

KING & SPALDING

CLIENT ALERT

October 10, 2002

Majority Stockholder's Tender Offer Obligations as set forth in In Re Pure Resources, Inc. Shareholders Litigation

On October 1, 2002, Vice Chancellor Leo Strine Jr. of the Delaware Chancery Court issued an opinion relating to the procedures a controlling stockholder must follow in such stockholder's tender offer for the company's publicly traded shares (*In re Pure Resources, Inc. Shareholders Litigation*, Del. Ch. Civil Action No. 19876 10/1/02). In *Pure Resources* the Delaware Chancery Court attempted to bridge the divide between the entire fairness standard adopted by the Supreme Court of Delaware for negotiated merger transactions involving a controlling stockholder (*Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994)) and the freedom given a controlling stockholder in a tender offer to acquire the target company's publicly traded shares at whatever price it chooses so long as the tender offer is not structurally coercive and the controlling stockholder has not misled the company's minority stockholders by concealing or misstating material facts (*Solomon v. Pathe Communications Corp.*, 672 A.2d 35 (Del. 1996)).

In *Pure Resources* the Vice Chancellor adopted the less restrictive two prong approach set forth in *Solomon*; however, in adopting the *Solomon* standard the Vice Chancellor also acknowledged that the inherent coercion that exists in negotiated merger transactions that involve a controlling stockholder may also exist in a tender offer by a controlling stockholder. Accordingly, the court established a three part test to determine that a tender offer by a controlling stockholder is not coercive: (1) the tender offer must be conditioned upon a non-waivable majority of the minority stockholders approving the tender offer; (2) the controlling stockholder must promise to complete a short form merger at the same price as the tender offer if it obtains 90% of the target company's shares; and (3) the controlling stockholder must not have made any threats of retaliation towards the target company's board of directors or stockholders.

In addition, the Vice Chancellor reiterated and refined the second prong of the *Solomon* test - the obligation of the controlling stockholder to adequately inform the minority stockholders about the tender offer - stating that "the majority stockholder owes a duty to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment."

Background of the Case

Pure Resources, Inc. was formed in May 2000 when Unocal Corporation, a natural gas and crude oil exploration company, spun off its operations in the Permian Basin of western Texas and southeastern New Mexico and combined it with Titan Exploration, Inc., an oil and gas company operating in the Permian Basin, south central Texas, and the central Gulf Coast region of Texas. Subsequent to the formation of Pure Resources, Unocal owned 65.4% of Pure Resources' issued and outstanding common stock. The remaining 34.6% of Pure Resources was held by former stockholders of Titan Exploration, including its managers who stayed on to run Pure Resources. The largest stockholder of Titan Exploration was Jack D. Hightower, Pure Resource's Chairman and Chief Executive Officer, who, as a result of the combination, held 6.1% of Pure Resources' outstanding stock (without giving effect to options).

The stockholders of Pure Resources entered into a voting agreement that obligated Unocal and Jack Hightower to vote their shares so as to elect to the Pure Resources Board of Directors five persons designated by Unocal, two persons designated by Hightower and one person jointly designated by Unocal and Hightower. As part of the consideration Unocal received for its portion of the contributed business, Unocal obtained a Business Opportunities Agreement with Titan Exploration that limited the Pure Resources business to certain designated geographic areas. Unocal also obtained a Non-Dilution Agreement that gave Unocal preemptive rights to maintain its ownership percentage in Pure Resources. Finally, the management of Pure Resources entered into Put Agreements that allowed the managers to sell their Pure Resources shares to Unocal upon the occurrence of certain triggering events, including the consummation of a tender offer by Unocal. As structured, the Put could, subject to Pure Resources' reserves and debt, potentially result in the managers receiving either more or less than a tender offer bid by Unocal. In addition to the Put Agreements, senior management of Pure Resources, including Hightower, entered into Severance Agreements that would, at management's election, be triggered in the event of a successful tender offer.

