



Volume 34 | Issue 3

Article 10

1989

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Recommended Citation

Edward J. Yocum Jr., *Securities Regulation - Financial Advisor as a Bidder in Actions Arising under the Williams Act*, 34 Vill. L. Rev. 635 (1989).

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1989]

SECURITIES REGULATION—FINANCIAL ADVISOR AS A “BIDDER”
IN ACTIONS ARISING
UNDER THE WILLIAMS ACT

City Capital Associates Limited Partnership v. Interco Inc. (1988)

I. INTRODUCTION

In 1968, Congress adopted the Williams Act (the Act)¹ to ensure that shareholders who are solicited in a tender offer will have sufficient information to allow them to make an informed investment decision.² The Securities and Exchange Commission (SEC) subsequently promul-

1. 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1982). Prior to passage of the Williams Act, the federal securities laws did not regulate cash for stock tender offers. 11A E. GADSBY, *BUSINESS ORGANIZATIONS: THE FEDERAL SECURITIES EXCHANGE ACT OF 1934*, § 7A.01, at 7A-5 (A. Sommer ed. 1988). To fill this void, the Williams Act added subsections (d) and (e) to § 13 of the Securities Exchange Act of 1934 (Exchange Act) and subsections (d), (e) and (f) to § 14 of the Exchange Act. *Id.* Section 13(d) requires any person who acquires greater than a five-percent beneficial ownership interest in any equity security registered under the Exchange Act to file a form Schedule 13D with the Securities and Exchange Commission (SEC) within 10 days. T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 11.10, at 337-38 (1985). Section 14(d) requires registration of all “tender offer material” and other information as the SEC may require where a person has acquired more than a five-percent beneficial ownership in the company. *Id.* § 11.14, at 355. Regulation 14D provides the additional filing and disclosure requirements of the SEC under § 14(d). *Id.* For a further discussion of the SEC rules promulgated under § 14(d), see *infra* notes 3-4 and accompanying text.

2. H.R. REP. NO. 1711, 90th Cong., 2d Sess., 2, *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 2811 [hereinafter WILLIAMS ACT LEGISLATIVE HISTORY]. The legislative history provides:

The persons seeking control . . . have information about themselves and about their plans which, if known to investors, might substantially change the assumptions on which the market price is based.

This bill is designed to make the relevant facts known so that shareholders have a fair opportunity to make their decision.

Id. at 2813.

The purpose of the Williams Act is to “insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information.” *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975); *accord* *Prudent Real Estate Trust v. Johncamp Realty, Inc.*, 599 F.2d 1140, 1144 (2d Cir. 1979) (substantial need for investment information in cash tender offer); *Koppers Co. v. American Express*, 689 F. Supp. 1371, 1382-83 (W.D. Pa. 1988) (Williams Act added by Congress to close gap in 1933 and 1934 Acts which did not require cash tender offer disclosures); *see also* Annotation, *Construction of 1968 Amendments to § 14 of Securities Exchange Act of 1934, Dealing with Tender Offers*, 6 A.L.R. FED. 906, 907 (1971) (Williams Act intended by Congress to be directed at cash tender offers).

While the stated purpose of the Williams Act was to provide shareholders with information and not to favor the target corporation’s management, Congress recognized that the disclosure requirements would prevent some tender

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gated Regulation 14D³ to establish the specific information which the bidder in a tender offer must disclose.⁴ The term "bidder" is defined by the SEC in rule 14d-1(b)(1) as a person who makes or on whose behalf a tender offer is made.⁵ While the definition of a bidder in rule 14d-1(b)(1) appears to be clear, the district courts have had difficulties in applying it to the various participants in tender offers.⁶ The controversy appears to be a product of the unprecedented level of participation by

offers. See 11A E. GADSBY, *supra* note 1, § 7A.01, at 7A-6 to -6.1. The House Report on the Williams Act provides in part:

The bill avoids tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. . . .

While the bill may discourage tender offers or other attempts to acquire control by some who are unwilling to expose themselves to the light of disclosure, the committee believes this is a small price to pay for adequate investor protection.

WILLIAMS ACT LEGISLATIVE HISTORY, *supra*, at 2813.

3. 17 C.F.R. §§ 240.14d-1 to -101 (1988).

4. The primary disclosure document under Regulation 14D is Schedule 14D-1. See *id.* §§ 240.14d-3(a)(1), -100. Schedule 14D-1 requires, among other disclosures, (1) the identity and background of the bidder, Item 2; (2) any past, present, or proposed contracts, transactions, negotiations or relationships with the target company, Item 3; (3) the sources of funds for the tender offer, Item 4; and (4) the purpose of the tender offer and the bidder's plans for the target, Item 5. See T. HAZEN, *supra* note 1, § 11.14, at 356-57.

5. Specifically, rule 14d-1(b)(1) provides: "The term 'bidder' means any person who makes a tender offer or on whose behalf a tender offer is made: Provided, however, that the term does not include an issuer which makes a tender offer for securities of any class of which it is the issuer." 17 C.F.R. § 240.14d-1(b)(1) (emphasis omitted). Schedule 14D defines a "bidder" as simply "any person on whose behalf a tender offer is made." *Id.* § 240.14d-100 (General Instruction (G)).

6. See, e.g., MAI Basic Four, Inc. v. Prime Computer, 871 F.2d 212, 220 (1st Cir. 1989) (firm acting as financial advisor, dealer manager and equity participant is bidder despite less than majority interest in acquisition vehicle, where firm is involved from beginning and probably indispensable to success of tender offer); Polaroid Corp. v. Disney, 698 F. Supp. 1169, 1179 (D. Del. 1988) (financial advisors not bidders absent evidence of control over tender offer), *aff'd in part and vacated in part*, 862 F.2d 987 (3d Cir. 1988); Koppers Co. v. American Express, 689 F. Supp. 1371, 1390 (W.D. Pa. 1988) (investment banker which "play[ed] a central participatory role" and became "a motivating force fueling the formation and capitalization" of tender offer deemed bidder); Arkansas Best Corp. v. Pearlman, 688 F. Supp. 976, 980-81 (D. Del. 1988) (motivating and controlling individuals behind several corporations and partnerships formed solely to make tender offer are bidders); Warnaco, Inc. v. Galef, No. B-86-146, slip op. at 14 (D. Conn. Mar. 3, 1986) (investors who contribute own shares of target stock to form acquisition vehicle without further direct capitalization not bidders), *aff'd*, 800 F.2d 1129 (2d Cir. 1986); Revlon, Inc. v. Pantry Pride, 621 F. Supp. 804, 814 (D. Del. 1985) (majority shareholder in parent of acquisition vehicle not bidder without direct capitalization of tender offer); Van Dusen Air, Inc. v. APL Ltd. Partnership, No. 4-85-1256, slip op. at 4 (D. Minn. Sept. 20, 1985) (person who merely loans funds for tender offer not bidder); Pabst Brewing Co. v. Kalmanovitz, 551 F. Supp. 882, 892 (D. Del. 1982) (individuals who "are the primary motivating force behind the formation and capitalization" of tender offer are bidders); Gray Drug Stores v. Simmons, 522 F. Supp. 961, 966-67 (N.D. Ohio 1981) (mere fact that acquisition vehicle may transfer rights to

financial advisors in recent tender offers, and the tactics utilized by incumbent management to prevent takeovers.⁷ The issue most frequently arises where the financial advisor goes beyond its traditional advisory role and takes a substantial equity position in the acquisition vehicle.⁸ In *City Capital Associates Limited Partnership v. Interco Inc.*,⁹ the United States Court of Appeals for the Third Circuit held that a financial advisor and dealer manager¹⁰ of a tender offer was not a bidder subject to the Regulation 14D disclosure requirements, even though it had the right to purchase a substantial minority interest in the acquiring corporation.¹¹

II. DISCUSSION

In *City Capital*, City Capital Associates Limited Partnership (City Capital) made a hostile takeover bid for control of Interco Incorporated (Interco).¹² The tender offer required a total of \$2.6 billion in financ-

purchase tendered shares of target stock to affiliates does not make affiliates bidders).

