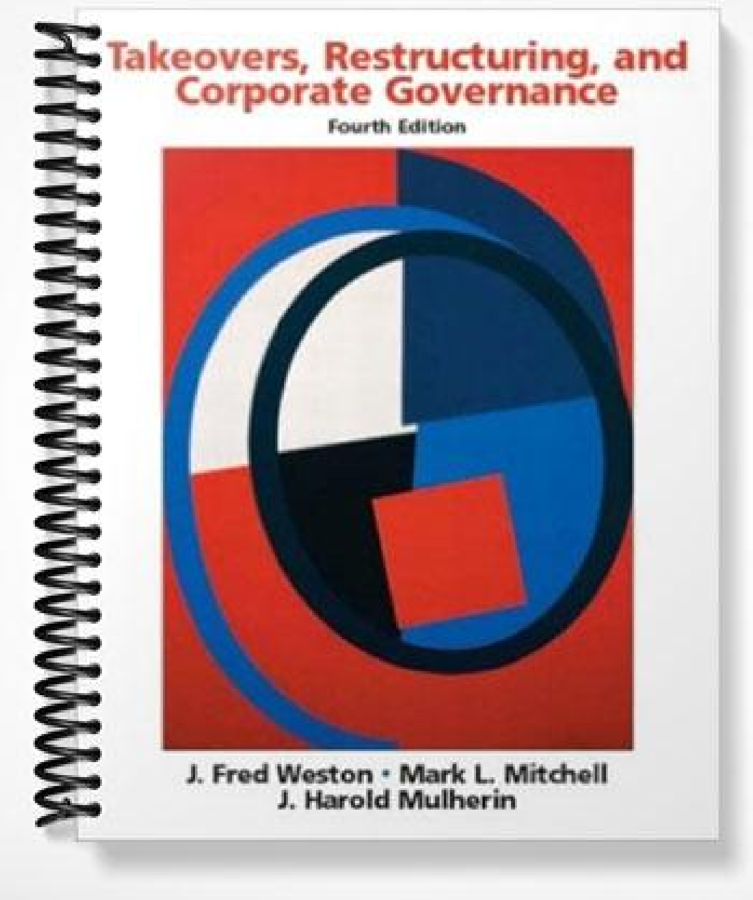
SOLUTIONS MANUAL



Chapter 2

The Legal and Regulatory Framework

I. Federal Securities Laws
   A. Seven main pieces of federal legislation
      1. Securities Act of 1933 — provides for registration of public offerings of securities
      2. Securities Exchange Act of 1934 — establishes Securities and Exchange Commission (SEC) to administer securities laws, regulate practices
      3. Public Utility Holding Company Act of 1935 — to correct abuses in financing/operation of electric and gas public utility holding company systems
      4. Trust Indenture Act of 1939 — sets forth responsibilities of indenture trustee for public issues of debt debentures; specifies requirements for bondholder protection
      5. Investment Company Act of 1940 — regulates publicly-owned companies in business of investing in and trading securities
      6. Investment Advisers Act of 1940 — provides for registration and regulation of investment advisers
      7. Securities Investor Protection Act of 1970 — establishes Securities Investor Protection Corporation to supervise liquidation of bankrupt securities firms and payments to customers
   B. More recent developments
      1. Securities Act Amendments of 1975
         a. Abolition of fixed minimum brokerage commissions
         b. Calls for increased automation of trading, linking markets
         c. SEC to work with securities industry to develop national market system
      2. SEC efforts to streamline securities registration process
         a. In 1978, allows registration statement to be abbreviated via references to other public documents; two-day approval versus several weeks
         b. Shelf registration (Rule 415) [1982] — allows registration of total amount of securities planned over two-year period; actual issuance date(s) chosen by firm
      3. Private Securities Litigation Reform Act of 1995 — places restrictions on the filing of securities fraud class action suits in order to discourage frivolous claims
      4. Securities Litigation Uniform Standard Act of 1998
         a. Establishes a uniform national standard for securities class action suits
         b. Securities class actions are the exclusive jurisdiction of the federal courts
         c. Protects defendant companies against unfounded securities fraud class actions
      5. Likely future legislation in wake of high profile fraud cases

