Fiduciary Duties in Negotiated Acquisitions: Questioning the Legal Requirement for "outs"

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I. INTRODUCTION .................................................................... 2261
II. FIDUCIARY OUTS ................................................................... 2263
   A. The Context ............................................................ 2263
   B. The Practice .......................................................... 2265
   C. The Background Law .................................................. 2268
III. NO LEGAL MANDATE ............................................................ 2271
   A. Statutory Law ............................................................ 2271
   B. Caselaw .................................................................... 2272
      1. Delaware Supreme Court ........................................ 2274
      2. Recent Delaware Chancery Court Rulings .............. 2276
      3. Analysis Of The Delaware Caselaw ....................... 2280
IV. THE EFFECTS AND THE REALITY ........................................ 2284
   A. The Effects ............................................................... 2285
      1. Bargaining Power And Stockholders' Interests .......... 2285
      2. The Judicial System ............................................... 2289
   B. The Reality ............................................................... 2292
V. CONCLUSION ........................................................................ 2294

I. INTRODUCTION

Generally, no provisions of a merger agreement involving a

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1. This article will refer exclusively to merger agreements. Although a merger is not the only method of acquiring all the capital stock of a public corporation, it is the only practical one. Tender offers (without a second-step merger), asset acquisitions, and direct purchases are either impracticable due to the high number of widely dispersed stockholders of the target, the necessity of obtaining third-party consents, or tax considerations.

2261
publicly held target corporation, other than those dealing with price, are as heavily negotiated or arouse such intense debate among the participants as those governing what actions the board of directors of the target may take in the face of a higher acquisition offer that is made after the agreement is executed. Often lost in the analysis of the intricacies of the limitations upon “fiduciary outs” from the performance of the merger agreement in the event of a higher offer or of the consequences of exercising the out is the threshold question of whether such an out is prescribed by law or merely an optional contractual provision, to be included or excluded from a merger agreement based on the parties’ information and bargaining power. Depending on the state of the target company’s incorporation, the answer to this threshold question may be viewed as either unknown or turning on issues of the nature of the decision to sell (i.e., for strategic or purely financial reasons) or of the ownership of the resulting entity (i.e., whether there will be a controlling stockholder or whether control will be maintained by dispersed public stockholders). Even in jurisdictions such as Delaware, where there is a substantial body of relevant case law, these latter two factors are not dispositive.

Part I of this article will first briefly analyze the nature of fiduciary outs and the context in which they are used. Part II will present the argument that fiduciary outs are not (and should not be) required by law in all contexts, with a particular focus on Delaware corporate law because of the large number of publicly held corporations incorporated in that state and the body of widely followed court decisions that result from that fact. This argument applies

2. Although often a misnomer, as this article will address, such a right of termination or forgiveness of certain covenants contained in the merger agreement is commonly referred to as a “fiduciary out.” Because it is such a widely used phrase, rightly or wrongly, this article will employ it as a convenient shorthand term.

3. More than forty percent of companies listed on the New York Stock Exchange are incorporated in Delaware, as are over eighty percent of the publicly traded Fortune 500 companies. Leo Herzel & Laura D. Richman, Foreword to 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS (3d ed. 1997).

4. There is scant decisional authority in other jurisdictions regarding the permissibility of a merger agreement with no fiduciary outs (sometimes called an “exclusive” merger agreement), although there are some notable exceptions. E.g., Jewel Cos. v. Pay Less Drug Stores N.W., Inc., 741 F.2d 1555, 1564 (9th Cir. 1984) (California law) (holding that a board of directors may lawfully agree in a merger agreement to forbear from accepting third-party bids until the stockholders’ vote occurs); ConAgra, Inc. v. Cargill, Inc., 382 N.W.2d 576, 587 (Neb. 1986) (deciding
whether or not the target corporation is selling for strategic or financial reasons and whether or not the merger will result in a controlling stockholder of the surviving corporation. Despite recent judicial opinions in Delaware questioning the validity of merger agreements with no fiduciary outs, this article contends that the decisions may be explained by two factors: the amount of information relating to the market for acquisition of the corporation possessed by the target board of directors before entering into the merger agreement, and the “lock-up” provisions that operate to deter or even preclude third-party acquisition offers. There is often a failure to distinguish between the question of whether the board of directors of a target corporation must have the right to exercise a fiduciary out to consider a higher third-party offer versus the consequences of the exercise of that right, including the triggering of the lock-up provisions. Part III of this article discusses the consequences to stockholders and to the legal system of the conclusion that fiduciary outs are not legally required in all contexts and the reasons why fiduciary outs will nevertheless very often be included in merger agreements, whether at the insistence of the target or even the acquiring corporation.

