supra.*

[31] 459 F. Supp. at 608.

[32] *Id.*; *see* note 19 *supra.*

[33] *See* Reserve Management Corp. v. Anchor Daily Income Fund, Inc., 459 F. Supp. 597, 608 (S.D.N.Y. 1978); Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1155 (S.D.N.Y. 1977); text accompanying notes 31 & 32 *supra. Cf.* Berman v. Gerber Products Co., 454 F. Supp. 1310, 1317-18 (W.D. Mich. 1978) (dismissal of § 14(e) damages claim because tender offer proposal not firm).

[34] Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1155 (S.D.N.Y. 1977).

[35] [1979-1980 Transfer Binder] FED. SEC. L. REP. ¶ 97,195, at 97,568.

[36] The court in *Applied Digital* reasoned that to limit the disclosure and fair dealing provisions of the '34 Act to the time after an offer actually has been made would thwart the purposes of § 14(e). 425 F. Supp. at 1154.

The Supreme Court's emphasis on the broad remedial purposes of the '34 Act was established in J. I. Case Co. v. Borak, 377 U.S. 426 (1964). In *Borak*, the Supreme Court liberally construed the federal securities laws to find an implied private right of action under § 14(a) of the '34 Act. *Id.* at 432. The Court focused on Congress' intent to protect investors as the justification for implying a private right of action. *Id.* at 431-32. Recently, however, the Supreme Court has established a restrictive approach to implying a private cause of action under the securities laws. The Supreme Court now emphasizes congressional

courts should follow the lead of the district court in *Lewis* by permitting actions for damages under section 14(e) for statements in connection with proposed tender offers.

Although allowing such damages claims will afford investors more remedies than currently exist, the practical difficulties of proving a shareholder's reliance under section 14(e) when no tender offer exists reduces the impact of these damages actions. The *Lewis* case exhibits circumstances in which the target shareholders likely were harmed because they lost the opportunity to respond to a proposed tender offer that could have become effective absent target management's opposition to the proposal.[37] Since the proposed tender offer never became effective, the shareholders never received an opportunity to rely on management's evaluation of AMEXCO's proposed offer.[38] In other circumstances, however, reliance may indeed be possible. For example, if a person announces a proposed tender offer solely to sell his own lot of the target's securities at higher prices, target shareholders may have a section 14(e) damages claim against the offeror.[39] In reliance on his proposed offer, target shareholders may decline to sell in the market at a favorable price while waiting to tender their shares to the offeror. Once the fraudulent offeror has disposed of his shares at a favorable price and has withdrawn the proposed tender offer, the harmed shareholders could gain nothing by an injunctive suit.[40] A damages action would be the only means of giving the shareholders an effective remedy for the offeror's misstatements, and the shareholders could successfully claim the requisite reliance.[41]

The Second Circuit decided *Lewis* solely on the McGraw-Hill shareholders' lack of reliance on the directors' statements.[42] The *Lewis* court failed to consider whether the shareholders had standing to sue for damages under section 14(e) for statements "in connection with" a tender offer. The district court in *Lewis*, however, held that

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intent as expressed in the statutory language and the legislative history of the statute in question. *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 568-69 (1979); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754-55 (1975). The Court's current strict constructionist approach to granting implied private rights of action indicates that the implication of damages claims under § 14(e) for tender offers not actually made will be subject to severe judicial scrutiny. *See generally* Note, *Section 17(a) of the '33 Act: Defining the Scope of Antifraud Protection*, 37 WASH. & LEE. L. REV. 859 (1980).

[37] *See* text accompanying notes 9-14 *supra*.

[38] *See* 619 F.2d at 194-195; *accord*, Rediker v. Geon Indus., Inc., 464 F. Supp. 73, 82 (S.D.N.Y. 1978).

[39] *See* Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971). *Levine* raised the issue of § 14(e) damages claims for tender offers never actually made, but the court dismissed the claim without reaching the § 14(e) question. *Id.* at 335; *see* ARANOW & EINHORN, *supra* note 5, at 123 (discussion of *Levine*); note 7 *supra*.

[40] *See* text accompanying notes 34-35 *supra*.

[41] *See* notes 23 & 24 *supra*.

[42] *See* text accompanying notes 22-28 *supra*.

shareholders could bring a section 14(e) damages action despite the tender offer never having been made.[43] Consequently, the Second Circuit's failure to address this issue leaves in doubt the availability of section 14(e) damages claims for ineffective tender offers.[44] Although the district court's opinion represents the correct approach to section 14(e) damages claims,[45] a definitive resolution of the issue must await further judicial deliberation.

C. *McDermott, Inc. v. Wheelabrator-Frye, Inc.*

Section 14(d)(4) of the Williams Act enables the SEC to prescribe rules and regulations governing solicitation of tender offers as a means of protecting investors.[1] Pursuant to section 14(d)(4), the SEC adopted rule 14d-4(c) which requires tender solicitors to disseminate information on any material changes in a tender offer.[2] The rule obligates the solicitor to distribute the information in a manner reasonably designed to inform the target shareholders of the change.[3] In addition, SEC rule 14e-1(b) requires tender offers that have undergone an increase in offered consideration to remain open for ten days following the increase.[4] Similarly, rule 14e-1(a) requires all tender offers to remain open for a minimum of twenty days.[5] While the SEC has established the length of time that a tender offer must remain effective after the solicitor raises

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[43] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) 97,195, at 96,568; *see* text accompanying notes 17-21 *supra*.

[44] The Second Circuit's focus on reliance in *Lewis* may be construed as an acceptance of the district court's holding that the shareholders had established standing under § 14(e). *See* text accompanying notes 17-19, 23-27 *supra*. On the other hand, the court's brief mention of an effective tender offer as a requirement of a section 14(e) damages claim, *see* note 27 *supra*, may contradict the district court and indicate that the Second Circuit will not allow damages claims to arise from tender offers not actually made. *See* 619 F.2d at 195; text accompanying notes 27 & 28 *supra*.

[45] *See* text accompanying notes 33-36 *supra*.