II. Operation of Securities Acts
   A. Securities Act of 1933 — recording of information
      1. Section 5 — no public offering and sale without a registration statement
      2. Section 8 — provides for registration to automatically become effective 20 days after filing (in absence or request for more information or stop order by SEC)
   B. Securities Exchange Act of 1934 — basis of later amendments applicable to takeover activities
      1. Section 12(j) — empowers SEC to revoke/suspend registration
      2. Section 13 — disclosure requirements for public firms
         a. Form 10-K — annual report
         b. Form 10-Q — quarterly report
         c. Form 8-K — current report for any month in which specified event occurs

3. Section 14 — proxy solicitation
    a. Shareholders must be furnished with proxy statement containing specified information prior to shareholder meetings
    b. Procedural requirements for proxy contests
    c. Rule 14a-8 — any security holder may require management to include his proposal for action in proxy materials

III. Tender Offer Regulation — The Williams Act of 1968
  A. Amendments to Securities Act of 1934
  B. Purpose — to protect target shareholders from swift and secret takeovers in three ways
    1. More information disclosure during takeover process
    2. Minimum period offer must be held open
    3. Explicit authorization of target lawsuits against bidders
  C. Section 13(d) [amended 1970] — persons must file Schedule 13D with SEC within 10 days of acquiring 5% or more of the stock of any public corporation
    1. Schedule 13D must disclose:
      a. Acquirer
      b. Occupation of acquirer and associates
      c. Sources of financing
      d. Purpose of stock acquisition
    2. If purpose of acquisition is takeover, must disclose business plans for target (e.g., liquidation, merger, any basic changes)
    3. Copies of Schedule 13D sent to target, stock exchanges
    4. Material changes in information must be disclosed promptly in amended schedules
    5. No filing required if persons purchased less than 2% of the stock within the previous 12 months
  D. Disclosure — Section 14(d) applies only to public tender offers
    1. Any group making solicitations/recommendations to target shareholders which may result in ownership of more than 5% of ownership securities must file Schedule 14D
    2. Acquiring firms
      a. Must disclose in a Tender Offer Statement (Schedule 14D-1):
        (1) Intentions/business plans for target
        (2) Any relationships, agreements between target and acquirer
      b. Must file "as soon as practicable" — hand delivery to target; telephonic notification to exchanges
      c. Sections 14(d)(4)-(7) — regulate terms of tender offer
        (1) Offer must be left open for 20 trading days
        (2) Right of shareholders to withdraw previously tendered shares
        (3) Purchase mechanism in oversubscribed offers
    3. Target management — as advisors to target shareholders must file Tender Offer Solicitation/Recommendation Statement (Schedule 14D-9)
      a. Until filing, may only suggest shareholders delay tendering while management evaluates offer
      b. Firms prepare blank 14D-9 Schedules to allow speedy response to surprise tender offers
    4. Section 14(e) prohibits misrepresentation, nondisclosure, or fraudulent, deceptive, or manipulative acts or practices in connection with tender offer

IV. Insider Trading

A. Three broad categories of insider trading regulation
   1. Rule 10b-5 — defines fraud, deceit
   2. Rule 14e-3 — insider trading in context of tender offer
   3. Insider Trading Sanctions Act of 1984 — more general — triple damage penalties for insider trading
B. Traditional insider trading by officers, directors, large block security holders
   1. Section 16(a) — insiders and any person owning 10% or more of firm's stock must report transactions involving purchase/sales on monthly basis
   2. Section 16(b) — corporation (or any security holder) may bring suit against insider to return profits of insider trades completed within a six-month period

V. The Racketeer Influenced and Corrupt Organizations Act of 1970 (RICO)
   1. Originally aimed at unions, now aimed at companies that defraud consumers, investors, or public bodies such as cities or states
   2. Provides for treble damages for winning plaintiffs
   3. Requirements
      a. Conspiracy, i.e., more than one person involved
      b. Repeated acts
   4. Allows seizure of assets of accused while case is pending in a criminal suit brought by the Department of Justice — pressure to settle quickly