II. FIDUCIARY OUTS

A. The Context

Long before a merger agreement is signed and the transaction is publicly announced, the acquiring corporation (and, to a lesser extent, the target corporation) has heavily invested in the deal. Whether measured in out-of-pocket expenses, investments of management’s time and attention, or opportunity costs of foregoing other promising potential targets, this investment can be substan-

that a target board may not agree to “best efforts” clause regarding the stockholder-approval process in the absence of a fiduciary out.

5. “Lock-ups,” as they will be broadly called in this article, suggest certainty of consummation, but in fact fall into a range from simple liquidated damages, which would not deter most potential third-party bidders, to stock or “crown jewel” options that would arguably deter nearly all. Although some would include the prohibitions on considering unsolicited third-party offers discussed in this article to fall into the broad category of lock-ups, this article will treat the two categories as distinct, with lock-ups only encompassing devices that could result in a wealth transfer from the target corporation to its initial merger partner. Lock-ups may be terms of the merger agreement itself or may be set forth in a separate document such as an option agreement or a voting agreement coupled with an irrevocable proxy.
tial. The unique strategic or synergistic advantages of the proposed merger, as perceived by the acquiring corporation (and sometimes the target corporation), also are frequently of significant value—one of the reasons why injunctive relief may be granted to prevent breach of a merger agreement, as opposed to after-the-fact monetary damages being the sole remedy of an aggrieved merger partner proposed to be left for another suitor.

In order to protect its investment and the perceived benefits of the merger, the board of directors of the acquiring corporation will often seek to push the limits on reducing or eliminating the target board of directors' ability to terminate either the merger agreement itself or merely some provisions of it, whether due to changed circumstances or an intervening unsolicited third-party bid. Numerous events may occur between the negotiation and execution of the merger agreement and the meeting of the target corporation's (and sometimes the acquiring corporation's) stockholders to approve it, which often may not occur until two to four months (or longer) after the agreement is executed. Depending on the nature of the parties (publicly held or private), the type of consideration being paid (stock, other securities, or cash), and the workload of the Securities and Exchange Commission's staff, the solicitation and disclosure document required to be sent to the target corporation's stockholders may be tied up for months in the SEC's review process. If the staff elects to review a merger filing, its stated goal is to provide an initial comment letter within 30 days of filing. William W. Barker, SEC Registration of Public Offerings Under the Securities Act of 1933, 52 Bus. Law. 65, at n.5 (1996). Typically, however, the receipt of the initial comments is merely the first stage of a two-to-four round process of back-and-forth comments and responses. Louis Loss & Joel Seligman, Securities Regulation 210 (3d ed. 1989).

7. This occurs when either party seeks to "incorporate by reference" the volume of its other SEC filings in the disclosure document. 17 C.F.R. § 240.14e-1, Note D(3) (2000); General Instruction A(2) to SEC Registration Statement Forms S-4 and F-4. Pursuant to regulations adopted under the Williams Act, a waiting period of 20 business days is applied to all tender offers. 17 C.F.R. § 240.14e-1 (2000).