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[1] 15 U.S.C. § 78n(d)(4) (1976). Section 14(d)(4) regulates both solicitation of tender offers and recommendations to shareholders to accept or reject an offer. *Id.* The SEC has promulgated rules under § 14(d)(4) that promote adequate disclosure to shareholders and the public to ensure that investors can make informed decisions. *See* Texasgulf, Inc. v. Canada Dev. Corp., 366 F. Supp. 374, 420 (S.D. Tex. 1973).

[2] *See* 17 C.F.R. § 240.14d-4(c) (1980). Rule 14d-4(c) also has statutory authority in 15 U.S.C. §§ 77g, 77j, 77s(a), 77ttt(a), 78c(b), 78j(b), 78m, 78n, 78w(a) (1976 & Supp. III 1979). *See* 44 Fed. Reg. 70,341 (Dec. 6, 1979).

[3] 17 C.F.R. § 240.14d-4(c) (1980).

[4] 17 C.F.R. § 240.14e-1(b) (1980). Rule 14e-1(b), promulgated pursuant to § 14(e), is designed to prevent manipulative practices by the solicitor. *Id.*; *see* 44 Fed. Reg. 70,348 (Dec. 6, 1979).

[5] 17 C.F.R. § 240.14e-1(a) (1980). In promulgating rule 14e-1(a), the SEC determined that tender offers must be open at least twenty days to provide shareholders with access to all information and to prevent deceptive acts by the offeror. *Id.*; *see* 44 Fed. Reg. 70,384 (Dec. 6, 1979).

the offered consideration,[6] rule 14d-4(c) does not state the amount of time, if any, during which a tender offer must remain open after the offeror makes a material change in the offer.[7]

In *McDermott, Inc. v. Wheelabrator-Frye, Inc.*,[8] the Seventh Circuit considered whether an increase in the number of shares sought in a tender offer requires an extension of the offering period of the tender offer. The court determined that such an increase does not require a twenty day extension of the offering period because the increase does not constitute a new tender offer subject to rule 14e-1(a).[9] McDermott and Wheelabrator made rival tender offers for control of a third corporation, Pullman, Inc.[10] During the offer, Wheelabrator increased the number of shares it sought to purchase but changed no other terms of the offer.[11] Through the increased offer, Wheelabrator changed its potential ownership of Pullman shares from 27% to 49%.[12] In effect, the increase would have given Wheelabrator control of Pullman.[13] On the day of Wheelabrator's increase, McDermott appeared before the district court to request a temporary restraining order against Wheelabrator's increased offer, which would have expired at the end of that day.[14] McDermott alleged that Wheelabrator had made a new tender offer for Pullman shares by increasing the number of shares sought.[15] McDermott contended, therefore, that Wheelabrator had violated rule 14e-1(a) of the

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[6] *See* text accompanying notes 4 & 5 *supra.*

[7] See 17 C.F.R. § 240.14d-4(c) (1980). Although rule 14d-4(c) contains no specific requirement extending the offer to allow for dissemination of information on material changes, the rule requires prompt dissemination in a reasonably informative manner. No court has previously litigated the implication of a time requirement in rule 14d-4(c).

[8] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,687, at 98,609 (7th Cir. 1980).

[9] *Id.* at 98,611; *see* text accompanying notes 20-22 *infra.*

[10] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,687, at 98,609. Pullman favored being acquired by Wheelabrator and was hostile to the offer by McDermott. *Id.* Wheelabrator's original offer was for 3,000,000 of Pullman's 11,150,000 outstanding shares at $52.50 per share. *Id.* McDermott had offered to purchase 5,400,000 shares of Pullman at $43.50 per share. *Id.* Wheelabrator had received over 1,000,000 shares, while McDermott had garnered almost 4,000,000. *Id.* at 98,610.

[11] *Id.* Wheelabrator increased the number of Pullman shares it sought to 5,500,000. *Id.* The increase had no immediate impact on the number of shares tendered, presumably because arbitragers were holding out for a reactionary increase by McDermott. *Id.*

[12] *Id.* at 98,613 (Pell, J., dissenting).

[13] *Id.*

[14] *Id.* at 98,610. McDermott increased its offering price subsequent to Wheelabrator's increase in order to attract some of Pullman's shareholders who had previously tendered to Wheelabrator. *Id.* McDermott requested a restraining order which would have given Pullman shareholders more time to withdraw their shares tendered to Wheelabrator and tender them to McDermott. Paradoxically, by the expiration date of Wheelabrator's offer, almost all of the shares provisionally tendered to McDermott were withdrawn and tendered to Wheelabrator. [1979-1980 Transfer Binder] FED SEC. L. REP. (CCH) ¶ 97,687, at 98,610.

[15] *Id.* McDermott argued that Wheelabrator's increase in the number of securities sought was such a material change that it constituted an entirely new tender offer. *Id.*

Williams Act by not extending its tender offer for another twenty days.[16] The district court granted McDermott's motion and ordered Wheelabrator to extend its changed tender offer by twenty days.[17]

On appeal to the Seventh Circuit, Wheelabrator sought to vacate the district court's order.[18] In deciding to lift the restraining order, the Seventh Circuit disagreed with the district court's ruling that an increase in the number of shares solicited constitutes a new tender offer.[19] The court reasoned that the SEC regulations do not treat an increase in consideration as a new tender offer and require only a ten day extension.[20] An increase in the number of shares sought, therefore, should not be subject to the more extensive twenty day requirement.[21] The court concluded that the restraining order could not be based upon McDermott's argument that the increase in the number of shares constituted a new tender offer.[22]

McDermott also asserted a new argument on appeal based on the dissemination requirements for material changes under rule 14d-4(c).[23] McDermott argued that Wheelabrator's increase in the number of shares sought was a material change in information that required Wheelabrator to extend the offer for a reasonable period of time so that the increase could be disclosed.[24] The Seventh Circuit failed to decide that the increase was material information.[25] The court ruled, however, that if rule 14d-4(c) did require the offer to remain open for a reasonable time beyond the increase, then the six days that passed between the district court's order and the appeal clearly were adequate for the information to be disseminated.[26] Accordingly, the Seventh Circuit vacated the district court's order that had extended Wheelabrator's offer for twenty days.[27] The Seventh Circuit's holding in *McDermott*, however, will be of little precedential value because the court refused to find that a

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[16] *Id.*

[17] [1979-1980 Transfer Binder] FED. SEC. L. REP (CCH) ¶ 97,687, at 98,610. The district court reasoned that the twenty day extension was necessary so that tendering shareholders who choose to do so would have time to withdraw their shares from Wheelabrator. *Id.*

[18] *Id.* at 98,610 & n.5.