VI. Court Cases and SEC Rules
A. Elements of liability under Rule 10b-5 (fraud, deceit)
   1. Fraud, misrepresentation, material omission, deception in purchase or sale of securities
   2. Misrepresentation/omission must be a fact, not an opinion
   3. Misrepresentation/omission must be material to investor's decision
   4. Must prove plaintiff believed and relied on the misrepresentation/omission
   5. Plaintiff must be actual purchaser or seller of securities
   6. Deception or fraud must be closely connected to transaction
   7. Plaintiff must prove intent to deceive or defraud (scienter); scienter requirement — set out in Ernst and Ernst v. Hochfelder (1976) and Aaron v. SEC (1980)
B. Two principles of insider trading
   1. Illegal for insiders to trade on basis of inside information
   2. Illegal for outsiders to trade on basis of information which they have "misappropriated"
C. Applications of 10b-5 to insider trading
   1. Cady, Roberts & Co. (1961) — broker placed sell orders for his clients on basis of negative information he learned from insider — held to have violated 10b-5
   2. SEC v. Texas Gulf Sulphur Co. (1968) — directors, officers, etc., concealed discovery of vast mineral deposit while they bought up stock and options at lower price — held to have violated 10b-5
   3. Investors Management Co. (1971) — lead underwriter in a client's debenture issue leaked negative earnings information to its major institutional clients who traded on basis of information — held to have violated 10b-5
   4. Morgan Stanley — Kennecott Copper — Olinkraft — Johns-Manville
      a. Kennecott considering purchase of Olinkraft
      b. Morgan investigates Olinkraft for Kennecott
      c. Kennecott decides against purchase

        d. Morgan Stanley thought Johns-Manville (a Morgan Stanley client) might find Olinkraft attractive
        e. Morgan Stanley bought up Olinkraft stock, and realized profits when Johns-Manville made bid
        f. No violation of 10b-5
    5. Dirks v. SEC (1983)
        a. Dirks learned of Equity Funding fraud from ex-officer of Equity Funding
        b. Dirks informed SEC and <u>Wall Street Journal</u>
        c. Dirks advised his clients to sell Equity Funding
        d. Supreme Court ruled Dirks did not violate 10b-5
            (1) Equity Funding ex-officer had not breached any fiduciary duty
            (2) Dirks did not pay for information

D. Misappropriation theory cases under 10b-5
    1. Chiarella v. United States (1980)
        a. Employee of financial printer figured out identities of takeover targets and traded based on knowledge
        b. Convicted of insider trading
        c. In Chiarella's appeal to Supreme Court, SEC argued misappropriation theory — had misappropriated information from employer causing harm to employer and employer's client
        d. Supreme Court reversed conviction on grounds SEC had not raised misappropriation theory in lower court
    2. Newman case
        a. Stockbroker Newman learned of prospective targets from investment banker friends
        b. Newman traded in target shares, shared profits with friends
        c. Convicted under misappropriation doctrine — defrauded investment banking house, injured their reputations as safe repositories of confidential information; defrauded investment bankers' clients
    3. SEC v. Materia (1984)
        a. Financial printer case (like Chiarella)
        b. SEC applied misappropriation doctrine from start and won conviction
    4. "Heard on the Street" — R. Foster Winans case
        a. Author of column and friends traded on basis of what they knew would appear in <u>Wall Street Journal</u> the following day
        b. Conviction barely upheld by Supreme Court

VII. Other Disclosure Requirements

A. Disclosure requirements of stock exchanges
    1. Notify exchanges promptly of any material development that may significantly affect trading volume and/or price of listed stock
    2. Allow trading halt of a listed stock in certain cases where additional time is necessary for public to digest information — NYSE limits the length of voluntary halts — once a halt is requested, company has 30 minutes to disclose news, after which the exchange decides when to reopen trading

B. Disclosure of merger talks
    1. Management must inform investors of material developments affecting stock price
    2. Boards may not deny substantive merger talks
    3. Rumor problem
        a. Either keep information secret so none leaks

b. Or fully disclose accurate information

VIII. State Regulation of Takeover Activity

A. States are primary regulators of corporate activity

B. Limitation — states cannot restrict interstate commerce

C. State legislation

1. Illinois antitakeover law [1982] — struck down as too favorable to target management over shareholders, bidders

2. Indiana Act [1987] — upheld

a. Provisions

(1) Transfer of voting rights of stock not automatic upon purchase if transfer would raise acquirer's control to specified levels

(2) Acquirer must request special shareholders' meeting at which majority of shareholders must approve transfer of voting rights

b. Gives target 50 days more to maneuver

3. New York/New Jersey acts — five-year moratorium on second-step transactions by hostile bidders (e.g., merging newly acquired company with another)