In August 2001, Unocal, through two of its designated directors on the Pure Resources Board of Directors, with the permission of Pure Resources' management, began investigating the possibility of Unocal's acquiring the remaining interest in Pure Resources. In September 2001, Unocal informed Hightower of its decision not to go forward with a transaction; however, Unocal, without the knowledge of the Pure Resources Board of Directors, soon thereafter renewed its evaluation process. In August 2002 certain business transactions contemplated by Pure Resources would have made it more difficult for Unocal to acquire the Pure Resources publicly traded stock in the future and would have increased Pure Resources' cash reserves which in turn would have resulted in the Pure Resources managers receiving more for their shares under the Put Agreements than would be offered in a tender offer. In addition, certain business opportunities being considered by Unocal in the geographic region that was the core of Pure Resources' operations were likely to create potential breach of fiduciary duty claims against those Pure Resources directors who were also Unocal officers. In response to these concerns, on August 20, 2002 Unocal sent a letter to the Pure Resources Board of Directors advising it of Unocal's intent to commence a tender offer for the remaining Pure Resources shares. Following receipt of the letter the Pure Resources Board of Directors voted to establish a Special Committee comprised of the joint designee to the Board of Directors, and one Unocal designee

to the Board of Directors who possessed no material ties to Unocal. The Special Committee was authorized only to retain independent advisors, advise the stockholders of its position on the tender offer and to negotiate to increase Unocal's bid. After creation of the Special Committee Unocal formally commenced its tender offer, which contained the following provisions: (1) an exchange ratio of 0.6527 of a Unocal share for each Pure Resources share; (2) a non-waivable condition that the tender offer receive a majority of the shares not then owned by Unocal (management of Pure Resources, including Hightower and the other Titan Exploration designee (who also was party to a Put Agreement and Severance Agreement), and the Unocal designees to the Board of Directors, were included as part of this minority); (3) a waivable condition that sufficient tenders of shares be received to enable Unocal to obtain 90% of the outstanding common stock of Pure Resources so that Unocal could proceed with a short form merger; and (4) a statement by Unocal of its intent to consummate the short form merger as soon as it received 90% of the issued and outstanding shares at the same exchange ratio as the tender offer.

At the commencement of the tender offer the litigation seeking to enjoin the tender offer was filed and among the issues raised was the Special Committee's scope of authority. The Special Committee of Pure Resources subsequently asked that the Board of Directors delegate to it the full authority of the Board of Directors under Delaware law to respond to the tender offer (including the authority to implement a rights plan, consider alternative financings or pursue other offers). In response to the Special Committee's request, certain directors designated by Unocal who had originally recused themselves from the Board of Director's consideration of the tender offer led an effort by the Board of Directors to revise the Special Committee's resolution for broader powers so that the Special Committee was left only with the ability to review the tender offer, negotiate it and make a recommendation to the stockholders as required by Schedule 14D-9 under the Securities Exchange Act of 1934. The Special Committee asked Unocal to increase its exchange offer from 0.6527 to 0.787; however, Unocal never made a counter offer. On September 17, 2002 the Special Committee voted not to recommend the tender offer. The Special Committee also prepared the Schedule 14D-9 on behalf of Pure Resources recommending that the stockholders not accept Unocal's offer.

The Court's Analysis

The plaintiffs argued that the tender offer should be enjoined because the tender offer was subject to the entire fairness review set forth in *Lynch*. Unocal responded that because it was going forward with an exchange offer and not a negotiated merger Unocal could proceed so long as the tender offer complied with the standard articulated in *Solomon*. Unocal argued that it met the *Solomon* standard because it conditioned its offer on a majority of the minority accepting its offer and because it intended to consummate a short-form merger with the stockholders in the merger receiving the same consideration as those stockholders who tendered their shares.

The court disagreed with plaintiff's argument and concluded that the *Solomon* standard governed. However, the court acknowledged that many of the concerns about coercion that motivated the Supreme Court of Delaware in *Lynch* to utilize the entire fairness standard when reviewing a negotiated merger by a controlling stockholder were also present in a tender offer by a controlling stockholder. To help define what actions would be considered coercive the Vice Chancellor created the three part test. The Vice Chancellor found that Unocal was not in

compliance with first requirement of the coercion test - that the tender offer be conditioned upon a non-waivable majority of the minority stockholders approving the tender offer - because it included within the definition of “minority” stockholders of Pure Resources who held positions as directors and officers of Unocal (i.e. the Unocal designees to the Pure Resources Board of Directors). In addition, the court found that the definition of “minority” utilized in the tender offer was also defective because it included the management of Pure Resources whose Put Agreements and Severance Agreements caused them to have interests that were not aligned with the other minority stockholders.