[19] *Id.* at 98,611.

[20] *Id.*; *see* 17 C.F.R. § 240.14e-1 (1980); note 4 *supra.*

[21] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,687, at 98,611. The *McDermott* court noted the illogicality of assuming that the SEC would limit to ten days the dissemination period for changes in consideration, yet impose a twenty day requirement for changes in the number of shares sought. *Id.*

[22] *Id.*

[23] *Id.*; *see* 17 C.F.R. § 240.14d-4(c) (1980); text accompanying notes 2 & 3 *supra.*

[24] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,687, at 98,611.

[25] *Id.* The *McDermott* court assumed, but expressly did not decide, that the regulations required Wheelabrator's offer to remain outstanding for a reasonable period. *Id.*

[26] *Id.* Since the time between the district court's holding and the circuit court's reversal was an appropriate period of time for dissemination of the changed offer, the Seventh Circuit did not remand *McDermott* to the district court to fix the reasonable time. *Id.*

[27] *Id.*

change in the number of shares sought in a tender offer is a material change requiring a reasonable time for dissemination.[28]

Wheelabrator's increased offer almost doubled the number of Pullman shares it was seeking and, thereby, created the potential for effective control of Pullman.[29] The likelihood of a change in corporate control to which the increased offer gave rise reasonably could affect the decisions of tendering shareholders.[30] The court thus would have been entirely correct in finding that an increase in the number of shares sought requires a reasonable extension of the offering period. Since the court refused to make that determination, *McDermott* stands only for the proposition that an increase in the number of shares sought is not a new tender offer.[31]

D. *Proposed Rule 13e-2*

Corporations commonly acquire their own stock through stock repurchase plans.[1] An issuer may choose to repurchase some of its own stock to increase financial leverage,[2] to reduce shareholder services costs,[3] or to entrench itself in the face of takeover proposals.[4] Some

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[28] *See* text accompanying notes 25 & 26 *supra.*

[29] *See* text accompanying note 12 *supra.*

[30] *See* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,687, at 98,613 (Pell, J., dissenting).

[31] *See* text accompanying notes 19-22 *supra.*

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[1] Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545, 1545 (1980) [hereinafter cited as Nathan & Sobel]. An issuer may repurchase its stock through an open market transaction, a privately negotiated purchase, or through a cash tender offer. *Id.* An issuer may have a variety of business reasons for repurchasing the stock. *See* text accompanying notes 2-5 *infra. See generally* Manges, *SEC Regulation of Issuer and Third Party Tender Offers*, 8 SEC. REG. L. J. 275 (1981).

Most states have statutes that permit stock repurchases. *See* 1 MODEL BUS. CORP. ACT ANN. § 5 ¶ 5 (1976). Repurchases may not, however, force the corporation into insolvency or impair the corporation's stated capital. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160 (1980); OHIO REV. CODE § 1701 (1980); MODEL BUS. CORP. ACT § 5 (1976). Federal regulation of issuer repurchases is based on § 13(e) of the Securities Exchange Act of 1934 ('34 Act). *See* 15 U.S.C. § 78m(e) (1976); text accompanying notes 7-16 *infra.*

[2] Zilber, *Corporate Tender Offers for Their Own Stock: Some Legal and Financial Considerations*, 33 U. CIN. L. REV. 315, 317-19 (1964). Repurchases can strengthen a corporation's financial position in a number of ways. Issuers may want to acquire stock for future acquisitions without diluting present capital, to reduce excess cash, or to recapitalize the corporation. *Id.*

[3] Note, *Corporate Stock Repurchases Under the Federal Securities Laws*, 66 COLUM. L. REV. 1292, 1293 (1966). The expense of notifying small shareholders of corporate proceedings may surpass the small shareholders' earnings and may justify the corporation's attempt to eliminate these small shareholders. *See id.*

[4] Nathan & Sobel, *supra* note 1, at 1546. A repurchase may ward off a prospective tender offer by increasing the percentage of stock held by a dedicated control group or by raising the price beyond that which the bidder is willing to pay. *Id.* at 1557.

repurchase plans are transactions that eliminate public shareholders and concomitant federal regulation.[5] Since repurchases are conducted by corporate insiders who may be able to coerce or pressure shareholders into tendering their shares for the sole benefit of the corporation, courts have concluded that repurchasing corporations should sustain a heavier burden of disclosure and fair dealing than purchasers who are not affiliated with the corporation.[6]

Consistent with the aims of the Securities and Exchange Commission (SEC) to protect investors and to encourage the smooth operation of financial markets,[7] the SEC currently regulates issuer repurchases through several different provisions under the '34 Act. Issuers are subject to the general fraud and manipulation prohibitions of rule 10b-5.[8] Under rule 10b-6, issuers participating in the distribution of securities may not bid for any of the securities until the distribution is completed.[9] Section 14(e) prohibits all purchasers, including issuers, from making material misrepresentations when purchasing shares through a tender offer.[10] Only one section of the '34 Act, however, directly pertains to issuer repurchases.[11] Section 13(e) enables the SEC to adopt rules and regulations that govern purchases by an issuer of its own securities.[12] Congress passed section 13(e) as part of the tender offer legislation in

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[5] *See* E. ARANOW, H. EINHORN, & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 258-59 (1977) [hereinafter cited as CORPORATE CONTROL DEVELOPMENTS]. *See generally* Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975). Going private transactions, in which the securities of the issuer will be held by fewer than 300 persons, are subject to rule 13e-3 of the '34 Act. *See* 17 C.F.R. § 17 C.F.R. § 240.13e-3 (1980), text accompanying note 62 *infra.*

[6] *See, e.g.* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 598 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974); Tanzer v. Haynie, 405 F. Supp. 650, 654-56 (S.D.N.Y. 1976); Broder v. Dane, 384 F. Supp. 1312, 1318 (S.D.N.Y. 1974). *See also* 1 A. BROMBERG, SECURITIES LAW FRAUD § 6.4(1), at 125 (1975).