4. Delaware law [1988]

a. Three-year moratorium on second-step transactions

b. Not applicable if:

(1) Hostile bidder buys virtually all target stock or

(2) Target board plus two-thirds of shareholders approve second step

c. Target board may opt out of statute within 90 days of its effective date

D. Need for state regulation

1. Rationale — to permit more considered response to two-tier and partial tender offers; more time for other bidders to emerge

2. Arguments against:

a. Only 30% of tender offers 1981-1984 were two-tier or partial

b. Many companies have fair price amendments to deal with two-tier offers

c. Many states allow shareholders to request court appraisal of share value

d. If more shareholder protection required, Williams Act could be amended instead of state regulation

e. Unconstitutional in that securities transactions are interstate commerce

E. Shareholder interests versus state interests

1. Passage of state regulations has negative effect on share prices of firms incorporated in the state

2. Goal is to protect employment in state and local control of companies

F. Tradeoffs

1. Purpose of two-tier and partial offers is to avoid free rider problem — balance with fair price

2. Delays may bring more bidders, higher premium for target shareholders — too much delay may discourage bidders altogether

3. Law must provide balance:

a. Shareholder protection

b. Stimulate reasonable competitive bidding

c. Avoid "abusive" takeovers with "speculative" financing (subjective terminology)

IX. Antitrust Policies

A. Merger announcements draw criticism from many consumer groups and firm stakeholders
B. US government analysis has overlapping jurisdictions between the FTC and DOJ
C. In 2000, DOJ challenged 48 transactions
    1. Filed a complaint in 21 mergers; of these, 18 settled, 2 dropped, and one went to litigation with DOJ winning
    2. In other 27 cases, notified that it would challenge unless deal was restructured; of these 16 restructured and 11 dropped the merger
    3. High profile case was WorldCom–Sprint
        a. DOJ required many divestitures before it would allow the merger
        b. Due to requirements, firms dropped merger plans
D. FTC challenged 32 mergers in 2000
    1. Challenges resulted in 18 consent orders, 9 terminated transactions, and 5 preliminary injunction proceedings
    2. Challenged 2 large oil mergers, BP–Arco and Exxon–Mobil; both completed with some divestitures
E. Regulatory activity requires consideration in M&A process

X. Basic Antitrust Statutes
A. Sherman Act of 1890
    1. Section 1 — prohibited mergers that would tend to create monopoly or undue market control
        a. Staples and Office Depot merger was blocked in 1997
        b. Lockheed Martin acquisition of Northrop Grumman stopped in 1998
        c. BP Amoco acquisition of Arco delayed and approved only after sale of Arco's Alaska assets to Phillips Petroleum and other concessions in 2000
    2. Section 2 — directed against firms that had already become dominant in the view of the government
        a. Actions against IBM beginning in the 1950s and dropped in 1983
        b. Suit against AT&T resulted in divestitures of operating companies in 1984
        c. Actions against Microsoft beginning in the 1990s
B. Clayton Act of 1914
    1. Original act
        a. Created the Federal Trade Commission (FTC) for purpose of regulating the behavior of firms
        b. Section 5 — FTC has power to prevent firms from engaging in harmful business practices
        c. Section 7 — illegal for a company to acquire the <u>stock</u> of another company if competition could be adversely affected
        d. Loophole — companies circumvent by using <u>asset</u> acquisitions
    2. 1950 amendment
        a. Federal Trade Commission (FTC) has power to block asset purchases as well as stock purchases
        b. Incipiency doctrine — FTC could block mergers if it judged there is a tendency toward increased concentration
C. Hart-Scott-Rodino Act of 1976 (HSR)
    1. Objective was to strengthen the powers of the DOJ and FTC by requiring approval before merger could take place — prior to HSR, antitrust actions usually taken after merger completion
    2. Three major parts