7. See *Koppers Co. v. American Express*, 689 F. Supp. 1371, 1390 (W.D. Pa. 1988) (citation omitted). The district court stated, "[t]here seems to be no dispute that this is the first time that a broker-dealer has become so intimately involved in a tender offer." *Id.* The court noted that "Shearson's role far surpasses that of the typical investment banker. Not only has Shearson assisted Mr. Beazer in developing a financial structure intended to enable him to acquire Koppers, Shearson has agreed to be a major equity participant in the takeover vehicles." *Id.*

8. An acquisition vehicle is a business entity created for the sole purpose of receiving the target's tendered shares. *City Capital Assocs. Ltd. Partnership v. Interco, Inc.*, 860 F.2d 60, 64 (3d Cir. 1988). Often, instead of merely providing advisory services in takeover situations, these advisors or dealer managers acquire an equity position in the acquisition vehicle. See, e.g., *Polaroid Corp. v. Disney*, 698 F. Supp. 1169 (D. Del. 1988) (financial advisors and co-dealer managers which received option to purchase 21% of equity interest in acquisition vehicle held not to be bidders); *Koppers Co. v. American Express*, 689 F. Supp. 1371 (W.D. Pa. 1988) (investment banker which acquired slightly less than 50% of common equity of acquisition vehicle held to be bidder); cf. McAtee, *The Role of the Dealer Manager in the Disclosure Process*, 32 Bus. Law. 1331, 1331 (1977) ("Currently, there is relatively low risk of liability under Federal securities laws for an investment banker whose sole capacity in a tender offer is advising on questions of offensive or defensive strategy.").

9. 860 F.2d 60 (3d Cir. 1988). This case was argued before Chief Judge Gibbons and Circuit Judges Stapleton and Weis. *Id.* at 61. Judge Stapleton wrote the majority opinion and Judge Weis dissented. *Id.*

10. See McAtee, *supra* note 8, at 1331. The dealer manager is one of many roles played by the investment banker in a tender offer. *Id.* The dealer manager's primary responsibility is to develop a successful takeover strategy. *Id.* See also *Chris Craft Indus. v. Piper Aircraft*, 480 F.2d 341 (2d Cir.) (defining duties of dealer manager to shareholders), *cert. denied*, 414 U.S. 910 (1973).

11. *City Capital*, 860 F.2d at 65. For a further discussion of the court's holding and rationale, see *infra* notes 22-42 and accompanying text. For a discussion of Judge Weis' dissent, see *infra* notes 43-56 and accompanying text.

12. *City Capital*, 860 F.2d at 61-62. City Capital was a limited partnership structured with two limited partners, each owning a 1% interest, and two gen-

ing, of which \$1.225 billion was to be in the form of bank financing from a syndicate of banks, led by Chase National Bank (Chase).¹³ The remaining \$1.375 billion was to be raised through the sale of preferred stock in the acquisition vehicle, Cardinal Acquisition Corp. (Acquisition) by Drexel Burnham Lambert, Inc. (Drexel).¹⁴ Drexel was also engaged

eral partners, City GP I, Inc. (City GP I) and City GP II, Inc. (City GP II), each with a 49% interest. *Id.* at 61. City GP I was wholly owned by Steven M. Rales, and his brother Mitchell P. Rales was the sole shareholder of City GP II. *Id.* Additionally, City Capital owned all of the stock of Cardinal Holdings Corporation (Holdings), which in turn held all of the stock of Cardinal Acquisition Corporation (Acquisition), the acquisition vehicle created for the sole purpose of acquiring Interco's stock. *Id.* For a further discussion of Acquisition's role in the tender offer, see *infra* note 14 and accompanying text.

On July 18, 1988, City Capital, pursuant to its obligations under the Williams Act, notified the SEC that it had acquired an 8.10% ownership interest in Interco's stock. *City Capital*, 860 F.2d at 61. On July 27, 1988, City Capital proposed a friendly merger with Interco for \$64 per share, and later increased its offer to \$70 per share. *Id.* Interco's board of directors rejected both offers as inadequate. *Id.* Two days later, City Capital retained Drexel Burnham Lambert, Inc. as its exclusive financial advisor and dealer manager. *Id.* at 63 n.4. On August 15, 1988, City Capital, City GP I, City GP II, Holdings, Acquisition, Steven Rales, and Mitchell Rales filed Schedules 13D and 14D-1 to advise the SEC of their hostile takeover bid for Interco. *Id.* at 61-62.

13. *City Capital*, 860 F.2d at 62. The use of bank financing in a tender offer is regulated by the Federal Reserve System and the SEC through the establishment of margin requirements. See Securities Exchange Act of 1934, § 7, 15 U.S.C. § 78g (1982). Under § 7 of the Exchange Act, the current margin requirement permits a bidder to finance up to one-half of a stock purchase by credit, using the purchased stock as collateral. *Id.* See also Floyd, *Junk Bonds: Do They Have Value?*, 35 EMORY L.J. 921, 956 (1986).

Prior to 1986, a popular method of skirting the margin requirements in corporate takeovers involved the issuance of high-yield, high-risk "junk" bonds by the acquisition vehicle. *Id.* Because an acquisition vehicle is nothing more than a shell corporation, the economic reality is that such bonds were secured entirely with the value of the tendered shares. *Id.* at 957. This is the exact situation that the margin requirements were designed to prevent. *Id.* In 1986, the Federal Reserve Board attempted to limit the use of junk bonds by restricting shell corporations from financing more than 50% of the takeover price with such bonds. See 12 C.F.R. § 207.112 (1988). Commentators have viewed the rule as ineffective due to the many methods of avoiding it. See Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 5 n.9 (1986) (citing Smith, *Fed Rule Restricting the Use of Junk Bonds in Takeovers Is by Most Accounts Ineffective*, Wall St. J., Aug. 18, 1986, at 47, col. 3). "One tactic is to issue a 'junk' preferred stock and then later refinance it with a debt issuance in connection with the follow-up merger." *Id.* (citing Smith, *supra*, at 47, col. 3).

14. *City Capital*, 860 F.2d at 62. Acquisition was created by City Capital for the sole purpose of acquiring the Interco stock. *Id.* at 61. As is common with tender offers, Acquisition's obligation to purchase the tendered shares was conditioned on, *inter alia*, 75% of the outstanding shares of Interco stock being tendered, including the shares already owned by City Capital. *Id.* at 62. If the requisite number of shares were tendered, City Capital planned to merge Interco with Acquisition in a cash-out merger at a price equal to the tender offer price, excluding only those shares owned by Acquisition, its affiliates, or shareholders who had perfected their appraisal rights. *Id.*

The finance plan for the transaction included the issue of both preferred

as the exclusive financial advisor and dealer manager, for which Drexel received substantial fees and an option to purchase between twenty-nine and thirty-six percent of the common equity of Acquisition for itself and its designees.¹⁵

City Capital initiated suit in the United States District Court for the District of Delaware seeking a preliminary injunction against the enforcement of Delaware's anti-takeover statute¹⁶ in this transaction on the grounds that the statute was unconstitutional.¹⁷ Interco filed a

and common stock in Acquisition, with City Capital retaining a minimum of 63% of the common stock in order to maintain control of Acquisition. *Id.* For a discussion of the use of preferred stock to avoid margin requirements, see *supra* note 13.

15. *City Capital*, 860 F.2d at 62. Drexel's fee for placement of the preferred stock was to be \$12 million if the takeover was successful or \$6 million plus 15% of the profits from any subsequent sale of the Rales' Interco stock if the tender offer failed. *Id.* In addition, Drexel was to receive a 1.125% fee for funds secured through written commitments, and between 3% and 5.25% of the gross proceeds from the sale of debt or equity securities it had underwritten. *Id.* Drexel also had the right to purchase between 29% and 36% of the common equity of Acquisition for itself or its designees. *Id.* The rights to the common equity were granted, in part, to allow Drexel to offer prospective investors common stock as a "sweetener" to make the preferred shares of Acquisition more marketable. *Id.* However, Drexel was entitled to retain for itself up to one-half of the 36% of the common equity. *Id.* Drexel was to receive an additional fee of \$2 million for its exclusive financial advisory service and \$1 million for acting as the dealer manager. *Id.*

16. DEL. CODE ANN. tit. 8, § 203 (Supp. 1988). Section 203(a) provides in pertinent part:

[A] corporation shall not engage in any business combination with any interested stockholder for a period of 3 years following the date that such stockholder became an interested stockholder, unless (1) prior to such date the board of directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder; [or] (2) upon consummation of the transaction which resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced [excluding from outstanding shares those shares owned by directors, officers, and specified employee stock plans]

Id.