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6. The staff of the SEC has discretion whether to review a merger proxy statement or registration statement (Form S-4 or F-4). Abba David Poliakoff, SEC Review: Comfort or Illusion?, 17 U. BALT. L. REV. 40, 43-46 (1987). If the staff elects to review a merger filing, its stated goal is to provide an initial comment letter within 30 days of filing. William W. Barker, SEC Registration of Public Offerings Under the Securities Act of 1933, 52 Bus. Law. 65, at n.5 (1996). Typically, however, the receipt of the initial comments is merely the first stage of a two-to-four round process of back-and-forth comments and responses. Louis Loss & Joel Seligman, Securities Regulation 210 (3d ed. 1989).
dominant players in a given market may be subject to substantial delays resulting from the Department of Justice and the Federal Trade Commission’s antitrust review. Any of these delays gives ample time for changed circumstances, such as a decline in the value of the acquiring corporation’s stock that it plans to use as the merger consideration, whether due to general market conditions or entity-specific developments, or for a third party to announce its intent to top the acquiring corporation’s offer, such as in the highly publicized fight in early 2000 involving American Home Products, Warner-Lambert, and Pfizer. The combination of these factors results in the acquiring corporation’s investment being placed at risk for what may seem like forever to its management.

B. The Practice

An initial question that one may ask regarding fiduciary outs is what are they are “outs” from? There is not a single answer to this question, as there are four distinct but related aspects of a typical merger agreement where the target corporation’s board of directors’ promises may conflict with the target stockholders’ desire for a higher-priced offer. First is the limitation on the target corporation or its affiliates’ discussing, entertaining, accepting, or providing confidential information to one considering a third-party offer after the agreement is executed. Second, the merger agreement will usually mandate that the target directors and management use their best efforts (or some variation of that standard) to satisfy all of the conditions to closing the merger, including regulatory approvals, contractual consents, and the stockholder vote. A typical third provision is for the target board to agree that, in the required proxy statement and thereafter, it will recommend that stockholders vote to approve the merger agreement (and no other) and will call a stockholder meeting for that purpose. Finally, a target board of directors may have the option to terminate the merger agreement itself and get out of the deal altogether. A merger agreement may contain an out for the target board from any or all of these provisions. The exercise of one of these outs by the target corporation is not free, however. There is virtually always tied to the exercise of such provisions (other than the out from prohibitions on third-party discussions or information disclosure) a termination fee

or other method of compensating the acquiring corporation for its sunk costs and lost opportunities.

Despite the importance and attention that practitioners give to negotiating fiduciary outs, many do so without considering whether they are required by law or merely optional contractual provisions, to be included only if the circumstances so warrant. For example, a not-uncommon formulation of the fiduciary out states that the directors may terminate the merger agreement or withdraw their recommendation that stockholders vote to approve the merger if the directors are required by their fiduciary duties to take such actions.\(^9\) Feeling that this formulation of the fiduciary out may have been too flexible and permissive for the target corporation, some acquirers have attempted to limit the target board’s discretion by requiring that the board obtain an opinion of counsel to the effect that the directors would breach their duties to the stockholders unless they exercise an out from the agreement.\(^10\) But unchecked discretion is merely one of the potential problems of drafting a fiduciary out using such circular language.

For a contractual provision that often takes up a great amount of time and energy, and often has important consequences, when compared to the other terms of the merger agreement, the first approach described in the preceding paragraph appears to leave much to chance. Some practitioners may believe that they are acting efficiently by incorporating into the merger agreement the body of relevant corporate law governing directors’ conduct rather than restating it or freezing it at a given point in time. Others may believe that they are acting prudently by ensuring that, depending on which side of the transaction they are on, they are either obtaining the maximum flexibility to terminate the agreement or their recommendation in the face of a better offer (in the case of the target) or limiting the target’s ability to terminate to the bare minimum of those situations where the law absolutely requires it (in the case of the acquirer). Both views cannot be correct. Nevertheless, these practitioners believe that, in either case, they are protected because a court cannot later determine that their agreement violates the relevant legal standards if those standards are incorpo-

\(^9\) Hence the common name for the provision. \(E.g.,\) Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 39 (Del. 1994).