[7] *See* Smolowe v. Delendo Corp., 36 F. Supp. 790, 791 (D.C.N.Y. 1940).

[8] *See* 17 C.F.R. § 240.10b-5 (1980); 2 A. BROMBERG, SECURITIES LAW FRAUD § 7.3(3), at 159-60 (1975).

[9] *See* 17 C.F.R. § 240.10b-6 (1980). A distribution is a major selling effort by an issuer of its securities. 2 A. BROMBERG, SECURITIES LAW FRAUD § 7.3(3), at 159 (1975). The SEC grants exemptions from rule 10b-6 where a specific transaction does not present the potential for abuse that the rule seeks to prevent. *See, e.g.*, Scientific Software Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,532.

[10] *See* 15 U.S.C. § 78n(e) (1976); *see, e.g.*, Smallwood v. Pearl Brewing Co., 489 F.2d 579, 598 (5th Cir. 1974); Broder v. Dane, 384 F. Supp. 1312, 1318 (S.D.N.Y. 1974).

[11] 15 U.S.C. § 78n(e) (1976); *see* note 12 *infra.* Sections 10(b) and 14(e) of the '34 Act are provisions of general applicability to security transactions, but the sections may properly be applied to specific repurchases. *See* 15 U.S.C. §§ 78j(b); 78n(e) (1976); text accompanying notes 8-10 *supra.*

[12] 15 U.S.C. § 78m(e) (1976). Section 13(e) prohibits issuers from purchasing their own securities if the purchases contravene SEC rules against fraudulent, deceptive or manipulative acts. *Id.* The statute also enables the SEC to prescribe rules to prevent those deceptive practices. Id.

the Williams Act,[13] but the section is not limited to regulating repurchases in connection with a tender offer.[14] Nonetheless, the only rules promulgated under section 13(e) to date apply to repurchases in the context of a tender offer.[15] The SEC, however, recently has proposed rule 13e-2 as a rule of general applicability to issuer repurchases.[16]

Rule 13e-2 has a two-fold purpose. The primary purpose of rule 13e-2 is to provide guidance to issuers involved in legitimate repurchase programs.[17] The SEC contends that current regulation of repurchases through the general fraud and manipulation prohibitions is inadequate because the regulation is piecemeal.[18] The SEC has concluded that a rule of specific applicability to repurchases is necessary to assist issuers and their affiliates in avoiding the risk of liability for inadequate or improper disclosure.[19] The SEC also designed rule 13e-2 to curb the issuer's opportunity for abuse in a repurchase plan by limiting the ability of an issuer to control the price of the securities.[20] Controlling the price of a corporation's securities may be of special benefit to the controlling shareholders or to incumbent management.[21] Shareholders who have an interest in maintaining control of the corporation may attempt to control the stock

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[13] 15 U.S.C. § §§ 78m(d)-(e), 78n(d)-(f) (1976), *amending* Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. III 1979).

[14] *See* note 12 *supra.*

[15] *See* note 17 C.F.R. § 240.13e-1 (1980) (prohibiting issuer repurchase if third party has filed tender offer proposal); § 240.13e-3 (regulating "going private" tender offers); § 240.13e-4 (regulating issuer tender and exchange offers).

[16] *See* SEC Release No. 33-6248; 34-17222; *reprinted in* [1980] 575 SEC. REG. & L. REP. (BNA) (K-1) [hereinafter cited as Proposed Rule]. Three issuer repurchase rule proposals have preceded the current proposed rule 13e-2. *See* Proposed Rule 10b-10, *reprinted in, Hearings on S.510 before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 214-16 (1967) (first proposed rule); Securities Exchange Act Release No. 8930 (July 13, 1970), 35 Fed. Reg. 11,410 (1970) (second proposed rule); Securities Exchange Act Release No. 10539 (December 6, 1973) 38 Fed. Reg. 34,341 (1973) (third proposed rule).

[17] *See* Proposed Rule, *supra* note 16, at K-4. Corporations that can relate repurchases to a legitimate corporate purpose are unlikely to suffer judicial intervention. *See, e.g.*, National Union Elec. Corp. v. Nat'L Presto Indus., Inc., [1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,460 (W.D. Wis. 1969) (valid repurchase since part of longstanding reacquisition for corporation investments); Cheff v. Mathes, 41 Del. Ch. 494, 499, 199 A.2d 548, 554 (1964) (valid repurchase since good faith maintenance of proper business practice). Some repurchase plans may not have a legitimate corporation purpose if the repurchase involves a bad faith attempt by management to retain control. *See* Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962).

[18] *See* text accompanying notes 51-62 *infra.*

[19] Proposed Rule, *supra* note 16, at K-1; *see* text accompanying notes 51-56 *infra.*

[20] Proposed Rule, *supra* note 16, at K-1. Issuers can control the price of their securities through a repurchase because the market tends to respond favorably to actively traded issues. 2 A. BROMBERG, SECURITIES LAW FRAUD § 7.3(3), at 159 (1975).

[21] Proposed Rule, *supra* note 16, at K-2. Issuers may want to control the price of their securities as a means of raising capital without diluting present ownership, or to enable the issuer to make stock exchanges or purchase assets. *Id.*

price to raise capital or purchase assets.[22] Incumbent management may discourage acquisition by hostile investors through inflating the price of the issuer's securities.[23] In light of these potential abuses, the SEC has determined that specific regulation is necessary to prevent issuer control of the price of securities.[24]

To meet the goals of adequate guidance for issuers and elimination of price control by issuers, the SEC included both purchase limitations and disclosure requirements in proposed rule 13e-2.[25] The purchase limitations are a codification of prior SEC policy and interpretations of the antifraud provisions as applied to issuer repurchases.[26] To prevent the issuer from dominating the market, the rule restricts the volume of shares an issuer may repurchase.[27] The rule also prevents issuers from establishing the opening or closing price of the security.[28] The SEC adopted this limitation as necessary to prevent issuer price control.[29] As another means of preventing issuer control, the rule prohibits issuer

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[22] *Id.* Controlling shareholders may choose to purchase more shares to increase their control position and to eliminate dissident shareholders. *See* Nathan & Sobel, *supra* note 1, at 1546.