17. See *City Capital Assocs. Ltd. Partnership v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del.), *aff'd*, 860 F.2d 60 (3d Cir. 1988). City Capital named Delaware's Attorney General and Secretary of State, and Interco in the suit seeking preliminary and permanent injunctions against application of the Delaware statute. *Id.* at 1552. City Capital challenged the statute with three constitutional arguments. First, City Capital contended that under the Supremacy Clause of the United States Constitution, the state statute infringed on the shareholder's ability to make a decision to tender or retain his shares, contrary to the purposes of the Williams Act. *Id.* at 1555. Second, City Capital argued that the statute interfered with the ability to conduct a nationwide tender offer, and therefore violated the Commerce Clause. *Id.* Finally, City Capital argued that the statute made a standardless delegation of legislative authority to the boards of directors in Delaware, and was therefore invalid under the Due Process Clause of the fourteenth amendment. *Id.* at 1555-56. The district court only considered the

counterclaim alleging that the tender offer proposed by City Capital violated the Williams Act and the regulations promulgated under the Act.¹⁸ Specifically, Interco asserted that City Capital's tender materials failed to disclose violations of both the Federal Reserve Board's margin requirements and the Hart-Scott-Rodino Act, and that Drexel and Chase were bidders under the Williams Act regulations.¹⁹ The district court

last argument because the other two had been previously rejected in that district. *Id.* at 1554-55 (citing *R.P. Acquisition Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988); *BNS, Inc. v. Koppers Co.*, 683 F. Supp. 458 (D. Del. 1988)).

The district court found that § 203 was not an improper delegation of governmental authority because the board of directors, not the state legislature, had the sole authority to approve mergers. *Id.* at 1556. Therefore, there was no delegation of authority. *Id.*

18. *City Capital*, 860 F.2d at 62.

19. *City Capital*, 696 F. Supp. at 1556. Interco's margin requirement argument centered on the classification of Acquisition's preferred stock as debt or equity. *Id.* at 1557. If the preferred stock were classified as debt, it would be violative of the Federal Reserve Board's interpretive ruling forbidding a shell corporation from issuing debt securities in excess of the margin requirements. *Id.* (citing 12 C.F.R. § 207.112(b), (e) (1987)). For a discussion of the use of junk preferred stock to avoid margin requirements, see *supra* note 13.

The district court in *City Capital* never reached the merits of the margin requirement issue because it found that Interco lacked standing to raise it. *City Capital*, 696 F. Supp. at 1558. The court noted that where a party does not have standing to litigate the margin requirement issue directly under § 7 of the Exchange Act, it should not be permitted to do so indirectly under § 14 of the Exchange Act. *Id.* Under § 7 of the Exchange Act, there may be an implied cause of action for a borrower against his bank or broker dealer where the borrower was extended credit in violation of the margin requirements. E. ARANOW, H. EINHORN & G. BERLSTEIN, *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 160 (1977). A target corporation and its shareholders would not be able to avail themselves of a § 7 cause of action because they were not a party to the loan transaction creating the margin violation. *Id.* Similarly, Interco and its shareholders were "strangers" to the transactions which allegedly created the margin violation in *City Capital* and, therefore, would not have direct standing to challenge the violation under § 7 of the Exchange Act. *City Capital*, 696 F. Supp. at 1556. However, Interco's cause of action was against City Capital for failure to disclose the margin violation under § 14(e) of the Williams Act. *Id.* Interco, as the target corporation, arguably would have standing for this action in some federal courts under the theory that § 14(d) and (e) of the Williams Act requires disclosure of all material facts related to the tender offer, and that a violation of the margin requirement would constitute a material fact. *Id.* In fact, the indirect standing argument appears to have been recognized in the District Court of Delaware until the *City Capital* case was decided. *See, e.g., Revlon, Inc. v. Pantry Pride*, 621 F. Supp. 804 (D. Del. 1985). The *Revlon* court stated, "[i]t is settled in this circuit that there is no private right of action under Section 7 of the Exchange Act or the regulations thereunder." *Id.* at 814 (citing *Walck v. American Stock Exch.*, 687 F.2d 778, 788 (3d Cir. 1982)). However, the *Revlon* court recognized an indirect cause of action giving "standing to allege failure to disclose margin violations." *Id.* (citing *Pabst Brewing Co. v. Kalmanovitz*, 551 F. Supp. 882, 885 (D. Del. 1982); *Alaska Interstate Co. v. McMillian*, 402 F. Supp. 532, 554 n.28 (D. Del. 1975)). It is interesting to note that Judge Farnan wrote both the *Revlon* and *City Capital* opinions.

Interco's second contention was that the Rales brothers constructed a series

denied Interco's motion for a preliminary injunction, holding that Interco had failed to show a likelihood of success on any part of its counterclaim, and that neither Drexel nor Chase was a bidder.²⁰ Interco appealed on the single issue of whether Drexel was a bidder under the Williams Act regulations.²¹

On appeal, the United States Court of Appeals for the Third Circuit addressed Interco's contention that Drexel had gained sufficient control over the tender offer to convert Drexel from an advisor into a bidder.²² In rejecting Interco's argument, the court emphasized two factors which tended to diminish the degree of Drexel's control. First, the court pointed to the fact that City Capital had already made a friendly merger proposal to Interco's board of directors and, upon rejection, decided to pursue the tender offer prior to engaging Drexel's services.²³ Second, the court classified Drexel's interest as merely an investment in the acquisition vehicle, concluding that since City Capital would retain a minimum of sixty-three percent of the common stock of Acquisition, Drexel

of shell corporations in an effort to avoid the filing requirements of the Hart-Scott-Rodino Antitrust Improvements Act, 15 U.S.C. § 18a (1982) (Hart-Scott). *City Capital*, 696 F. Supp. at 1559. Hart-Scott applies to an entity in control (defined as 50% or more ownership) of the entity making the acquisition. *Id.* (citing 16 C.F.R. § 801.1(a)(1), (b)(1) (1987)). As previously noted, the Rales brothers each owned 49% of City Capital, with the remaining 2% held by two employees. *Id.* Although the court recognized that this structure was suspicious, it concluded that Interco failed to show that it was illegal. *Id.*

This Casebrief will focus on Interco's third assertion that Drexel had become a "bidder" under the Williams Act and the regulations promulgated under the Act.

20. *City Capital*, 696 F. Supp. at 1558. To obtain a preliminary injunction, a party must establish four elements: (1) a reasonable probability of success on the merits of the claim, (2) irreparable harm, (3) denial of the injunction would harm the party seeking the injunction more than the enjoined party and (4) the injunction is in the public interest. *Id.* at 1554. The district court found that Interco did not demonstrate a reasonable probability of success on the merits and, therefore, failed the first element. *Id.* at 1558. The district court did note, however, that Drexel had come "dangerously close to the point at which [the] Court would not hesitate to classify Drexel as a bidder." *Id.*

21. *City Capital*, 860 F.2d at 63.