a. Title I — Department of Justice (DOJ) has power to issue civil investigative demands (CIDs) in antitrust investigation
b. Title II — premerger notification provision
   (1) Acquiring firms with sales or assets of $100 million or more and acquired firms with sales or assets of $10 million or more, or vice versa, must submit information for review
   (2) Information must be submitted to DOJ and FTC to enable the agencies to render an opinion on legality of merger
   (3) Thirty-day waiting period for mergers and 15 days for tender offers
   (4) Either agency may request 20-day extension of waiting period for mergers and 10 days for tender offers
   (5) Prenotification process in 2000
      (a) 4,926 (51%) transactions out of 9,566 merger announcements required Title II filings
      (b) About 71% of filings were reviewed and permitted to proceed before the end of the 30-day waiting period
      (c) About 16% (809) of the transactions were assigned either to DOJ or FTC for further substantive review
      (d) Of the 809 transactions for further review, DOJ or FTC issued "second requests" for 98
c. Title III — Parens Patriae Act
   (1) Each state is the parent or protector of consumers and competitors
   (2) State attorneys general are given power to initiate triple damage suits on behalf of persons injured by violations to antitrust laws
   (3) State itself does not need to be injured by the violation
   (4) In the Microsoft case 19 states joined in the DOJ suit

XI. Antitrust Guidelines
   A. Merger guidelines of 1968
      1. Mechanical application of concentration tests
      2. Antitrust investigation may be triggered if share of sales or value added by the top four firms exceeded 20% (in some cases even lower)
   B. Merger guidelines of 1982 and later years
      1. Quantitative test shifted to Herfindahl-Hirschman Index (HHI)
         a. Concentration measure based on the sum of the squared market shares of each firm in the industry
         b. Examples
            (1) 10 firms each with 10% market share: HHI = $10\ (10^2) = 1{,}000$
            (2) 10 firms each with 1% market share, 1 firm with 90%: HHI = $90^2 + 10\ (1) = 8{,}110$
         c. Critical concentration levels
            (1) Postmerger HHI less than 1,000 — unconcentrated industry — no challenge
            (2) Postmerger HHI between 1,000 and 1,800 — moderate concentration — investigation if HHI increased by 100
            (3) Postmerger HHI more than 1,800 — highly concentrated market — challenge if HHI increased by 50
      2. Firms with a high market share may be unable to restrict output or raise prices because:
         a. Close product substitutes

b. New product introductions
c. Technological innovations
d. Existing and potential competitors have the ability to expand supply of a product

C. The theory that high concentration results in recognized interdependence or tacit collusion is invalid because:
   1. Product differences — heterogeneity
   2. Frequency of quality changes
   3. Frequency of new products
   4. Technological changes
   5. Contract complexities and variations
   6. Cost differences among suppliers
D. Nonhorizontal mergers — less likely to cause competitive problems
   1. Still consider market definitions, concentration measures, ease of entry, etc.
   2. Concern over elimination of potential entrants; depends on ease of entry; if entry is easy, effects on potential entrants are likely to be small; if entry is difficult, merger will be examined more closely
   3. Three circumstances under which vertical mergers may facilitate collusion
      a. If upstream (exploration and development) firms obtain high level of vertical integration into associated retail market, this facilitates collusion in upstream market through monitoring of retail prices
      b. Elimination by vertical merger of disruptive buyer in downstream market facilitates collusion in upstream market
E. State antitrust activity said to be stimulated by change in federal antitrust policy
   1. Hart-Scott-Rodino Act increased power of states in 1976
   2. National Association of Attorneys General (NAAG)
      a. Published both merger and vertical restraint guidelines
      b. More active development of program to change content of federal laws by states
      c. Risk of chaos, parochialism even with increased cooperation among states

XII. Private antitrust suits
A. Business firms can sue other firms under antitrust laws
B. Government investigations usually followed complaints lodged by competitors against the behavior of other firms
C. Because of high cost of litigation, private antitrust suits may be used as blackmail to pressure prospective defendants to make cash settlements
D. Some basic statistics
   1. Most cases are Sherman Act cases
   2. Average triple damage case takes about 1.5 years
   3. Median award is $154,000