[23] Proposed Rule, *supra* note 16, at K-2. Repurchases designed to prevent or forestall acquisition by an outsider are referred to as defensive stock acquisition programs. Nathan & Sobel, *supra* note 1, at 1557. Defensive acquisitions may increase the number of shares held by a safe control group, may raise the stock beyond which the offeror will pay, may eliminate vulnerable shareholders, and may permit the issuer to settle with the offeror by buying at a premium the offeror's stock. *Id.*

[24] Proposed rule, *supra* note 16, at K-1. An essential purpose of the '34 Act is to prevent manipulation of markets. *See* SEC v. Scott Taylor & Co., 183 F. Supp. 904, 906 (D.C.N.Y. 1959); note 16 *supra.*

[25] Proposed Rule, *supra* note 16, at K-2 (proposed rule 13e-2(d) & (e)). In addition to purchase and disclosure requirements, *see* text accompanying notes 25-34 *infra*, rule 13e-2 contains a general antifraud and antimanipulation provision similar to § 10(b) of the '34 Act. *See* Proposed Rule, *supra* note 16, at K-20 (proposed rule 13e-2(b)).

Rule 13e-2 applies to issuers, affiliates, and affiliated purchasers. *See id.* at K-18 (proposed rule 13e-2(a)). An issuer is a company with securities registered under § 12 or § 15(d) of the '34 Act, or a closed-end investment company registered under the Investment Company Act of 1940. *Id.* (proposed rule 13e-2(3) & (4)). An affiliate is any person who control or is under the control of the issuer. *Id.* (proposed rule 13e-2(a)(1)). An affiliate purchaser includes persons who act with the issuer in acquiring the issuer's securities, who controls the issuer's purchases, whose purchases are controlled by the issuer, or who controls the issuer through owning the issuer's securities. *Id.* (proposed rule 13e-2(a)(2)). Brokers and dealers are expressly excluded from the definition of affiliated purchasers, even if they participate in a 13e-2 purchase. *Id.* (proposed rule 13e-2(a)(2)(iv)).

[26] *Id.* at K-2, K-4 & n.10 & 11; *see* text accompanying notes 35-43 *infra.*

[27] Proposed rule, *supra* note 16, at K-22 (proposed rule 13e-2(e)(4)). The volume limitations of rule 13e-2 prohibit a purchase that. when added to all other 13e-2 purchases of that day, exceeds the higher of one round lot or the number of round lots nearest to 15% of the security's trading volume. *Id.*

[28] *Id.* at K-21 & 22 (proposed rule 13e-2(e)(2)). An issuer may not make a 13e-2 purchase if that purchase would be the opening transaction of a national exchange or if the purchase would be within one-half hour of the scheduled closing of the exchange. *Id.*

[29] *Id.* at K-2; *see* text accompanying notes 20-24 *supra.*

price leadership.[30] Issuers also are restricted to purchasing through one broker per day, so that they cannot create a misleading appearance of widespread purchases.[31] The disclosure requirements of proposed rule 13e-2 attempt to inform investors participating in the market that an issuer is purchasing its own securities.[32] Only issuer repurchase programs acquiring more than 2% of the outstanding stock must comply with the disclosure provisions.[33] The provisions under rule 13e-2 require issuers to disclose pertinent information in a manner reasonably designed to inform investors of the pending repurchase.[34]

Rule 13e-2 is patterned after two settlements arranged by the SEC in 1966.[35] In *SEC v. Georgia Pacific Corp.*[36] and *Genesco, Inc.*,[37] the SEC enjoined two corporations from violating the antifraud and antimanipulation provisions of the '34 Act.[38] Both corporations were involved in repurchases for employee stock bonus plans.[39] In *Georgia Pacific*, a federal district court imposed a consent judgment on the corportion that included several disclosure and purchasing requirements.[40] The SEC im-

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[30] Proposed Rule, *supra* note 16, at K-22 (13e-2(e)(3)). The price limitations of rule 13e-2 prohibit an issuer from purchasing at a price higher than the highest current independent bid or the last independent sale price. *Id.*

[31] *Id.* at K-21 (proposed rule 13e-2(3)(1)).

[32] *Id.* at K-2; *see id.* at K-21 (proposed rule 13e-2(d)). Issuers must disclose the pertinent information "in a manner reasonably calculated to inform investors." *Id.* The disclosure must include the time of the purchases, the maximum number of shares to be purchased, the maximum amount of funds to be spent, the purpose of the acquisition, and any plan related to the disposal of the shares. *Id.* The issuer must inform all persons acting in the transaction that the transaction must be in accordance with rule 13e-2. *Id.*

[33] *Id.* at K-21 (13e-2(d)(1)).

[34] *Id.* at K-2; *see* text accompanying note 6 *supra*. Proposed rule 13e-2 may exceed current disclosure requirements in that rule 10b-5 does not obligate the issuer to disclose the purpose of its purchase, whereas rule 13e-2 does require disclosure of purpose. *See* note 32 *supra*.

[35] E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 236 & n.54 (1973) [hereinafter cited as ARANOW & EINHORN]. *See also* Proposed Rule, *supra* note 16, at K-4 & n.10 & 11.

[36] [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,692, at 95,525 (S.D.N.Y. 1966) [hereinafter cited as *Georgia Pacific*].

[37] [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,354, at 82,649 (May 10, 1966) (prospectus) [hereinafter cited as *Genesco*].

[38] *Georgia Pacific*, *supra* note 36, at 95,525; *Genesco*, *supra* note 37, at 82,652-53; *see* ARANOW & EINHORN, *supra* note 35, at 242 & n. 76.