22. *Id.* As evidence of Drexel's control over the tender offer, Interco pointed to the substantial fees Drexel would be paid in connection with the tender offer and the option to purchase between 29%-36% of Acquisition's common stock for itself and its designees. *Id.* The court stated that "the former evidence is irrelevant to the 'bidder' issue and the latter is insufficient to make Drexel a 'bidder.'" *Id.*

23. *Id.* Specifically, City Capital retained Drexel after it had already developed its tender offer strategy, made a merger proposal to Interco, purchased over three million shares of Interco stock, filed a Schedule 13D with the SEC, and filed two lawsuits against Interco and its board of directors. *Id.* at 63 n.4. However, it is important to note that Drexel was retained by City Capital only two days after its friendly merger proposal was rejected by Interco's board of directors and 18 days before the hostile tender offer began. *Id.* at 61-62 & 63 n.4.

could not be in control of the tender offer.²⁴

The Third Circuit implicitly acknowledged, however, that a minority shareholder could become a bidder under some circumstances.²⁵ The court distinguished the decision in *Koppers Co. v. American Express*,²⁶ which held that Shearson Lehman Hutton, Inc. (Shearson), an indirect owner of a substantial minority interest (46.1%) in the acquisition vehicle, had become a bidder through its active participation in the tender offer.²⁷ The *City Capital* court's distinction was based on Shearson's right to elect two members to the board of directors of the acquisition vehicle.²⁸ According to the court, this representation gave Shearson additional control over the tender offer, which Drexel did not have in *City Capital*.²⁹

Moving from the "control" aspect of Interco's argument, the court next analyzed the definition of the term "bidder."³⁰ The Third Circuit began its analysis of the regulatory definitions of the term "bidder" by stating that deference should be given to the SEC interpretations of the Williams Act.³¹ The court first looked to the definition of the word

24. *Id.* at 63. The court noted that while the Rales brothers agreed to pay Drexel's substantial fees and granted Drexel the option to purchase a large equity position in Acquisition, there was no evidence that they ever gave up control of the tender offer to Drexel. *Id.*

25. *Id.* at 63 n.5. By distinguishing *Koppers Co. v. American Express*, 689 F. Supp. 1371 (W.D. Pa. 1988), in which a minority shareholder was deemed a bidder, the *City Capital* court apparently would classify a minority shareholder as a bidder where it had the right to elect some directors. *City Capital*, 860 F.2d at 63 n.5. The court also stated that "[w]here a stockholder of a corporation making a tender offer is in a position to have a significant impact on the future of that corporation, information about the stockholder may well be material to a decision of stockholders of the target . . ." *Id.* at 65 (citing *Prudent Real Estate Trust v. Johncamp Realty, Inc.*, 599 F.2d 1140, 1147 (2d Cir. 1979)).

26. 689 F. Supp. 1371 (W.D. Pa. 1988).

27. *City Capital*, 860 F.2d at 63 n.5; see *Koppers*, 689 F. Supp. at 1389-90. In *Koppers*, the investment banker, Shearson Lehman Hutton, Inc., assumed multiple roles "at an early stage in the tender offer." *Id.* at 1389. The court discussed a number of factors demonstrating the level of participation by Shearson. *Id.* The court pointed to Shearson's (1) enormous cash investment in the acquisition vehicle, (2) involvement in the tender offer at an early stage, (3) significant, yet not controlling equity holdings and (4) large fees and expected future fees from the tender offer and subsequent restructuring. *Id.* at 1389-90.

28. *City Capital*, 860 F.2d at 63 n.5. Shearson, through a subsidiary, SL-Merger, owned 95.1% of the Class B stock entitling it to elect two Class B directors. *Koppers*, 689 F. Supp. at 1389. For a discussion of the rights of these Class B shareholders and directors, see *infra* notes 78-86 and accompanying text.

29. *City Capital*, 860 F.2d at 63 n.5. The *City Capital* court reasoned that "the equity securities held by the Shearson Lehman interests entitled them to representation on the board of the surviving company and the [*Koppers*] court viewed the Shearson Lehman interests as sharing control of the board with others." *Id.*

30. For the text of rule 14d-1(b)(1) defining a "bidder," see *supra* note 5 and accompanying text.

31. *City Capital*, 860 F.2d at 64. The court stated that it would defer to the SEC's interpretation of the Williams Act and the regulations promulgated there-

“bidder” provided in rule 14d-1(b)(1) and Schedule 14D-1.³² The court acknowledged that the language “any person on whose behalf a tender offer is made,” which is contained in both the rule and schedule, could be interpreted to include the stockholders of a corporation making the tender offer.³³ However, the court then referred to the usage of the term “bidder” within the context of Schedule 14D-1 and determined that bidder status was intended by the SEC to be limited to the actual purchaser of the tendered securities.³⁴ The court referred to Item 9, which is an instruction on how to complete a portion of Schedule 14D-1, as the clearest evidence that the term “bidder” was interpreted by the SEC to exclude shareholders of the acquiring corporation, even where the corporation was merely an acquisition vehicle.³⁵ Item 9 requires a non-natural person in control of the bidder to make current and adequate financial disclosures.³⁶ From this distinction between the bidder and the entity in control of the bidder, the court concluded that the SEC intended that only the actual entity receiving the tendered shares should

under, so long as there was no conflict between the interpretation and congressional intent. *Id.* (citing *Chevron, U.S.A. v. Natural Resource Defense Counsel*, 467 U.S. 837 (1984); *SEC v. Chenery Corp.*, 332 U.S. 194 (1947)). See *Chevron*, 467 U.S. at 842-43; *Chenery*, 332 U.S. at 209.

In *Chevron*, the United States Supreme Court applied a two-part test to determine if judicial deference to administrative interpretation was required. *Chevron*, 467 U.S. at 842. First, if Congress had expressed a clear intent in the statute, that intent controls over any judicial or agency interpretation. *Id.* at 842-43. Second, if Congress had not spoken directly on the issue, the court must defer to the agency interpretation so long as it is “based on a permissible construction of the statute.” *Id.* at 843. See also Starr, *Judicial Review in the Post-Chevron Era*, 3 YALE J. ON REG. 283, 296 (1986) (“[T]he Court made it clear that if its two conditions for deferring to the agencies are met, ‘a court may not substitute its own construction’ for that of the agency.”) (citing *Chevron*) (footnotes omitted).

The Supreme Court in *Chenery* held that administrative judgments are entitled to deference regardless of whether the court agreed with the result or not. *Chenery*, 332 U.S. at 209. The Court reasoned that an agency judgment “is the product of administrative experience, appreciation of the complexities of the problem, and responsible treatment of the uncontested facts.” *Id.*

32. *City Capital*, 860 F.2d at 64. For the text of rule 14d-1(b)(1) and Schedule 14D-1, see *supra* note 5.

33. *City Capital*, 860 F.2d at 64.

34. *Id.* For a discussion of Schedule 14D requirements, see *supra* note 4.

35. *City Capital*, 860 F.2d at 64. Item 9 of Schedule 14D provides:

Where the bidder is other than a natural person and the bidder’s financial condition is material to a decision by a security holder of the subject company whether to sell, tender or hold securities being sought in the tender offer, furnish current, adequate financial information concerning the bidder; *Provided*, That if the bidder is controlled by another entity which is not a natural person and has been formed for the purpose of making the tender offer, furnish current, adequate financial information concerning such parent.

17 C.F.R. § 240.14d-100 (1988) (emphasis in original).

36. See 17 C.F.R. § 240.14d-100 (General Instruction (G), Item 9).

be the bidder.³⁷

The Third Circuit next stressed the importance of predictability in the area of securities law.³⁸ The court stated that the regulations promulgated under the Williams Act should give fair notice of the disclosures required by the Act and, therefore, the court would read the regulations in light of their plain meaning.³⁹ The court concluded that the regulations and Schedule 14D-1 would not "communicate to any lawyer or layman attempting to comply with the law that financials are required from an entity that ultimately will be a minority stockholder in a corporation making a tender offer."⁴⁰ In addition, the court pointed out that even if Drexel were a bidder, Item 9 required disclosure of financial information only if it were material to the target shareholder's decision to tender its stock.⁴¹ The court stated that where the party in question is not the controlling entity, there must be at least a clear showing that the disclosure would materially affect the target shareholder's investment decision.⁴²

In a dissenting opinion, Judge Weis argued that the statutory provisions of the Williams Act itself should guide the court's analysis, rather than the regulations and other "appendages" promulgated under the Act.⁴³ Judge Weis argued that the SEC's use of the term "bidder" must

37. *City Capital*, 860 F.2d at 64. For a further discussion of the court's interpretation of Item 9, see *infra* notes 60-62 and accompanying text.