\(^10\) A recent Delaware case has invalidated this element of the fiduciary out, however. \(ACE Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch. 1999),\) discussed \textit{infra} at the text accompanying notes 55-62.
rated into the agreement itself. This certainty may be upset, however, if the governing state law does not provide that a corporate board of directors must have the ability to terminate a deal that turns out, in hindsight, to have been a poor one.

Some have recognized this uncertainty and circularity, however. A number of commentators now advise that it may be unwise for both acquiring and target corporations to rely on what a court may or may not determine directors' fiduciary duties require, including the possibility that the court may determine that the state’s corporate law does not provide directors the right to terminate a poor agreement in the face of a better one. In response to these admonitions, it is now common practice for attorneys negotiating a merger agreement to avoid murky concepts such as what a board’s fiduciary duties require and instead to specifically delineate the terms on which the target corporation’s board of directors may exercise a fiduciary out. Common provisions often include most of the following factors: an unsolicited offer from a third party is received by the target corporation or is publicly announced by the third-party bidder; the target’s board of directors, after consulting with its legal and financial advisers, determines that the third-party offer is more valuable than the current transaction; and the target board believes that there is a reasonable likelihood that the third-party offer, if accepted, will be able to be consummated. Sometimes, the acquirer will negotiate for a limited window of time (such as five days) during which it may match the usurper’s offer. Others get more creative and ask for such conditions as the acquirer’s right to be kept fully informed of developments concerning the third-party offer at all times or even to have a representative of the acquirer be present (in person or via conference call) at all

12. Bird & Bab, supra note 11.
13. Id. at 6.
14. ACE Ltd., 747 A.2d at 100. Contrary to intuition, this right to match may actually work to the target corporation’s benefit by causing a bidder to top its competitor by a meaningful amount, rather than engaging in a series of incremental price increases and resulting five-day waiting periods. The recent bidding war for Funco, Inc. conducted by Barnes & Noble and Electronics Boutique is an example of such a provision working to the target’s advantage in that manner. Philip S. Garon, Maximizing Shareholder Value: The Funco Experience, Faegre & Benson LLP CLIENT NEWSL. (Faegre & Benson LLP, Minneapolis, Minn.), Aug. 2000.
negotiations regarding the other offer. The imagination of acquirers and their attorneys, tempered by the risk of judicial review, is the only limitation on how a fiduciary out may be crafted.

Although these more-specific "superior offer" formulations of the fiduciary out provide greater certainty for the parties than the circular definition of such a provision, many negotiators nevertheless start their discussions with the premise that the target's board of directors must have an out—the only issue is how to define and circumscribe it. Part II of this article argues that that baseline premise is mistaken and that there is no such clear legal requirement. Before beginning that argument, however, it is first necessary to briefly review some fundamental points of law regarding directors' fiduciary duties in the merger context.

C. The Background Law

It is black letter law that corporate directors owe a fiduciary duty to their stockholders. This duty takes two forms: the duty of care (i.e., the exercise of a level of care that a prudent person would exercise in the management of his or her own affairs) and the duty of loyalty (i.e., the absence of self-interest in the exercise of one's judgment). The fiduciary out may be seen as advancing both aspects of directors' fiduciary duties. With respect to the duty of care, the fiduciary out may serve as additional insurance against a claim by aggrieved stockholders that the board of directors was negligent in failing to maximize the purchase price for the corporation, where the courts have determined that such price-maximization is legally required. If no superior offer is forthcoming during the delay between execution of the merger agreement and the stockholders' meeting to approve it, in the absence of other contractual provisions that may unduly deter such an offer, how can one reasonably claim that the board could have obtained a better price for the corporation under current conditions? The fiduciary out also serves as a check against director self-interest in

15. As so called by Bird & Bab, supra note 11, at 5, and Johnston & Alexander, supra note 11, at 19 & n.40.
16. ROBERT C. CLARK, CORPORATE LAW § 3.4 (1986); MINN. STAT. § 302A.251, subd. 1 (West 2000 Supp.). Delaware courts have defined the duty as the absence of gross negligence. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).
17. CLARK, supra note 16, § 4.1.
that any pro-management deal struck with a favored party will likely be topped in the market for corporate acquisitions, again assuming no contractual provisions making such a topping bid too costly.