[39] *Georgia Pacific*, *supra* note 36, at 95,525; *Genesco*, *supra* note 36, at 82,650; *see* A. BROMBERG, SECURITIES LAW FRAUD § 7.3(3), at 160-61 (1975). The SEC alleged that Georgia Pacific concentrated its purchases toward the end of the business day and did not attempt to minimize the price paid. *Id.* Genesco's purchases of its own stock during a five year period amounted to one-third of its entire trading, an amount the SEC viewed as excessive. *Id.*

[40] *Georgia Pacific*, *supra* note 36, at 95,525-26. The court enjoined Georgia Pacific from all fraudulent or manipulative acts in connection with its repurchase, including bidding that creates apparent active trading in Georgia Pacific stock. *Id.* at 95,525. The court also prohibited Georgia Pacific from purchasing through more than one broker per day, from establishing the opening or closing price of the securities, from engaging in price leadership,

posed the same requirements on Genesco, which had voluntarily submitted to the requirements in order to avoid possible violations of the anti-manipulation and antifraud provisions of the '34 Act.[41] The *Georgia Pacific* and *Genesco* requirements include prohibitions against repurchases during a distribution, issuer establishment of the opening or closing price of the security, and use of more than one broker per day.[42] Each of these provisions is present in the proposed rule.[43]

Most critics commenting on proposed rule 13e-2 have questioned the need for and the propriety of the substantive regulations in the rule.[44] One argument against the rule is that existing rules such as 10b-5, 10b-6, 13e-3 and 13e-4 prohibit every abuse that the proposed rule seeks to prevent.[45] The SEC has acknowledged that duplication of coverage may occur,[46] but has concluded that the rule is necessary to eliminate the cumbersome "regulation by exemption" that currently exists.[47] For example, corporations wishing to purchase their own securities during a distribution must solicit an exemption from rule 10b-6 through the Division of Market Regulation of the SEC.[48] The Division usually will condition the exemption upon compliance with certain disclosure and repurchasing restrictions that are now embodied in proposed rule 13e-2.[49] If rule 13e-2 becomes effective, the SEC has reasoned that these lengthy individual review procedures would be unnecessary in most cases.[50]

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and from purchasing more than 10% per week of the New York Stock Exchange's average weekly trading volume. *Id.* at 95,526. In addition, Georgia Pacific had to disclose pertinent information to all persons whose securities were to be acquired. *Id.*

[41] *Genesco*, *supra* note 37, at 82,652-53. The requirements that the SEC imposed on Genesco were substantially identical to those imposed on Georgia Pacific. *See id.*; note 40 *supra.*

[42] *Georgia Pacific*, *supra* note 36, at 95,525-26; *Genesco*, *supra* note 37, at 82,652-53.

[43] *See* Proposed Rule, *supra* note 16, at K-21 & 22; notes 9, 27-28, 31 *supra.* The SEC cited *Georgia Pacific* and *Genesco* in the release for proposed rule 13e-2 as examples of prior SEC regulation of repurchases. *See* Proposed Rule, *supra* note 16, at K-4 & n.10-11.

[44] *See* Letter from American Financial Enterprises, Inc. to SEC (January 15, 1981) (SEC File No. S7-858) (issuer repurchases sufficiently regulated); Letter from Paul, Hastings, Janofsky & Walker to SEC (January 15, 1981) (SEC File No. S7-858) (SEC's jurisdiction to impose rule questionable since repurchases sufficiently regulated); Letter from Walsh, Case, Coale, Brown & Burke to SEC (October 31, 1980) (SEC File No. S7-858) (statutory and constitutional authority for prohibitions in rule questionable). *See also* Proposed Rule, *supra* note 16, at K-5; text accompanying notes 64-70 *infra.*

[45] *See* Letter from American Financial Enterprises, Inc. to SEC (January 15, 1981) (SEC File No. S7-858); Letter from Paul, Hastings, Janofsky & Walker to SEC (January 15, 1981) (SEC File No. S7-858); text accompanying notes 51-63 *infra.*

[46] *See* Proposed Rule, *supra* note 16, at K-4; text accompanying notes 64-65 *infra.*

[47] *See* Proposed Rule, *supra* note 16, at K-4.

[48] *See* 17 C.F.R. § 240.10b-6(f) (1980). Rule 10b-6 flatly prohibits any person from purchasing a security that is the subject of a distribution if that person has a beneficial interest in the security. 17 C.F.R. § 240.10b-6 (1980). *See generally* Whitney, *Rule 10b-6: The Special Study's Rediscovered Rule*, 62 MICH. L. REV. 567 (1964).

[49] *See* Proposed Rule, *supra* note 16, at K-4 & n.14; text accompanying notes 35-43 *supra.*

[50] Proposed Rule, *supra* note 16, at K-4. The SEC has proposed amendments to rule 10b-6 that would eliminate the exemption procedure for issuers. *Id.* at K-3. The amendment

Current regulation of issuer repurchases is not only cumbersome, but also leaves the issuer unclear concerning the bounds of permissible behavior. The regulation most applicable to issuer repurchases is rule 10b-5, which prohibits manipulative practices in the sale of securities.[51] An issuer seeking to avoid liability under rule 10b-5 could not rely entirely on cases applying rule 10b-5 because trading that would be legitimate when done by an uninterested third party may constitute a manipulative practice for an issuer.[52] As a market participant, an uninterested third party may establish the opening or closing price of a security with impunity.[53] Issuer control of the opening or closing price, however, creates the misleading impression that the price is market determined, when in fact the issuer may have artificially raised the price.[54] The issuer, therefore, may unwittingly violate rule 10b-5 for manipulating the price of the security.[55] Proposed rule 13e-2 directly prohibits the issuer's unique incentives for manipulating the price and delineates the types of illegal issuer behavior that rule 10b-5 has left unclear.[56]

Other current regulations of issuer repurchases are also of limited guidance to an issuer in establishing a legitimate repurchase plan. Rule 10b-6, which prevents purchases by issuers during a distribution, applies to repurchases only in limited circumstances.[57] An issuer wishing to repurchase during a distribution must solicit an exemption to be able to conduct a repurchase.[58] In addition to the exemption, the SEC will usually provide guidelines to prevent the issuer from engaging in manipula-

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would permit issuers to purchase shares during a distribution if the purchases are made in accordance with rule 13e-2. Id.

[51] *See* 17 C.F.R. § 240.10b-5 (1980). *See generally* Kennedy, *Transactions By a Corporation in Its Own Shares*, 19 BUS. LAW. 319 (1964).