38. *City Capital*, 860 F.2d at 64. The court stated that it "must be constrained by a fair reading of the text of the regulations even if [the court] might reach a different result were [it] charged with the responsibility of promulgating regulations to implement the Williams Act." *Id.*

39. *Id.* For a discussion of the disclosures required under the regulations, see *supra* note 4.

40. *City Capital*, 860 F.2d at 65.

41. *Id.* Regardless of whether § 14(d) or (e) specifically requires disclosure, all material information must be disclosed. *Revlon, Inc. v. Pantry Pride*, 621 F. Supp. 804, 808 (D. Del. 1985) (citing SEC Release No. 33-5844 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,256 at 88,379 n.22 (July 21, 1977)). The dissent in *City Capital* suggested that the standard for materiality established by the Supreme Court in *TSC Industries v. Northway Inc.*, 426 U.S. 438, 449 (1976), is the proper test for materiality in this case. *City Capital*, 860 F.2d at 70 (Weis, J., dissenting) (citing *TSC Industries*, 426 U.S. at 449). Under the *TSC Industries* standard, if the reasonable investor would take the information into consideration in making his investment decision, the information is deemed material. *Id.* (Weis, J., dissenting). Because the district court did not evaluate the materiality of the undisclosed financials against the standard, the dissent urged that the case be remanded to decide this issue. *Id.* (Weis, J., dissenting).

42. *City Capital*, 860 F.2d at 65. The court, in dictum, stated that if Drexel had acquired a controlling interest in Acquisition, a presumption that Drexel's financials were material information to Interco's shareholders might be appropriate. *Id.* However, in the present case, Drexel could only receive a minority interest and, therefore, no presumption of materiality was required. *Id.* The court concluded that Interco had failed to meet its burden of demonstrating that Drexel's financial statements would be of material interest to its stockholders in responding to the tender offer. *Id.*

43. *Id.* (Weis, J., dissenting). The Williams Act provides in pertinent part:

be read consistently with the language of the Williams Act, and not in a manner which would narrow the scope of the Act.⁴⁴ Specifically, the dissent disagreed with the majority's interpretation of Item 9, finding that it limited the scope of the Williams Act.⁴⁵ Instead, Judge Weis read Item 9 as a cautionary instruction against any attempt by a bidder to evade the disclosure requirements of the Williams Act by using a shell corporation to carry out the transaction.⁴⁶ In support of his interpretation of Item 9, Judge Weis relied on the statutory language of the Williams Act which forbids a person from indirectly acquiring a beneficial interest in the target without making the required disclosures.⁴⁷ Under

It shall be unlawful for any person, directly or indirectly, . . . to make a tender offer for . . . any class of any equity security . . . if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than five per centum of such class, unless . . . such person has filed with the Commission a statement containing . . . such additional information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78n(d)(1) (1982) (citations omitted).

For a discussion of §§ 13(d) and 14(d) of the Williams Act, see *supra* note 1.

44. *City Capital*, 860 F.2d at 66 (Weis, J., dissenting) (“[T]he agency’s use of the word ‘bidder’ must be read in harmony with the statutory language and not as an attempt to narrow the scope of the Act . . .”). Judge Weis observed that the Williams Act provided a broad definition of the term “person.” The definition of person under the Act provides that “[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a ‘person’ for purposes of this subsection.” 15 U.S.C. § 78n(d)(2). Thus, the dissent concluded that “the word ‘person’ includes not only its plural, but entities such as partnerships, syndicates and ‘groups’ as well.” *City Capital*, 860 F.2d at 66 (Weis, J., dissenting) (citing 15 U.S.C. § 78n(d)(2)).

In interpreting the statute in conjunction with the SEC’s definition of the term “bidder,” the dissent pointed to an SEC Release which explained that the terms “bidder” and “subject company” were used to provide “short-hand references to the principal participants in a tender offer and avoid certain pejorative terms now commonly used to describe participants in a tender offer.” *Id.* (Weis, J., dissenting) (citing Exchange Act Release No. 15,548, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,935, at 81,216 (Feb. 5, 1979)).

45. *City Capital*, 860 F.2d at 68 (Weis, J., dissenting). As mentioned previously, the majority used Item 9 in an attempt to glean an SEC interpretation of rule 14d-1(b)(1). *Id.* at 64. Because Item 9 drew a distinction between the “bidder” and the entity in control of the “bidder,” the majority inferred that the SEC considered only the entity receiving the tendered shares as the “bidder.” *Id.* For a further discussion of the majority’s position, see *supra* notes 30-37 and accompanying text.

46. *City Capital*, 860 F.2d at 68-69 (Weis, J., dissenting) (interpreting Securities Act Release No. 5844, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,256, at 88,380 (July 21, 1977)) (“[T]he Commission will not tolerate schemes to circumvent the requirements of Item 9 by relying on this proviso.”).

47. *Id.* at 69 (Weis, J., dissenting) (citing 15 U.S.C. § 78n(d)(1)). Judge Weis stated that “[t]he formation of a shell corporation for the purpose of making a tender without disclosing who or what is behind the legal facade would be a blatant device to circumvent the express congressional prohibitions against an

this analysis, the dissent found that Drexel had acquired a beneficial interest in Acquisition by becoming a "critical player" in the tender offer strategy, receiving the option to purchase voting stock in Acquisition, and receiving substantial advisory fees.⁴⁸

In addition, the dissent stated that a public shareholder cannot make an informed decision to tender or retain shares solicited in a tender offer without adequate information about those persons making the offer.⁴⁹ Judge Weis suggested that a significant factor in the shareholder's decision would be the financial condition of the bidder.⁵⁰ Where a bidder is well-financed, the shareholder might want to hold its shares, speculating that if the tender offer is only partially successful, the bidder would subsequently increase its bid.⁵¹ Conversely, where the bidder is poorly financed, a shareholder may tender its stock to avoid remaining as a shareholder in a company whose control has fallen into "irresponsible hands."⁵²

Furthermore, the dissent rejected the requirement enunciated by various district courts that the bidder control or dominate the tender offer in order to be subject to the disclosure requirements of the Williams Act.⁵³ Instead, the dissent read the Williams Act to require disclosure "by all parties who combine to make an offer."⁵⁴ The dissent

undisclosed party 'indirectly' acquiring beneficial ownership." *Id.* (Weis, J., dissenting).

48. *Id.* (Weis, J., dissenting). The dissent distinguished the situation where an entity is both a strategist and equity partner in the tender offer, from the typical bank financing arrangement where there is a fixed rate of return. *Id.* (Weis, J., dissenting). According to the dissent, Drexel went beyond lending, and was actually a partner in the venture. *Id.* (Weis, J., dissenting). The dissent compared Drexel's equity holdings with that of the Rales brothers. The court noted that if the Rales brothers voted together they could out-vote Drexel; however, there was no guarantee that the Rales brothers would vote together. *Id.* (Weis, J., dissenting).

49. *Id.* at 67 (Weis, J., dissenting) (citing WILLIAMS ACT LEGISLATIVE HISTORY, *supra* note 2, at 2812) (purpose of Williams Act is to provide shareholders with material information about tender offer). For the text of the House Report and a further discussion of the purpose of the Williams Act, see *supra* notes 1-2 and accompanying text.

50. *City Capital*, 860 F.2d at 67 (Weis, J., dissenting) ("[I]n the case of a partial tender, a shareholder must weigh staying with the company and the bidder as part of the minority bloc, a decision in which the bidder's financial condition may be quite significant.").

51. *Id.* (Weis, J., dissenting) (citing *Prudent Real Estate Trust v. Johncamp Realty, Inc.*, 599 F.2d 1140, 1147 (2d Cir. 1979)).

52. *Id.* (Weis, J., dissenting) (quoting *Prudent Real Estate Trust*, 599 F.2d at 1147).

53. *Id.* at 68 (Weis, J., dissenting). For a list of district court cases relying on the degree of control or ability to dominate the tender offer to determine whether an entity is a bidder, see *supra* note 6.