When a corporation is to be broken up or when an acquisition will result in a change of control from the unaffiliated mass of public stockholders to a single stockholder or group, the Delaware courts have created a rule that the directors' fiduciary duties require them to maximize the price paid for the corporation; this is the so-called “Revlon duty.” Underlying this duty is the courts' concern that the break-up or the change of control of a corporation results in the stockholders of the corporation losing the ability to realize a premium for their shares. The merger is the stockholders' last chance at obtaining such a premium. In contrast, where the surviving corporation in a merger will continue to be held by widely dispersed public stockholders, including the former stockholders of the target corporation, the target stockholders may yet enjoy the payment of a control premium for their shares when the acquiring company is itself sold. The satisfaction of directors' Revlon duties requires the care of an informed and deliberative process and the loyalty of avoiding favoring a potential bidder for reasons other than the stockholders' best interests.

After Revlon, there arose and developed a dichotomy in the

19. A party may be favored because it offers to keep certain members of the board of directors or management in place, because it shifts some of the acquisition price from the stockholders to management by means of lucrative employment or consulting contracts, or because of directors' subjective beliefs about one potential acquirer's reputation and intent versus another.

20. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); see also Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1994). Unlike Delaware, the statutory law of a number of states allows directors evaluating a merger to consider other corporate constituencies such as employees, creditors, and the community. E.g., MINN. STAT. § 302A.251, subd. 5 (2000). It is unclear how such a statute would be interpreted. Could the directors of a Minnesota corporation, having agreed to sell the corporation for cash, reject a substantially higher third-party bid because that bidder indicates its plan to close all the corporation's plants in the state and move them elsewhere? Although the statutory language would seem to indicate that the directors' decision would be permissible, no court has yet been called upon to make this determination. See 18 JOHN H. MATHESON & PHILIP S. GARON, MINNESOTA PRACTICE SERIES: CORPORATION LAW AND PRACTICE § 8.2, at 287 (1996).

21. QVC, 637 A.2d at 43.


23. A third standard of review, that of “entire fairness,” applies when the
level of judicial scrutiny applied by the Delaware courts when analyzing directors' conduct in the merger context.\textsuperscript{24} When a corporation is in the "Revlon zone," that is, when it is to be broken up or sold to a person or group that will control the acquiring corporation's stock after the transaction, the Delaware courts will analyze the board of directors' conduct using an enhanced level of scrutiny that focuses on whether the directors acted reasonably in obtaining the best value for stockholders.\textsuperscript{25} Outside of the Revlon zone, directors' actions are subject to the less-rigorous and highly deferential business judgment rule.\textsuperscript{26}

Because of this distinction in the Delaware courts' standard of review between Revlon transactions and those that do not involve a change of control from the ever-changing mass of public stockholders, most practitioners believe that the inclusion of one of more fiduciary outs in an acquisition agreement is a necessity when a target corporation is in the Revlon zone. Many of those practitioners, but not all, would, however, be reasonably comfortable advising a board of directors considering a strategic stock-for-stock

\textsuperscript{24} Although this apparent bright-line division makes life easier for attorneys advising merger participants, it may be less certain than it first seems. It may serve as a useful heuristic device when comparing opposite transactions such as a sale of a corporation for cash with a stock-for-stock merger of two publicly held corporations of nearly equal size with no acquisition premium. The distinction becomes less clear, however, when the stockholders of the target corporation will make up only a tiny percentage of the surviving corporation after a stock-for-stock merger. For stockholders such as these, the acquisition may be their last chance to control (indirectly) their receipt of a control premium, even if there is no controlling stockholder post-deal. This is because the post-acquisition performance of the target will do little to affect the sale price of the acquirer when it itself is sold and because of the limited power of the former target stockholders to influence the management of the acquirer. This area of the law is unsettled and continuing to develop.