[52] Several commentators have noted the unique insider status of issuers dealing in their own shares and have concluded that rule 10b-5 exposes such issuers to broad but ill-defined liability. *See* Kennedy, *Transactions By A Corporation in Its Own Shares*, 19 BUS. LAW. 319, 326 (1964); Zilber, *Corporation Tender Offers For Their Own Stock: Some Legal And Financial Considerations*, 33 U. CIN. L. REV. 315, 336-37 (1964); Comment, *Rule 10b-5 and Purchase by a Corporation of its Own Shares*, 61 NW. U. L. REV. 307, 314 (1966). The dearth of cases applying rule 10b-5 to issuer repurchases contributes to the issuer's risk of inadvertent liability. *See id.* at 314 & n.41.

[53] Rule 10b-5 imposes no absolute purchasing limitations on insiders or outsiders. *See* 17 C.F.R. § 240.10b-5 (1980); Proposed Rule, *supra* note 16, at K-19. Courts have found violations of 10b-5 for market manipulation, however, only where an insider performs the manipulative acts. *See* Hundahl v. United Ben. Life Ins. Co., 465 F. Supp. 1349, 1362 (N.D. Tex. 1979).

[54] *See* 2 A. BROMBERG. SECURITIES LAW FRAUD § 7.3(3), at 160 & n.78.1 (1975).

[55] *Id.* Issuers, as insiders, may violate rule 10b-5 for nondisclosure if they do not disclose information that would affect the stock price or that is unknown to the public. *See* ARANOW & EINHORN, *supra* note 3, at 239.

[56] *See* text accompanying notes 25-34 *supra*.

[57] *See* 17 C.F.R. § 240.10b-6(f); text accompanying notes 48-49 *supra*.

[58] 17 C.F.R. § 240.10b-6(f).

tion during the repurchase.[59] Adherence to the guidelines protects an issuer from 10b-5 liability.[60] An issuer repurchasing when no distribution is present, however, will be subject to no guidelines and will risk liability for inadvertent violations of 10b-5.[61] Similarly, rules 13e-3 and 13e-4 provide limited direction in the context of "going private" transactions and tender offers.[62] Issuers whose repurchases are not either for a going private transaction or for a tender offer cannot rely on rules 13e-3 and 13e-4 to protect the issuer from 10b-5 liability because the rules are inapplicable. The failure of rules 10b-6, 13e-3, and 13e-4 to provide guidance to all repurchase plans demonstrates the need for a rule of general applicability to issuer repurchases. Rule 13e-2 would address all repurchase plans that are not covered otherwise.[63] The rule likely will encourage more legitimate repurchase plans because issuers would no longer risk inadvertent liability and would have adequate guidelines to conduct a legal repurchase.

Despite the explicit direction that proposed rule 13e-2 provides, many securities lawyers prefer the current issuer repurchase regulations because the rules are less intrusive than proposed rule 13e-2.[64] These critics argue that the current regulation of issuer repurchases renders the proposed rule unnecessary and therefore without statutory authority.[65] The SEC, however, has broad authority to determine which regulations are necessary and then to promulgate the appropriate rules.[66] Section 13(e) of the '34 Act gives the SEC explicit power to adopt substantive issuer repurchase rules in the public interest and for the protection of investors.[67] The legislative history of section 13(e) compels the same conclusion.[68] Despite the Supreme Court's narrowing construc-

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[59] *See* Proposed Rule, *supra* note 16, at K-4 & n.14. The SEC grants 10b-6 exemptions where the transaction presents little potential for manipulative abuse. *Id.* at K-4 & n.13.

[60] *Id.* at K-4.

[61] Commentators have noted the risk of relying on unofficial SEC guidelines. *See* CORPORATE CONTROL DEVELOPMENTS, *supra* note 5, at 259 & n.4; 2 A. BROMBERG, SECURITIES LAW FRAUD § 7.3(3), at 160.1 & n.81 (1975).

[62] *See* 17 C.F.R. § 240.13e-3 & 4 (1980). Rules 13e-3 and 13e-4 prohibit fraudulent and manipulative practices and set forth extensive disclosure requirements. *See generally* Manges, *SEC Regulation of Issuer and Third Party Tender Offers*, 8 SEC. REG. L. J. 275 (1981).

[63] Proposed Rule, *supra* note 16, at K-4.

[64] *See* Letter from American Financial Enterprises, Inc. to SEC (January 15, 1981) (SEC File No. S7-858); Letter from Paul, Hastings, Janofsky & Walker to SEC (January 15, 1981) (SEC File No. S7-858); Letter from Walsh, Case, Coale, Brown & Burke to SEC (October 31, 1980) (SEC File No. S7-858).

[65] *Id.*

[66] *See* Proposed Rule, *supra* note 16, at K-5. The SEC cited §§ 2, 3, 9(a)(6), 9(b), 10(b), 13(e), 15(c) and 23(a) as enabling provisions for rule 13e-2. *Id.*; *see* 15 U.S.C. §§ 78b, 78c, 78i(a)(6), 78i(b), 78j(b), 78m(e), 78o(c), 78w(a) (1976).

[67] 15 U.S.C. § 78m(e) (1976).