Notably, Vice Chancellor Strine did not take issue with the actions of the those Pure Resources directors designated by Unocal who originally recused themselves from the Board of Directors’ consideration of the tender offer and then played an active role in limiting the powers of the Special Committee. Moreover, the court determined that the plaintiffs had not established a probability of success as to their claim that the Pure Resources Board of Directors should have blocked the tender offer with a poison pill or other measures. The court noted that there was at least a rational basis to believe that a poison pill would not have been necessary to protect the minority stockholders against coercion, largely because Pure Resources’ management had expressed strong opposition to the tender offer and the Board of Directors of Pure Resources had allowed the Special Committee a “free hand” to recommend against the tender offer, as it did, to negotiate a higher exchange ratio, which it attempted to do, and to prepare Pure Resources’ Schedule 14D-9, which it did.

Second, plaintiffs argued that neither the Registration Statement on Form S-4 (the “Registration Statement”) issued by Unocal in support of its offer nor Pure Resources’ Schedule 14D-9 filed in response to the offer provided complete and accurate disclosure. Specifically, plaintiffs argued that the Schedule 14D-9 should (i) include a summary of the analysis and conclusions made by the investment bankers retained by the Special Committee, and (ii) have indicated that the Special Committee was denied the authority it sought to negotiate the tender offer. The court agreed with plaintiff’s claims. The Vice Chancellor emphasized the right to stockholders to a “fair summary of substantive work performed by the investment bankers” employed by the board of directors of a target corporation. In addition, the Vice Chancellor was skeptical of the usefulness of an investment banker’s fairness opinion without more information. The court indicated that in certain circumstances the target corporation or special committee may have legitimate reasons from concealing the investment banker’s work during ongoing negotiations; however, the court found that because Unocal did not make a counter-offer and because the 14D-9 disclosed the Special Committee’s attempt to increase the exchange ratio, the target company’s interest in protecting its reserve price was not legitimate. The court also found that it would be material for stockholders to know that the authority requested by the Special Committee to negotiate the tender offer was denied.

The court enjoined the tender offer pending an amendment of its terms to eliminate its coercive structure and pending revisions to the Registration Statement and Schedule 14D-9 to provide adequate and accurate information for the minority stockholders to evaluate the tender offer.

Subsequent Actions

Following the court's ruling, on October 2, 2002 Unocal increased its offer from 0.6527 to 0.70 of a Unocal share for each Pure Resources share. Unocal offered to further increase the exchange ratio to 0.74 if the managers of Pure Resources agreed to surrender their options and their rights under the Put Agreements. On October 9, 2002 Unocal announced that it had signed an agreement with the management of Pure Resources to exchange the Pure Resources shares not held by Unocal for Unocal shares at an exchange ratio of 0.74. As part of the agreement, management of Pure Resources agreed to surrender their put rights and options.

Terms of Tender Offers Going Forward

The holding in *Pure Resource* provides substantial guidance for a controlling stockholder when making a tender offer. Following the court's analysis, a controlling stockholder should take care to make sure that its offer is not deemed coercive by following the three criteria laid down by the court. These three protections "minimize the distorting influence of the tendering process on voluntary choice . . ., recognize the adverse conditions that confront stockholders who find themselves owning what have become very thinly traded shares. . . and also provide a partial cure to the disaggregation problem, by providing a realistic non-tendering goal."

In addition to the obligations of the controlling stockholder to prevent coercion, the target company and the controlling stockholder should be cognizant of their obligation to provide information that "a reasonable investor would consider important in tendering his stock". In addition, the Registration Statement and Schedule 14D-9 must also "provide a balanced, truthful account of all matters they disclose." To this end, if doing so would not hurt the target company's on-going negotiations, the target company should include a summary of the investment banker's analysis of the transaction. Moreover, any attempt by the controlling stockholder or the board of directors of the target company to reduce the powers of the Special Committee or denial of the Special Committee's request for additional powers should be disclosed in the Company's Schedule 14D-9.

If you would like more information regarding these cases, please contact Bill Bates in King & Spalding's New York office (telephone: 212/556-2240; e-mail: wbates@kslaw.com).

King & Spalding's M&A Practice consists of over 75 lawyers within the Corporate practice area in Atlanta, D.C., Houston and New York who have a principal focus on merger and acquisition activity. The lawyers in the M&A Practice have extensive experience in representing bidders, target companies, special committees, dealer managers and financial advisors in a wide variety of transactions, including the acquisition and divestiture of public and private companies; going-private transactions, the structuring and formation of strategic joint ventures; advising financial intermediaries in evaluating and facilitating transactions; antitrust strategies; advising proxy contestants; and structuring acquisition offers and arranging public and private financing.