\textsuperscript{25} \textit{QVC,} 637 A.2d at 43.

\textsuperscript{26} \textit{Time-Warner,} 571 A.2d at 1150. The business judgment rule derives from the Delaware statute vesting in the board of directors the authority to manage the business and affairs of the corporation. \textit{Del. Code Ann. tit. 8, \S\ 141(a)}(1999). The rule has been stated by the Delaware Supreme Court as follows: "[the rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." \textit{Aronson v. Lewis,} 473 A.2d 805, 812 (Del. 1984).
transaction, especially if the parties were close in size and little or no control premium was being paid, that a fiduciary out to the agreement is not a legal requirement. Part III of this article will present the argument that this distinction in practice does not always accurately track what is required by law.

III. NO LEGAL MANDATE

A. Statutory Law

Before 1998, the question of whether a fiduciary out was required in a merger agreement was an unsettled question under Delaware law. The Delaware merger statute, like the merger statutes of all other states, requires that the board of directors act as a gatekeeper for mergers; stockholders cannot approve a merger unless the board has done so first. Until 1998, the Delaware merger statute had been interpreted by some as requiring as a condition for the stockholder vote that the board of directors continue to recommend that the stockholders approve the merger agreement right up until the vote; stockholders could not approve a merger in the absence of such a continuing recommendation even if they wanted to. Thus, a board of directors faced with a higher third-party bid for the corporation, yet bound by a merger agreement without a fiduciary out, would face a serious dilemma: either continue to recommend that the original transaction be approved even though they themselves do not believe it to be in the best interests of the stockholders, thereby violating their duty of candor—an element of the duty of loyalty—to the stockholders, or violate the agreement and suffer the consequences of a breach-of-contract suit. Neither choice was appealing.

In July 1998, however, the Delaware statute was amended to

27. E.g., 1 MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS AND FREEZEOUTS § 5A.03[3] (2000 Supp.). Recent decisions of the Delaware Court of Chancery may have diminished this comfort level, however. See also infra notes 51-74 and accompanying text.


29. This general rule does not apply, however, in those states that allow stockholders, by unanimous written agreement, to bypass the board’s authority to manage the business and affairs of the corporation or to act in lieu of the board. E.g., MINN. STAT. §§ 302A.201, 302A.457 (2000). Such agreements are obviously wholly impracticable for a publicly held corporation.


state that a merger agreement may provide that it be submitted to the stockholders for approval even if the board of directors deems it no longer advisable and recommends that the stockholders vote against it. Before analyzing the complicated web of Delaware decisional law in the merger context, it should be noted that this statutory amendment provides a strong base from which to argue that there is no legal requirement that there be a fiduciary out to terminate the agreement itself in every merger. If there were an implied-in-law right for a board of directors to terminate a merger agreement due to the emergence of a higher offer, the statutory language would be meaningless. The statute may not stand for the proposition that the lack of a fiduciary out is a good idea, for either the target or the acquirer, but it does support the conclusion that certain types of fiduciary outs are not legal requirements.

B. Caselaw

A trio of opinions by the Delaware Supreme Court in 1985-86 ushered in a new level of substantive after-the-fact judicial review of directors' actions in the mergers-and-acquisitions arena. Unocal Corp. v. Mesa Petroleum, Van Gorkom, and Revlon signaled an increased willingness by the courts to give less deference to boards of directors' actions in extraordinary corporate transactions. Although all three cases are of great importance, the Revlon case is


34. Because a board of directors must continue to inform the stockholders of the board's recommendation regarding whether or not the merger agreement should be approved, the statutory amendment does not advance the argument that there need not be an out to the target board's agreement to recommend the merger or to refrain from providing confidential information regarding the corporation to a potential third-party bidder. Cf. Phelps Dodge Corp. v. Cyprus Amax Co., Nos. Civ.A.17398, Civ.A.17583, Civ.A.17427, 1999 WL 1054255, at *1 (Del. Ch. Sept. 27, 1999) (discussing the requirement of the target board's continuing and informed recommendation regarding how stockholders should vote); see also infra text accompanying notes 51-54.