54. *City Capital*, 860 F.2d at 68 (Weis, J., dissenting). Judge Weis stated that "[n]othing in the Act indicates that Congress intended that only an entity or individual that 'dominates' or 'controls' the group making a tender offer is bound by the disclosure requirements." *Id.* (Weis, J., dissenting). This dissent

stated that the legislative history of the Act focused on all members of the offering group, not merely the entity which dominated the group.⁵⁵ Moreover, the dissent concluded that where there is any doubt as to whether a person or entity should have made the disclosures, the court should favor disclosure to protect shareholders and fulfill the purpose of the Act.⁵⁶

III. ANALYSIS

It is submitted that the Third Circuit's interpretation of the term "bidder" in *City Capital* is too narrow to give full effect to the congressional purpose underlying the Williams Act.⁵⁷ Congress intended to provide the shareholders of a target corporation with material information about the tender offer, including financial information about the principal offerors.⁵⁸ By refusing to look behind the facade of an acquisition vehicle, the *City Capital* decision allows some of the principal participants in a tender offer to avoid the disclosures required of a bidder, and thereby denies public shareholders vital investment information.⁵⁹

The majority's construction of the term "bidder" was based on an inferred SEC interpretation of rule 14d-1(b)(1) found in Item 9, which is

argued that it is better to err on the side of disclosure than to risk inadequate disclosure. *Id.* (Weis, J., dissenting). In addition, the dissent feared that if all members of a group were not required to make disclosures, "shell" corporations might be created for the purpose of evading the requirements of the Williams Act. *Id.* (Weis, J., dissenting).

55. *Id.* at 66 (Weis, J., dissenting). In addition to the legislative history, the dissent interpreted a 1979 SEC Release which used the term "principal participants" to describe both the "bidder" and the "subject company" in the tender offer. *Id.* (Weis, J., dissenting) (interpreting Exchange Act Release No. 15,548, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,935 at 81,216 (Feb. 5, 1979)). For a further discussion of the SEC Release, see *infra* note 63 and accompanying text.

56. *City Capital*, 860 F.2d at 68 (Weis, J., dissenting) ("Excess information may well be harmless, but inadequate disclosure could be disastrous to the shareholder.").

57. The majority's interpretation of the definition of a bidder did not include the stockholder of an acquisition vehicle. *Id.* at 64. However, the majority did state that an entity in control of the bidder would be required to make the same disclosures as the bidder if such information would be material to the target's shareholders. *Id.* at 65. For a discussion of the congressional purpose in enacting the Williams Act, see *supra* note 2.

58. *City Capital*, 860 F.2d at 66-67 (Weis, J., dissenting) (citing WILLIAMS ACT LEGISLATIVE HISTORY, *supra* note 2, at 2818). The House Report on the Williams Act stated that "[t]his provision is designed to obtain full disclosure of the identity of any person or group obtaining the benefits of ownership of securities by reason of any contract, understanding, relationship, agreement, or other arrangement. *Id.* (Weis, J., dissenting) (quoting WILLIAMS ACT LEGISLATIVE HISTORY, *supra* note 2, at 2818).

59. *City Capital*, 860 F.2d at 69 (Weis, J., dissenting). The dissent noted that "the majority's interpretation of Item 9, taken to its logical conclusion, would suggest that the disclosures made by each of the Rales brothers were gratuitous" *Id.* (Weis, J., dissenting).

a filing instruction to Schedule 14D-1.⁶⁰ While it is arguable that a court should give “some weight” to an SEC instruction which interprets a statute, it is not clear that any weight should be given an instruction where the court must glean from it an SEC interpretation by inference.⁶¹ Item 9 was not contemplated by the SEC for that constructional purpose and, therefore, any deference given the inferred interpretation would be highly speculative.⁶²

Furthermore, it is suggested that where there is an express SEC interpretation of the language in question, the express interpretation

60. *Id.* at 64. For the relevant text of rule 14d-1(b)(1) and Item 9, see *supra* notes 5 and 35, respectively.

61. *City Capital*, 860 F.2d at 68 & n.1 (Weis, J., dissenting). As noted by the Supreme Court in *Chevron*, U.S.A. v. Natural Resource Defense Counsel, 467 U.S. 837, 842-43 (1984), courts must defer to an agency interpretation where Congress has not clearly expressed its intent in a statute, so long as the agency interpretation is reasonable. Therefore, had Item 9 been an instruction directed toward interpreting the Williams Act, at least some deference would be required. Here, however, Item 9 is not an interpretation of the Williams Act, but rather an instruction on how to complete Schedule 14D-1. Thus, the connection between Item 9 and the Williams Act is too remote to draw an inference about the SEC's understanding of the term “bidder.”

The dissent did not focus on the propriety of judicial deference to instructional administrative interpretations, but rather focused on the construction of Item 9. *City Capital*, 860 F.2d at 68 (Weis, J., dissenting). The dissent, however, was skeptical of the majority's deference to the SEC instruction, stating: “It is doubtful that ‘instructions’ on how to complete a form qualify as an administrative construction of a statute so as to be entitled to the deference cited in [*Chevron*], 467 U.S. 837 or *SEC v. Chenery Corp.*, 332 U.S. 194 (1947). The ‘instructions’ are not a reasoned, considered discussion of the statute.” *City Capital*, 860 F.2d at 68 n.1 (Weis, J., dissenting). For a discussion of the dissent's construction of Item 9, see *supra* notes 45-48 and accompanying text.

The courts have not given deference to administrative instructions where the agency did not directly address the matter being construed or when its interpretation was in conflict with the statute. See, e.g., *United States v. Barter Sys.*, 694 F.2d 163, 168 n.12 (8th Cir. 1982) (instructions in IRS' Manual Supplement not entitled to deference where they do not speak to issue presented); *Morris v. Morrow*, 594 F. Supp. 112, 117 (W.D.N.C. 1984) (no deference to instructions from United States Department of Health and Human Services where interpretation clearly inconsistent with statute). Even where the instruction was interpretive of the statute, the courts have shown less deference than with an administrative rule. See *West Coast Constr. v. Oceano Sanitary Dist.*, 311 F. Supp. 378, 383 (N.D. Cal. 1970) (FHA instruction not given same deference as administrative rule, but rather “some weight”).

However, when an instruction is declared by a governmental department as opposed to an administrative agency, courts have used the instruction to support its interpretation of a statute passed by Congress. See, e.g., *United States v. Sanchez Vasquez*, 585 F. Supp. 990, 993 (N.D. Ga. 1984) (district court supported its interpretation of term ‘financial institution’ with Treasury Department instruction for completing Currency Transaction Report form).

62. *City Capital*, 860 F.2d at 68 n.1 (Weis, J., dissenting) (“The ‘instructions’ are not a reasoned, considered discussion of the statute.”). The deference required by the *Chenery* decision was premised on the administrative agency's “appreciation of the complexities of the problem.” *Chenery*, 332 U.S. at 209. For a discussion of the *Chenery* decision, see *supra* note 21.

should be given preference over an inferred interpretation. In a 1979 release, the SEC stated that the term "bidder" was adopted to "provide short-hand references to the *principal participants* in a tender offer."⁶³ This release directly addressed the purpose of the SEC's use of the term "bidder" in rule 14d-1(b)(1) and should therefore have been the focus of any judicial interpretation of the SEC rule.⁶⁴

It is further submitted that the Third Circuit did not fully explore the possibility that Drexel was a principal participant in the tender offer.⁶⁵ While the court stated that there was no indication that Drexel exercised any control over the tender offer, it is suggested that a finding of control should not be a mechanical determination based solely on the ownership of a majority interest in the acquisition vehicle or on the right to representation on the acquisition vehicle's board of directors.⁶⁶ The inquiry to determine "on whose behalf a tender offer is made"⁶⁷ is nec-

63. Exchange Act Release No. 15,548, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,935, at 81,216 (Feb. 5, 1979) (emphasis added). There are two possible readings of the term "principal participants." As the dissent noted, "[i]t is significant that in using the term 'principal participants' the SEC Release was referring to both the bidder and the subject company—not the bidder alone. There is no basis to infer that 'principal participants' applies to only some of the 'bidders.'" *City Capital*, 860 F.2d at 66 (Weis, J., dissenting). Another possible reading of the release could be that the plural use of the term "participants" referred to a single bidder and the subject company only.

