BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

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PRIVILEGED AND CONFIDENTIAL

Gary Lynch, Esq.
Director
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Securities and Exchange Commission
450 Fifth Street, N.W.
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Dear Mr. Lynch:

This is in response to your letter of January 19 with respect to the tender offer made by Farley, Inc. for the shares of West Point-Pepperell, Inc. Your letter raises several questions about our earlier communications dealing with whether the proposed financing for the tender offer violates the Board's margin regulations, in particular, Regulation G and the 1986 interpretation of that Regulation concerning debt securities issued by shell acquisition corporations. 12 C.F.R. § 207.112 (the "Interpretation").

The Interpretation establishes a presumption that debt securities issued by a shell subsidiary company to finance a tender offer for margin stock of a target company are "indirectly secured" by the margin stock to be acquired and therefore subject to the limitations on amount contained in the Board's Regulation G. This presumption is premised on the finding that in this situation the lenders can reasonably rely only on the margin stock as security for the credit. This presumption, however, does not apply if the debt securities are issued or guaranteed by an operating company with substantial non-margin stock assets or cash flow.

In our December 23 letter, we informally provided our views on, among other things, whether this presumption applies to $560 million in notes (the "New Notes") that would be issued by shell subsidiaries of Farley to finance the tender offer. The New Notes would be guaranteed by Farley. We noted that there is a question with regard to whether the exception to the presumption for debt guaranteed by an operating company applies here because Farley has a negative net worth and negative cash

flow. We also stated that an inquiry should be made as to whether the New Notes should be aggregated for purposes of applying the margin regulations with $500 million in notes issued by Farley in February 1988 for the purpose of acquiring a then unidentified company (the "Existing Notes"). We stated that in conducting this inquiry it would be particularly appropriate to inquire whether the purchasers of the New Notes and the purchasers of the Existing Notes would be the same.

We have had the opportunity to analyze the facts and questions contained in your January 19 letter and we believe that we can provide some further clarification of our earlier statements. It should be pointed out, however, that our analysis is based solely on the facts provided by the parties and the Commission staff, and there may be relevant facts of which we are not currently aware. In addition, on February 1, Farley increased its offer to $52 a share from $48 a share. We are uncertain at this time as to what effect this amendment might have on the financing arrangements for the tender offer. Finally, we have also reviewed a letter from Farley's counsel, dated February 1, responding to certain matters raised in our December 23 letter.

The Commission staff has asked for guidance with respect to the extent to which the identities of the lenders must overlap for the aggregation theory to apply. You also ask whether, if the facts ultimately show that there is little overlap between the purchasers of the Existing and New Notes, there are other theories that would justify the aggregation of both extensions of credit.

Our view that both sets of Notes might be integrated for purposes of the margin requirements is premised on the proposition that these requirements cannot be avoided by dividing up into various parts an extension of credit that otherwise would exceed the limitations on amount in the regulations, each part of which, viewed in isolation, would appear to comply with the margin limitations. In other words, if the New Notes and the Existing Notes are part of what in economic reality is a single borrowing transaction by Farley, identical in purposes, and different only in the timing, then the total amount of credit should be treated as an extension of credit undertaken for the purpose of purchasing margin stock. As we have indicated, the identity or substantial identity of the purchasers of both issues of the Notes appears to be the clearest single factual indication that the Notes were understood by the lenders or by those arranging the credit to constitute integrated transactions. If the lenders are the same in both transactions, then, at least for purposes of the banking laws, any credit extended for a "common enterprise" would be treated as single extension of credit. See 12 C.F.R.

§ 32.5(a)(1). An acquisition of a controlling block of a company's voting shares is clearly a common enterprise. Id. § 32.5(a)(2)(iv).

However, any other evidence would be probative on this point if it tended to show that the purchasers of the Notes, especially the purchasers of the Existing Notes, knew that the credit extended would be used to acquire margin stock and that a significant amount of additional credit for this purpose would be issued or guaranteed by Farley. This type of inquiry seems to be very similar to the kind of determination the Commission must make in deciding whether separate offers or sales of securities should be integrated for purposes of applying various exemptions to the registration requirements. We think it would be relevant to determine, for example, whether the issues are part of a single plan of financing made at or about the same time, involve the same class of securities and type of consideration, and are made for the same general purposes. See SEC Release No. 33-4552 (Nov. 6, 1962). This is the type of record that it would be appropriate to develop as as part of your investigatory responsibilities.