[68] *See* H.R. REP. No. 1711, 90th Cong., 2d Sess. II, *reprinted in* (1968) U.S. CODE CONG. & AD. NEWS 2811, 2811-13. Prior to Congress' enactment of the Williams Act, the SEC presented to Congress a proposed rule on issuer repurchases that was a close antecedent of

tion of securities laws,[69] the SEC still possesses broad authority to establish rules such as 13e-2.[70]

Technical objections to rule 13e-2 are numerous and reflect a wide disparity of opinion held by the securities bar and by brokers concerning the proper scope of rule 13e-2.[71] One critic has suggested that the rule should apply not only to issuers, issuers' affiliates, and controlling stockholders, but also to substantial individual stockholders.[72] Wealthy individual stockholders could raid the corporation's stock and sell it to another corporation, while the founding and controlling shareholders are restricted by rule 13e-2 from preventing the raid.[73] Imposing the same restrictions on both parties would prevent these raids.[74] Although the scenario above is possible, the problem is clearly outside the scope of the rule. These wealthy individual stockholders are not in control of the issuer and are not able to manipulate the price of the stock to the detriment of investors, and the prevention of manipulation by those in control is the purpose of rule 13e-2.[75] In contrast, another critic has argued that some issuer repurchases by affiliates should be excluded from rule 13e-2.[76] Purchases of small amounts of securities or those made without any deceptive intent should be excluded from the rule because the rule would unduly restrict an affiliate's activities that are unlikely to be manipulative.[77] While an intent requirement would undermine easy en-

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the current proposed rule 13e-2. *See* Proposed Rule, *supra* note 16, at K-5; note 16 *supra*. Congress thus passed § 13(e) aware that the SEC would use that rule-making authority to regulate substantively issuer repurchases. *See* Proposed Rule, *supra* note 16, at K-5. Moreover, a Senate committee has observed that issuer repurchases have both legitimate purposes that must be encouraged and potential abuses that must be prevented. S. REP. No. 550, 90th Cong., 1st Sess. at 5 (1967).

[69] Since the early 1970's, the Supreme Court has shifted from pro-plaintiff to pro-defendant in civil actions. *See* 4 A. BROMBERG, SECURITIES LAW FRAUD, § 2.4, at 384.1-84.2 (1975).

[70] *See* Commercial Capital Corp. v. SEC, 360 F.2d 856, 858 (7th Cir. 1966).

[71] The investment firm of Merrill Lynch Pierce Fenner & Smith Inc. favors the adoption of rule 13e-2, but another investment firm, American Financial Enterprise, Inc. opposes the rule. *See* Letter from American Financial Enterprises, Inc. to SEC (January 15, 1981) (SEC File No. S7-858); Letter from Merrill Lynch Pierce Fenner & Smith Inc. to SEC (January 13, 1981) (SEC File No. S7-858). Law firms also differ on the adoption of the rule. *Compare* Letter from Paul, Hastings, Janofsky & Walker to SEC (January 15, 1981) (SEC File No. S7-858) (strong objection to rule) *with* Letter from Walsh, Case, Coale, Brown & Burke to SEC (October 31, 1980) (SEC File No. S7-858) (need for rule questionable but recommends expansion of persons subject to rule).

[72] Letter from Walsh, Case, Coale, Brown & Burke to SEC (October 31, 1980) (SEC File No. S7-858). Mr. Case recommends that rule 13e-2 apply to individual stockholders who own 10% or more of a corporation's shares. *Id.*

[73] *Id.*

[74] *Id.*

[75] *See* Proposed Rule, *supra* note 16, at K-1 & 2; text accompanying notes 17-34 *supra*.

[76] Letter from Merrill Lynch Pierce Fenner & Smith Inc. to SEC (January 13, 1981) (SEC File No. S7-858).

[77] *Id.*

forcement of the rule, the scope of the rule should be limited to purchases and corporations of a significant size so that the opportunity for manipulative abuse is not inconsequential.[78] The SEC has previously limited some of its rule-making to corporations or purchases of a certain size, and a continuation of that policy is appropriate for rule 13e-2.[79]

Although the purchase limitations of rule 13e-2 are quite controversial, the securities bar also disagrees on the necessity of disclosure requirements in rule 13e-2. Some critics argue that the disclosure requirements of the rule are unnecessary because they repeat those found in other provisions of the '34 Act.[80] Other critics argue that the rule needs more specific disclosure procedures,[81] and suggest that the disclosure procedures include a requirement for a press release and direct notification to shareholders rather than require no specific form of disclosure.[82] The SEC designed rule 13e-2 to provide explicit guidance to issuers, and since courts have indicated that issuers should sustain a heavy burden of disclosure,[83] specific disclosure requirements may be appropriate for rule 13e-2.

Although many technical objections to proposed rule 13e-2 exist, the SEC should adopt the rule. The rule reasonably promotes the SEC's aims to facilitate legitimate issuer repurchases and to prevent undue issuer control in the securities market.[84] Moreover, despite its technical inadequacies, the rule is needed to provide accurate and efficient guidance to issuers planning to repurchase some of their own securities.[85] Further revision of proposed rule 13e-2 is unnecessary because whatever benefit to be had from revision must surely have been gleaned in rule 13e-2's three prior revisions.[86] In its present form, proposed rule 13e-2 preserves the balance between investors and market forces that Congress sought to achieve in the Williams Act.[87] The rule

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[78] The SEC has expressly avoided determining that all of the prohibited transactions are indeed manipulative. *See* Proposed Rule, *supra* note 16, at K-2. The SEC has chosen to rely on its § 13(e) authority "to define means reasonable designed to prevent . . . manipulative acts," so that, on balance, abusive conduct is prohibited. *Id.*

[79] *See, e.g.*, 17 C.F.R. §§ 230.251-263 (1980) (less extensive registration requirements for small businesses); 17 C.F.R. § 240.15b10-7 (registration exemption for brokers with incomes under $1000).

[80] *See* Letter from American Financial Enterprises, Inc. to SEC (January 15, 1981) (SEC File No. S7-858).

[81] *See* Letter from Merrill Lynch Pierce Fenner & Smith Inc. to SEC (January 13, 1981) (SEC File No. S7-858).

[82] *Id.*; *see* text accompanying notes 32-34 *supra*.

[83] *See* Proposed Rule, *supra* note 16, at K-2; note 6 *supra*.

[84] *See* Proposed Rule, *supra* note 16, at K-1.

[85] *See* text accompanying notes 51-63 *supra*.

[86] *See* note 16 *supra*.

[87] *See* H.R. REP. No. 1711, 90th Cong., 2d Sess. II, *reprinted in* (1968) U.S. CODE CONG. & AD. NEWS 2811, 2811-13. Congress sought to balance the need for protection of investors with the promotion of the smooth operation of the marketplace.

protects investors by limiting an issuer's excessive influence on the market and protects the market by eliminating the risk of an issuer's inadvertent noncompliance.[88]

LIZANNE THOMAS

[88] *See* text accompanying notes 25-34, 51-63 *supra*.