XIII. Regulatory Bodies
A. Certain industries are monitored by additional regulatory bodies
B. Railroads
   1. Surface Transportation Board (STB) established in 1995 to replace Interstate Commerce Commission
   2. STB has authority on antitrust matters, but must file notices with Justice Department
   3. STB is required to consider:

a. Effect on adequacy of transportation
b. Effect on competition among rail carriers
c. Interests of rail carrier employees
4. Example: STB was key in brokering deal between CSX and Norfolk Southern to breakup Conrail
C. Commercial banks
1. Three agencies may be involved — all take into account a review by the Department of Justice
a. Comptroller of the Currency has jurisdiction when national banks are involved
b. Board of Governors of the Federal Reserve System makes decisions for state banks that are part of the system
c. Federal Deposit Insurance Corporation (FDIC) reviews for banks that are part of FDIC but not part of Federal Reserve
2. Bank mergers are subject to Section 7 of the Clayton Act of 1914
a. Clayton was modified by the Bank Merger Act of 1966
b. Attorney General has 30 days to challenge any merger approved by one of the three agencies
c. Anti-competitive effects can be outweighed by serving convenience and needs of a community
D. Telecommunications
1. Federal Communications Commission (FCC) has responsibility for merger review
2. Mergers are subject to FCC review, but FCC defers to DOJ and FTC

XIV. International Antitrust
A. Most developed countries have some form of control over mergers
1. About one-half of mergers reviewed by U.S. regulators have an international component
2. International Competition Policy Advisory Committee recommended explicit antitrust policies, rapid approval
3. Most countries rely on market share percentages as initial tests
B. Canada
1. Competition Bureau reviews mergers
2. No common law concept of monopoly, therefore little antitrust consideration
C. United Kingdom
1. Director General of Office of Fair Trading is required to review all mergers where combined firm would have 25% market share or assets over 30 million British pounds
2. Director advises Secretary of State for Trade and Industry whether to make a referral to the Monopolies and Mergers Commission (MMC)
3. If a referral is made to the MMC, the current bid lapses
4. If MMC approves, Secretary of State has no override
5. If MMC prohibits, Secretary of State can still allow, but merger proposal must be reviewed
D. Japan
1. Japanese government has 30 days (can extend by 60 days) to review antitrust implications, but review is not required in a stock for stock transaction
2. Focuses on market share, but is probably more flexible in compromising with the merging companies
E. Europe

1. Minister of Competition of European Union requires premerger notification for deals where the combined firm has over \$4.5 billion of annual sales and EU sales of over \$250 million (but if over two-thirds of revenues are from a member country of the EU, EU defers to that country's antitrust agencies)
2. EU must render an approval decision within five months
3. EU demonstrated growing power by blocking GE–Honeywell merger, the first time it blocked a merger that was approved by the FTC or DOJ

XV. Regulation by Publicity

A. Three clinical studies on junk bond usage and its regulation by publicity

1. Seizure of the First Executive Corporation (FE) — DeAngelo, DeAngelo, and Gilson (1994)
   a. Total assets of subsidiary Executive Life Insurance Company (ELIC) grew from 355th in rank in 1974 to 15th in 1988 under management of Fred Carr, chief executive officer of First Executive. The spectacular growth due to:
      (1) Innovative products
         (a) Single premium deferred annuities
         (b) Interest-sensitive whole life products
         (c) Cost-reducing methods
      (2) Investment in high yield junk bonds increased income
   b. In 1989, the enactment of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) forced S&Ls to dispose of their junk bonds, causing a collapse of the junk bond market
   c. Policyholders were encouraged to cash policies resulting in the equivalent of a bank run
   d. On 4/11/91California regulators placed ELIC in a conservatorship
   e. In March 1992, regulators sold \$6.13 billion par value of ELIC's junk bonds for \$3.25 billion
   f. In hindsight, without regulatory intervention, FE and ELIC would have been solvent within a year-and-a-half after junk bond market bottomed since by July 1992, junk bonds increased in value by almost 60%
2. Seizure of First Capital Life — DeAngelo, DeAngelo, and Gilson (1996)
   a. Similar to FE and ELIC cases
   b. Seizure of First Capital Life and its parent First Capital Holdings was related to the investment of 40% of its portfolio in junk bonds
3. Hostile takeover of the Pacific Lumber Company — DeAngelo and DeAngelo (1996)
   a. In 1986, the Pacific Lumber Company (PL) was acquired by the MAXXAM Group in a leveraged hostile takeover financed by junk bonds
   b. Media coverage linked junk bonds and takeover greed to the destruction of old redwood trees
   c. DeAngelo and DeAngelo point out that under any private ownership, basic timber economics principles explain that old growth forests will be harvested first because they will yield virtually no further growth in harvestable timber
   d. Both old and new management had similar timetables for harvesting remaining old growth forests. Junk bonds and takeovers have little effect on these timetables.