You have also asked for any analysis and legal support for the theory that the subordination of the Existing Notes to the New Notes, which is a necessary condition for the issuance of the New Notes, justifies aggregation of the Notes for margin requirement purposes. We believe that, based on prior Federal Reserve rulings, a case can be made that the agreement by the holders of the Existing Notes to subordinate the debt to the New Notes, clearly in furtherance of a plan to acquire the West Point-Pepperell margin stock with the proceeds of both issues, at a minimum would justify treating the Existing Notes as credit extended for the purpose of acquiring West Point-Pepperell margin stock, at least at the time of the subordination. It would be a much harder case under that precedent to show that the agreement to subordinate, in itself, is conclusive evidence that the lenders understood that at the time they were issued the Existing Notes would finance the acquisition of margin stock as part of an integrated transaction. See 12 C.F.R. § 207.3(g)(3).

The Commission staff has also raised a question about our view that there is a serious issue whether, because Farley currently has a negative net worth and negative cash flow, the proposed transaction would qualify for the exception to the presumptive applicability of the margin limitations that excludes debt issued or guaranteed by an operating company with substantial non-margin stock assets or cash flow. See 12 C.F.R. § 207.112(f), (h). Your letter notes that under the literal terms of the Interpretation, debt guaranteed by an operating company that does not have positive cash flow could

still qualify for the exemption if the guarantor company has substantial non-margin stock assets.

In light of your comments, we have undertaken a more extensive analysis of this question in the hopes of clarifying and refining our earlier statements. First, it is clear that, based on published financial statements, Farley does not qualify for the "cash flow" exception in the Interpretation, since Farley has experienced continuing operating losses and does not have any positive cash flow. In its February 1 letter, Farley states that it now qualifies for the cash flow exception because it estimates a marginally positive cash flow of $3.22 million, on a parent company only basis, for the year ending in December 1988. If this estimate proves accurate, then Farley would argue that the proposal comes within the literal terms of the cash flow exception. We do not believe, however, that the exception for guarantors with "substantial non-margin stock assets or cash flow" was meant to exclude every guarantee where the parent company can demonstrate some positive cash flow, regardless of how marginal. In our view, the qualifying term "substantial" applies to cash flow as well to non-margin stock assets.

Whether a particular company's cash flow is substantial in relation to the acquisition debt to be guaranteed necessarily depends on the facts of each case. Here a good argument can be made that Farley's cash flow would not be substantial in light of the small amount of projected cash at year end and the company's history of continuous cash flow deficiencies from 1986 through the third quarter of 1988.

We also believe it can be plausibly argued that the New Notes, even viewed in isolation, are subject to the presumption that they are indirectly secured by margin stock and thus subject to the limitations on amount in the margin rules, because Farley cannot take advantage of the "substantial non-margin stock assets" exception. With respect to what constitutes "substantial non-margin stock assets," the Board stated in the preamble to the Interpretation that guidance as to the Board's views on this point is provided by reference to two specific tender offers in which acquisition debt was issued or guaranteed by operating companies, Pantry Pride, Inc., and the GAF Corporation. 51 Fed. Reg. 1771, 1774 (1987). The Board found these transactions to fall outside the presumption because these companies had substantial non-margin stock assets. In describing both of the transactions, the Board explicitly compared the debt to be issued and/or guaranteed by

the operating companies to their total assets and to their net worth (or shareholders' equity). Id. at 1772 & fn. 2.[1]

Consistent with the express language employed by the Board, a dual test for "substantial non-margin stock assets" was intended -- the debt involved must be compared to both the operating company's total assets and to its net worth. In our view, it is reasonable to assume that the amount of a company's net worth -- the amount by which its assets exceeds its liabilities and by which its capital funds remain unimpaired -- is significant in assessing the level of indebtedness lenders can reasonably believe the company is able to support without reference to the margin stock to be acquired.