36. 493 A.2d 946 (Del. 1985).


arguably the best known.

Revlon involved a hostile bid for Revlon by Panty Pride, Inc. after the former rebuffed the latter's desire for a negotiated acquisition. Following the implementation of various defensive tactics to hinder the unwanted takeover attempt, which the Revlon board of directors had determined was at an inadequate price, the Revlon board agreed to a leveraged acquisition of the company by a “white knight,” Forstmann Little & Co. As part of its financing of the proposed acquisition, Forstmann planned to break up Revlon after consummation of the acquisition and to sell certain of its divisions to other interested parties. In order to protect Forstmann's agreement to acquire Revlon, the acquisition agreement contained a “crown jewel” option—that is, a lock-up option to acquire certain of Revlon’s prize divisions at a favorable price—and a promise to deal exclusively with Forstmann for the acquisition of the company.

The Revlon court first analyzed the initial defensive measures designed to thwart Panty Pride's hostile bid. Applying the standards of Unocal, the court found those measures to be reasonable responses to a perceived threat against the corporation. After the Revlon board had turned to Forstmann to rescue it from the hostile grasp of Panty Pride, however, it became clear that the corporation would be sold for its parts. Once the board made this decision, the court, in a widely cited metaphor, stated that “[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.” Finding that the lock-up option and the exclusivity provision granted to Forstmann Little were impediments to achieving the highest price reasonably obtainable for Revlon’s stockholders, the court held that the Court of Chancery had properly enjoined their application.

Because a board of directors' actions are currently subject to

39. Mesa Petroleum, 493 A.2d at 955 (holding that directors may enact defensive measures that are reasonable responses to a perceived threat to the corporation).
40. Revlon, 506 A.2d at 180-81.
41. Id. at 182.
42. Id. at 183-84. Although some had believed that Revlon was highly context-specific, applying only to cash purchases and corporate “bust-ups,” the QVC court held that view too narrow of a reading and that Revlon’s enhanced judicial scrutiny also would come into play upon a sale that, although leaving the corporate entity intact, resulted in a change of corporate control from unaffiliated stockholders to a single person or group. Paramount Communications, Inc v. QVC Network, Inc., 637 A.2d 34, 46 (Del. 1994).
more meaningful scrutiny in the *Revlon* context, this article will turn its focus there instead of the more deferential *Time-Warner* arena. Based on the Delaware courts' paradigm of reviewing directors' conduct in the merger context, if the courts do not mandate a fiduciary out when a corporation is in the *Revlon* zone, they certainly will not do so when there is no change of control and thus no loss of the public stockholders' ability to receive a control premium for their shares. If the directors' conduct satisfies the Delaware courts' enhanced scrutiny test, it surely will not be second-guessed under the deferential business judgment rule.

1. Delaware Supreme Court

Although the Delaware Court of Chancery recently decided a string of three cases (discussed below) that play an important part in the analysis of whether fiduciary outs are required in the merger context, the leading Delaware Supreme Court opinion on this subject after *Revlon* is the 1994 *QVC* opinion.44

*QVC* involved the proposed acquisition of Paramount Communications by Viacom Inc. The merger agreement between Paramount and Viacom contained three elements that the court subjected to enhanced scrutiny: a "no-talk" provision with a fiduciary out, which prohibited Paramount from entertaining a third-party offer unless the Paramount board was required by its fiduciary duties to do so; a termination fee of $100 million (or approximately 1.25% of the approximately $8 billion initial acquisition price), which would be payable by Paramount if its board of directors terminated the agreement because of a third-party offer or recommended a third-party transaction or if the Paramount stockholders voted against the merger; and an option that would have allowed Viacom to purchase 19.9% of Paramount's common stock

43. *Time* may be thought of as the doctrinal opposite to *Revlon* and is widely cited for the proposition that a board of directors may hold fast to its vision for the future of the entity in the face of an unwanted acquisition bid either when the corporation is not for sale or when it is a party to a strategic stock-for-stock merger where there will be no controlling stockholder after the deal.