64. Where implied and expressed administrative interpretations appear inconsistent, the court should attempt to reconcile their possible meanings. The approach used in *Gray Drug Stores v. Simmons*, 522 F. Supp. 961, 966 (N.D. Ohio 1981) first determined those entities who were controlling entities for the purposes of Item 9, and then attempted to determine "on whose behalf" the tender offer was made. *Id.* The court then used the 1979 SEC Release defining the term "bidder" as a short-hand reference to the "principal participants in a tender offer" to interpret the language that a bidder is a person "on whose behalf a tender offer is made." *Id.* Under the facts of *Gray Drug*, the court concluded that an acquiring corporation's right to transfer some of the tendered shares to its affiliates, standing alone, is not enough to determine that the tender offer was made "on behalf" of the affiliates and, therefore, only the actual purchaser was a "principal participant." *Id.* at 967.

65. The concept of a principal participant is analogous to the "primary motivating force" language used in a number of district court cases. For a list of district court cases focusing on what constitutes a primary motivating force, see *supra* note 6.

66. *City Capital*, 860 F.2d at 63. The determination of control in the context of a tender offer should be predicated on a number of factors. Some factors provided by the court in *Koppers Co. v. American Express*, 689 F. Supp. 1371 (W.D. Pa. 1988), include: the amount of cash invested in the acquisition corporation, the stage at which the person became involved in the tender offer, the degree of equity holdings acquired in the acquisition vehicle, and the large fees received or expected by the person. *See also* *Polaroid Corp. v. Disney*, 698 F. Supp. 1169, 1177 (D. Del. 1988) ("holdings on this issue have been quite fact-specific"). For a discussion of the *Koppers* case, see *supra* notes 27-29.

67. The language "on whose behalf a tender offer is made" is found at 17 C.F.R. § 240.14d-1(b)(1) (1988) and 17 C.F.R. § 240.14d-100 (1988) (General Instruction (G)). For the text of these rules, see *supra* note 5.

essarily predicated on the actor's degree of participation in the tender offer.⁶⁸ One method of determining the degree of participation which a financial advisor has attained in a tender offer is to evaluate the risks facing the advisor by virtue of its involvement in the tender offer.⁶⁹

An analysis of the level of risk to the advisor would enable the court to draw a line between an entity which is merely receiving compensation for its advisory services and an entity which is taking a proprietary risk and actively participating in the takeover.⁷⁰ Drexel's participation in the tender offer involved substantial risks. For instance, Drexel had agreed to provide a large part of the financing required for the tender offer through the sale of Acquisition preferred stock.⁷¹ When Drexel was unable to obtain enough outside support for the stock, Drexel itself was committed to purchase preferred stock for over \$609 million.⁷² This

68. The district court cases which have focused on the issue of when a financial advisor in a tender offer becomes a "bidder" have analyzed the degree of participation by the advisor. The first case which addressed the issue in the context of a financial advisor was *Koppers*, which was decided only six months before *City Capital*. In *Koppers*, the court stated that "the SEC's distinction between 'bidders and the rest of humanity is not subtle, but rather is used to make a simple differentiation between those who are central to the offer and those who are not.'" *Koppers*, 689 F. Supp. at 1388 (quoting *Van Dusen Air, Inc. v. APL Ltd. Partnership*, No. 4-85-1256, slip op. at 4 (D. Minn. Sept. 20, 1985)). In *Polaroid Corp. v. Disney*, 698 F. Supp. 1169 (D. Del. 1988), decided one month after *City Capital*, Drexel and a co-dealer manager were involved in a tender offer transaction similar to that in *City Capital*. The *Polaroid* court stated that "[a]n entity is a bidder only if it directly capitalizes the acquisition vehicle and was consequently to receive some control over the common stock, or if it was a principal in the takeover plan." *Id.* at 1177-78 (citations omitted). Therefore, the degree of participation by the financial advisor and dealer manager in a tender offer remains an element of the definition of a bidder.

69. *City Capital*, 860 F.2d at 69 (Weis, J., dissenting). In *City Capital*, the dissent alluded to a kind of risk analysis in its discussion of who is a beneficial owner. *Id.* (Weis, J., dissenting). The dissent contrasted a loan transaction, where the return on investment was fixed, with Drexel's potential equity position and overall involvement in the tender offer, which was closer to that of a partner. *Id.* (Weis, J., dissenting). See also *Polaroid Corp.*, 698 F. Supp. at 1177 ("An entity is a bidder only if it directly capitalizes the acquisition vehicle.").

70. *City Capital*, 860 F.2d at 69 (Weis, J., dissenting). The investment risk to a lender is significantly less than that to an equity owner due to preferential treatment in the event of liquidation. Also, a lender may have less input into the strategy of the tender offer. The dissent stated that "[t]he present situation is quite different from one in which a lending institution enters into an agreement where it seeks the return of the amount it had loaned with interest." *Id.* (Weis, J., dissenting). See also *Revlon, Inc. v. Pantry Pride*, 621 F. Supp. 804, 817 (D. Del. 1985) (Chemical Bank, as lender of funds to finance tender offer, held not bidder).

71. *City Capital*, 860 F.2d at 62.

72. *Id.* at 62 n.1 & 69-70 (Weis, J., dissenting). The dissent stated: Apparently, Drexel Burnham was unable to secure outside support for a substantial part of the financing it had pledged to provide. As a result, in the Second Supplement to the tender offer dated October 4, 1988, the following statement appears: "The Purchaser [Acquisition] also has received a commitment letter, dated as of September 26, 1988

commitment left Drexel with a substantial financial risk in the tender offer, far exceeding the risks ordinarily undertaken by a financial advisor or dealer manager.⁷³

Practicality requires the conclusion that Congress did not intend to classify all minority shareholders of a corporation initiating a tender offer as bidders.⁷⁴ However, where the nominal bidder is merely an acquisition vehicle created for the sole purpose of receiving the target's tendered shares, the argument against having minority shareholders make the Williams Act disclosures is not persuasive.⁷⁵ A distinction should be drawn between a corporation whose primary purpose is making the tender offer (i.e., an acquisition vehicle) and a corporation which is making a tender offer incident to its business operations.⁷⁶ When an acquisition vehicle makes a tender offer, it is directly made "on behalf" of its equity shareholders.⁷⁷

(Group's Commitment Letter') from the Drexel Burnham Lambert Group Inc. whereby Group has agreed to purchase an aggregate of \$609.685 million of Series A Stock and Series B Stock ('Group's Commitment')."

Id. at 69-70 (Weis, J., dissenting).

73. *Id.* at 62. The \$609.685 million represents more than one-half of the total amount Drexel was committed to raise through the sale of the preferred stock and approximately 24% of the financing required for the entire tender offer. *Id.* For a discussion of the traditional role played by a dealer manager, see *supra* note 10.

74. Of course, where there are numerous minority shareholders who do not take an active role in the tender offer, the disclosures would be immaterial to a target shareholder's decision to tender his shares. Therefore, such disclosures would not be required under the Williams Act. See, e.g., 17 C.F.R. § 240.14d-100 (1988) (Item 10 requires disclosures only if material to security holder's decision to sell, tender, or hold its securities).

75. The disclosure needs of the target's shareholders are different when the offer is made by an acquisition vehicle as opposed to a company with actual operations. A clear example of this distinction can be seen in the case of the partial tender offer, where only some of the target shareholder's stock is purchased, leaving the shareholder with an interest in the target company. In this situation, the shareholder cannot look to the financial statements of the acquisition vehicle to determine if it has the ability to operate the company successfully, because the acquisition vehicle has no track record. See WILLIAMS ACT LEGISLATIVE HISTORY, *supra* note 2, at 2812 (in partial tender offer, shareholder remains as investor under new management "he has helped to install without knowing whether it will be good or bad for the company").