When the total assets test is applied to the Farley proposal, it is clear that, even if the New and Existing Notes are aggregated, the amount of acquisition debt Farley would assume in relation to its total assets would not be out of line with the total asset ratios involved in Pantry Pride and GAF transactions. However, when the net worth test is applied from the point of view of the purchasers of the New Notes, the ratio of debt to net worth of the guarantor, Farley, is not at all comparable to the net worth ratios involved in the Pantry Pride and GAF transactions. Based on its most recent published financial statements, on which the purchasers of the Notes presumably would rely, Farley has a negative net worth. Accordingly, in our judgment, a strong argument can be made that the New Notes fail to meet both the total asset and net worth requirements for the exception and, therefore, are subject to the presumption that the margin limitations apply.

If there is an evidentiary basis for aggregating both issues of Notes, it would be even clearer that the financing for this transaction is not consistent with the net worth ratios in the transactions described by the Board in the interpretation. At the time the Existing Notes were issued in February 1988, Farley had only marginal net worth ($3.6 million), based on the most recent financial statements at that time. Thus Farley would have had insufficient net worth to support even the Existing Notes alone.

In its recent submission, Farley argues that its net worth in reality is positive, again suggesting that the current

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[1] In particular, Pantry Pride had approximately $400 million in assets and $145 million in net worth to support approximately $840 million in debt. GAF had approximately $800 million in assets and about $280 million in shareholders' equity to support $2.3 billion in debt. Id.

market value of the Class B shares of Fruit of the Loom, Inc. held by Farley is higher than book value. Farley cites an analysis by an independent investment firm predicting that the market valuation of the Class A Fruit of the Loom shares, which are publicly traded, should move closer to the company's estimated private market value, which exceeds the current book value of the Class B shares. While more reliable than an evaluation by an interested party, the independent valuation clearly does not deal with the current value of the Fruit of the Loom shares, which is more relevant to what the purchasers of the New Notes would rely on.

Your letter also raises the question whether Farley, or any other bidder, would have had adequate notice of this construction of the Interpretation. As we noted, the Interpretation, as explained by the Board at the time it was adopted, explicitly compared the acquisition debt to both total assets and net worth of the operating companies involved. Thus, a credible argument can be made that fair notice was given that in determining whether a particular operating company has substantial non-margin stock assets, both factors must be considered.

Your letter further asks for our views on whether, if the presumption does apply to the Farley tender offer, the presumption can be rebutted based on the facts now available. As indicated in our previous letter, the senior position of the New Notes as a result of the subordination agreement is probative evidence that the purchasers of these Notes could reasonably rely in good faith on Farley's non-margin stock assets, notwithstanding the lack of net worth. Even though Farley's total liabilities exceed the amount of available assets and its capital is totally impaired, given their priority, the New Notes would be covered nearly dollar-for-dollar by non-margin stock assets of Farley.

On the other hand, we believe that in determining whether the presumption can be rebutted, all probative facts should be considered. However, we cannot say for certain that such facts exist. For example, Farley admitted in its February 1988 prospectus relating to the Existing Notes that Farley's funds generated by existing operations are not sufficient to meet the debt service on the Existing Notes and other fixed charges. Farley points out in its February 1 letter that as a result of a restructuring after issuance of the Existing Notes, the company's liquidity improved and that in subsequent disclosure statements Farley stated that current debt service requirements could be met from available funds. While these subsequent disclosures would not be relevant in assessing what the purchasers of the Existing Notes could reasonably rely on, they clearly would be relevant in reviewing the New Notes. As

we noted above, however, Farley's cash flow would have to be substantial in order for lenders to rely on that source of repayment, rather than on margin stock.

As we have indicated above, because we have not investigated the proposal, there may be other facts that we are not aware of that might have a bearing on whether the presumption should or should not be rebutted.

Finally, because this letter relates to a possible enforcement action by the Commission, we will not disclose it to the public.

Sincerely,

Michael Bradfield