B. Regulation by the politics of finance

1. Use of junk bonds became a lightning rod for widespread hysteria, animosity and pressure on government regulators to limit and penalize their use

2. Widespread animosity toward junk bonds by companies which feared takeovers
3. Pro arguments for junk bonds
    a. Junk bonds could finance the takeover of any firm not performing to its potential
    b. Junk bonds filled an important financing gap for new and risky growth companies
    c. Use of junk bonds in takeovers led to value enhancement for shareholders

CASE STUDIES

I. Broader Board Responsibilities
   A. Directors of a target firm must prove that they received best possible price for their shareholders
      1. Test the market (shop around) for other possible bidders
      2. Hire financial intermediary to test the market or to conduct auction
   B. Disadvantage if target is being shopped
      1. May reflect some weakness and potential problem at the target
      2. First bidder may lower offer if no other offers are presented or if other offers are much lower
      3. First bidder may drop out rather than continue to incur additional evaluation expenses
   C. Target may encourage bids by reducing the investment risk of potential bidders
      1. <u>No-shop agreement</u> prohibits the target from seeking other bids or providing nonpublic information to third parties. A related agreement commits the management to use its <u>best efforts to secure shareholder approval</u> of the offer by the bidder.
      2. <u>Breakup or termination fee payment</u> to the initial bidder if the target is ultimately acquired by another bidder
      3. <u>Stock lockup</u> option to buy target's stock at the first bidder's initial offer when a rival bidder wins
      4. <u>Crown jewels lockup</u> option that allows first bidder to purchase target's valuable assets if its bid fails

II. Case Illustrations
   A. Van Gorkom
      1. In 1980, Van Gorkom, a senior officer of Trans Union, offered Jay Pritzker a merger agreement to purchase Trans Union shares at a 60% premium
         a. But Van Gorkom wanted Trans Union to be free to accept a better offer
         b. Pritzker required that he be able to buy 1.75 million shares at the then current market, so he could sell them at a profit if a higher bidder succeeded
         c. This condition discouraged competing bids
         d. Pritzker's bid won with 70% of the votes
      2. In a subsequent class action suit, the Delaware court (1985) concluded that the directors had breached their fiduciary duty to their shareholders because
         a. They failed to inform themselves of all information relevant to the decision to recommend the Pritzker merger
         b. They failed to disclose all material information that a reasonable stockholder would consider important in evaluating the merger offer
      3. Within a few months after court decision, Delaware legislature amended the Delaware general corporate law
         a. Once a company is recognized that it was going to be sold, directors had the responsibility to get the best price for the shareholders
         b. Directors should be equally fair to all bidders
         c. The decision should not be tainted by the self-interest of management or directors
   B. Revlon Inc. v. Pantry Pride
      1. In 1985, Pantry Pride and Forstmann Little bid for Revlon Inc.

2. Revlon took the following defensive measures against Pantry Pride
    a. Granted Forstmann a lockup option to purchase certain Revlon assets
    b. A no-shop provision to deal exclusively with Forstmann
    c. A termination fee of $25 million
3. The Delaware Supreme Court concluded the defensive measures taken by Revlon were inconsistent with the board's duty to get the best price for the shareholders

C. Maxwell Communications v. Macmillan
1. Management of Macmillan decided to restructure the company so that it would increase its share of stock ownership to block a Maxwell takeover
2. Maxwell and Bass Group were involved in a takeover contest for Macmillan
3. Macmillan did not respond to bidder offers but instead negotiated a preferential agreement with KKR to do an LBO of Macmillan. KKR asked for
    a. A no-shop rule
    b. A lockup option to purchase eight Macmillan subsidiaries
4. Delaware Supreme Court concluded that the Macmillan board did not conduct a fair auction to get the best price for shareholders and blocked the sale to KKR
5. Maxwell acquired Macmillan in 1988 for $2,335 million

D. Paramount v. Time
1. Time and Warner entered into a merger agreement
2. Paramount made a higher dollar value bid for Time
3. The Time board saw greater long-term value in the merger with Warner
4. The Delaware court held that
    a. The exchange of stock between Time and Warner did not put Time "in play"
    b. The right of the Time board to seek a program of long-term share value maximization for its shareholders and not to accept Paramount's higher bid