76. There is a distinction between a minority shareholder in a functioning corporation and a minority shareholder in an acquisition vehicle. The former's beneficial interest is primarily in the operations of the acquiring company with an indirect benefit derived from the tender offer through synergism, economies of scale, vertical integration or other possible efficiencies. Cf. W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1089 (6th ed. 1988). The latter's beneficial interest is derived directly and only from the success of the tender offer. If the tender offer fails, the corporate shell itself is worthless as a going concern, and its value then becomes the exploitation of an inflated market price for the tendered shares acquired by the shell, fueled by speculation about the takeover attempt.

77. It is clear that there would be no reason to invest in a corporation cre-

Finally, it is submitted that the Third Circuit incorrectly distinguished the *Koppers Co. v. American Express*⁷⁸ decision. The minimal degree of representation which Shearson had on the Board of BNS, Inc., the acquisition vehicle in *Koppers*, was insufficient to make a meaningful distinction between the cases.⁷⁹ This point can be demonstrated through an examination of the relative voting rights and powers possessed by the three classes of stock in BNS, Inc.⁸⁰ The Class A and Class B common shareholders each had the right to elect two directors; the Class C Shareholders could not elect any directors.⁸¹ The two directors elected by the Class A shareholders each had three votes, while each of the Class B directors were entitled to only one vote.⁸² In addition, the Class A shareholders were entitled to four votes, as compared to only one for Class B shareholders and none for the Class C shareholders, when voting on matters other than the election or removal of directors.⁸³ Moreover, each of the Class B shareholders had waived his right to enforce any fiduciary duty on the part of the Class A shareholder or directors for at least six years.⁸⁴ Therefore, Shearson's right to elect two board members may have been one of a number of factors which the *Koppers* court used to determine that Shearson was a bidder; however, it

ated for the sole purpose of making a tender offer without the expectation that the tender offer will be made "on behalf" of the acquisition corporation's shareholders.

78. 689 F. Supp. 1371 (W.D. Pa. 1988). The *City Capital* court distinguished *Koppers* on the basis that Shearson, by virtue of its Class B stock ownership, was able to elect two directors to the board of directors of the acquisition vehicle. See *City Capital*, 860 F.2d at 63 n.5 (determining that *Koppers* decision was founded on Shearson's sharing of control of board). In *Polaroid Corp. v. Disney*, 698 F. Supp. 1169 (D. Del. 1988), *Koppers* was distinguished based on Shearson's contribution of "more than \$23 million to the acquiring partnership prior to the tender offer." *Polaroid*, 698 F. Supp. at 1179. The court also pointed to Shearson's near 50% interest in the acquisition vehicle. *Id.* (quoting *Koppers*, 689 F. Supp. at 1390).

79. The *Koppers* court estimated that approximately 80% of the voting power of the common stock remained in the one Class A shareholder (a non-Shearson interest), even though one-half of the board was appointed by Shearson. See *Koppers*, 689 F. Supp. at 1385 (citation omitted).

80. *Id.* at 1384. In *Koppers*, there were three shareholders of the acquisition vehicle, BNS, Inc. *Id.* at 1376. Bright Aggregates, which was wholly-owned by Beazer PLC ("Beazer"), owned .490 shares of BNS which was all of its outstanding Class A shares. *Id.* at 1376 & 1385. SL-Merger, a wholly owned subsidiary of Shearson, held .461 Class B shares, with the remaining .024 Class B shares outstanding held by Speedward, which was a wholly owned subsidiary of National Westminster Investment Bank Limited. *Id.* at 1377 & 1385. Speedward held all of the Class C stock. *Id.* at 1385.

81. *Id.*

82. *Id.*

83. *Id.* Moreover, the Class B shares had to be voted in the same manner as the Class A shares. *Id.*

84. *Id.* at 1389-90. There was also a stock transfer restriction on Shearson's interest in the acquisition vehicle. *Id.* at 1389.

does not appear to have been a significant factor.⁸⁵ The emphasis of the *Koppers* court appeared to be on Shearson's "formation and capitalization" of the acquisition vehicle and not on its minimal board representation.⁸⁶

IV. CONCLUSION

The ramifications of the Third Circuit's decision in *City Capital* are threefold. First, shareholders who are confronted with a tender offer may have to make their investment decision without the benefit of full disclosure, thereby frustrating the purpose of the Williams Act.⁸⁷ Second, this ruling will allow those persons who do not wish to disclose material information, for whatever reasons, to evade the requirements of the Williams Act by using an acquisition vehicle.⁸⁸ Finally, the SEC's ability to monitor the tender offer for violations of the securities laws will be impaired.⁸⁹ Given the adverse effects of the Third Circuit's narrow definition of the term "bidder," the *City Capital* decision fails to fulfill the intent of Congress in its enactment of the Williams Act.⁹⁰ Since the *City Capital* decision was premised on giving deference to an inferred SEC interpretation of the term "bidder," it would be appropriate for the

85. The *Koppers* court responded to Shearson's argument that its voting power was insignificant as compared to the Class A shareholder's by stating that "the limited voting does not change the result that Shearson is one of the entities on whose behalf the tender offer is made." *Id.* at 1390.

86. *Id.*

87. The stated purpose of the Williams Act was to protect shareholders solicited in a cash tender offer. For a comprehensive discussion of the purpose of the Williams Act, see *supra* notes 1-2.

88. As noted by the dissent, the SEC feared that the wording of the proviso in Item 9 might be used to avoid the Williams Act disclosures. The SEC stated that it would not permit the use of a shell corporation to evade filing requirements. See *City Capital*, 860 F.2d at 69 (Weis, J., dissenting) (citing Securities Act Release No. 58444 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,256 at 88,380 (July 21, 1977)). For a discussion of Judge Weis' interpretation of the SEC Release, see *supra* note 46 and accompanying text.

89. For instance, when a multi-service securities firm undertakes to perform a number of roles in a single tender offer transaction, there is the potential for conflicts of interest to arise. See J. McLaughlin, *Counselling the Multi-Service Securities Firm*, 576 PRAC. L. INST. 515, 517-18 (1987). The *Koppers* court addressed this issue in its discussion of Schedule 14D-1, Item 10(b). *Koppers*, 689 F. Supp. at 1391. The court stated that "[t]he relationship between brokers/dealers and their clients is not that of an ordinary merchant to his customer; strict standards of a fiduciary must be adhered to by the dealer." *Id.* (citing S. JAFFE, BROKERS-DEALERS AND SECURITIES MARKETS § 7.01 (1978)). Without disclosures by the broker-dealer, these conflicts of interest may be difficult for the SEC to uncover.

90. For a discussion of the congressional purpose underlying the enactment of the Williams Act, see *supra* notes 1-2.

SEC to issue a clarifying statement delineating the scope of the “bidder” definition under rule 14d-1(b)(1).⁹¹

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91. On March 6, 1989, the SEC published a notice of proposed revisions to the instructions under certain schedules filed in control transactions. 54 Fed. Reg. 10,360 (1989) (to be codified at 17 C.F.R. pt. 240) (proposed Mar. 13, 1989). The proposed revisions would require responses to specified items of the schedules relating to the identity, background, funding, and purposes of the filing person with respect to each person who (i) contributes more than 10 percent of the equity capital or (ii) has the right to receive, in the aggregate, more than 10 percent of the profits or assets upon liquidation or dissolution of the filing person.

Id. at 10,331.

Under the current instructions, an acquisition vehicle could be created with a limited partnership, or closely-held entity identified as the control person. *Id.* at 10,362. With such a scheme, only the general partners would be required to make certain disclosures. *Id.* The proposed revisions would prevent the ability to legally avoid the disclosure requirements through the use of an acquisition vehicle, by focusing the disclosure requirements on “substantial equity participants” rather than “control persons.” *Id.* As noted by the SEC, substantial equity participants are often “the persons actually financing, benefiting from and, in some instances, structuring the transaction.” *Id.* (citing *City Capital*, 860 F.2d at 64).