E. Paramount v. QVC Network
1. Paramount negotiated an acquisition by Viacom. The merger agreement included
    a. A no-shop provision
    b. A termination fee to Viacom of $100 million
    c. An option for Viacom to purchase about 20% of Paramount's outstanding common stock at $69.14 per share if any of the triggering events related to the termination fee occurred
2. Paramount management disparaged a competing bid from QVC that was $1 billion higher than the best of Viacom
3. Supreme Court of Delaware held that the directors of Paramount had breached their fiduciary duty in not getting the best price
4. Ultimately Viacom won the bidding at a higher price

F. Sandoz – Gerber
1. Gerber Products was acquired by Sandoz
2. Deal involved a $70 million breakup fee or 1.9% of the $3.7 billion deal value
3. As long as compensation of stock options and breakup fees are under 2.5% of the deal's value, courts probably would not find preferential treatment

G. United Airlines and U.S. Airways
1. DOJ blocked because anticipated higher fares
2. DOJ anticipated reduced competition on the east coast
3. Blocking the merger put U.S. Airways in a difficult position

Illustrative Examples of Application of HHI

1a. Assume an industry dominated by a single large firm which controls 75% of the market. The remaining 25% of the market is controlled by five firms each with a 5% market share.

What is the 4-firm concentration ratio?

$75 + 5 + 5 + 5 = 90\%$

What is the HHI?

$1(75)^2 + 5(5)^2 = 5{,}625 + 125 = 5{,}750$

Whatever the measure of concentration, this market would be classified as highly concentrated.

1b. Now suppose that two of the smaller firms in this industry merge.

What would be the effect on the 4-firm concentration ratio?

$75 + 10 + 5 + 5 = 95\%$

What would be the effect on the HHI?

$1(75)^2 + 1(10)^2 + 3(5)^2 = 5{,}625 + 100 + 75 = 5{,}800$

Both measures of concentration have increased. However, the market was already highly concentrated, and the increase in the HHI is only 50 points. Under the 1982 merger guidelines, a challenge of the merger between two of the smaller firms would not necessarily occur.

1c. Suppose that the merger in 1b increases the ability of the merged firm to compete with the dominant firm. For example, suppose the merged firm is able to take away 15% of the market from the larger firm.

What is the effect of this on the 4-firm concentration ratio?

$60 + 25 + 5 + 5 = 95\%$ (no change from 1b)

What is the effect on HHI?

$1(60)^2 + 1(25)^2 + 3(5)^2 = 3{,}600 + 100 + 625 + 75 = 4{,}300$

The HHI has declined by 1,500 points. Shows reduced position of the dominant firm.

2a. Now consider an unconcentrated industry (defined in the 1982 merger guidelines as an industry with an HHI below 1,000). Twenty firms in an industry each have a market share of 5%.

What is the 4-firm concentration ratio?

$5 + 5 + 5 + 5 = 20\%$

What is the HHI?

$20(5)^2 = 500$

2b. Two of the firms in the industry propose to merge.

What is the effect on the 4-firm concentration ratio?

$10 + 5 + 5 + 5 = 25\%$

What is the effect on the HHI?

$18(5)^2 + 1(10)^2 = 550$

Using the 4-firm concentration ratio, antitrust action might be taken. Using the HHI, the industry would still be classified as unconcentrated.

2c. Now suppose that the merged firm in 2b embarks on an expansion program, acquiring, one by one, the smaller firms in the industry. According to the HHI criteria set forth in the 1982 merger guidelines, at what point might the expansion be challenged by antitrust authorities?

Acquisition of one more firm:

$\text{HHI} = 17(5)^2 + 1(15)^2 = 425 + 225 = 650$

Acquisition of one more firm:

$\text{HHI} = 16(5)^2 + 1(20)^2 = 400 + 400 = 800$

Acquisition of one more firm:

$\text{HHI} = 15(5)^2 + 1(25)^2 = 375 + 625 = 1{,}000$

Acquisition of one more firm:

$\text{HHI} = 14(5)^2 + 1(30)^2 = 350 + 900 = 1{,}250$

By the time the expanding firm has reached a 25% market share, further expansion would result in a 250 point increase in the HHI. Under the 1982 guidelines, a challenge would be considered even though the market is only moderately concentrated.