44. *QVC*, 637 A.2d at 34.

45. Although the contractual term was called a "no-shop" provision by the *QVC* court, it actually prohibited not only Paramount's shopping for a better deal but also its responding to, or providing confidential information that would assist, an unsolicited bid. In the current nomenclature of the Delaware courts, this type of contractual term is referred to as a "no-talk" provision. *Infra* note 53 and accompanying text.
at a per-share price approximately equal to the per-share merger consideration.

After the negotiated acquisition was announced, QVC Network Inc. publicly stated its intention to commence a tender offer at a price that was approximately 15% more than Viacom's offer. In light of the unsolicited bid from QVC, the Paramount board, now with increased leverage, went back to renegotiate its deal with Viacom. Although Viacom agreed to pay a higher price for Paramount, Paramount did not use its increased leverage to lessen or eliminate the deterrent effect on third-party offers of the three provisions noted by the court. After back-and-forth price increases by potential acquirers, the Paramount board was confronted with a $10 billion offer from QVC. Citing questions regarding QVC's financing and concerns that the no-talk provision limited it from inquiring further into that issue and the other elements of QVC's offer, however, the Paramount board rejected QVC's overtures and clung to its deal with Viacom, even though Viacom was then offering to pay five percent less to acquire the company.

The Delaware Supreme Court, focusing on the three elements of the Paramount-Viacom merger agreement that could deter or preclude potential third-party bids, stated that those provisions would be subject to the court's enhanced "reasonableness" test set forth in Unocal. Building on Revlon, the court's justification for this enhanced scrutiny was twofold: Paramount had agreed to a change-of-control transaction in that Viacom was controlled by a single person (and would be so even after the consummation of the merger) and the Paramount board had agreed to defensive measures to protect that transaction against unwanted third-party bids.46

At first blush, the strong language in QVC would lead one to think that a fiduciary out is an absolute requirement in any Revlon transaction. When discussing the no-talk provision of the Paramount-Viacom merger agreement, the court stated that, whether or not the provision was presumptively valid or invalid in the abstract, it might limit directors' fiduciary duty to obtain the highest value reasonably obtainable for the stockholders.47 Because the Paramount board had determined to sell control, it had a continuing obligation to search for the best value for stockholders, which the no-talk provision impermissibly hindered.48

46. QVC, 637 A.2d at 42.
47. Id. at 49 n.20.
48. Id. at 48-49.
The *QVC* decision was expressly limited to its facts.\(^49\) Those facts were particularly poor ones for a target board of directors facing judicial review: although the Paramount board had decided to sell the company, it negotiated with only one favored bidder, without any canvass of the market; even if the Paramount board legitimately feared a public or private auction of the company, *QVC* had already expressed an interest in acquiring Paramount, yet it was not given the opportunity to top Viacom's offer; and the consequences of termination included Viacom's right to exercise a "draconian" stock option, one without limit on its value.\(^50\) One cannot be certain that the Delaware Supreme Court would apply its holding in *QVC* to a merger agreement that was not so tainted at the outset.

2. Recent Delaware Chancery Court Rulings

A one-month period in the fall of 1999 witnessed three different judges of the Delaware Court of Chancery hand down three opinions that quickly caught the attention of practitioners and commentators in the mergers-and-acquisitions arena. Each has its own impact on directors' actions in this arena, and each bears on the question of whether a fiduciary out is required in a merger agreement. Each case focused on contractual provisions that limited or prohibited the target's board of directors from entertaining unsolicited third-party offers. It is also interesting to note that each case involved a negotiated stock-for-stock merger that did not involve a change of control and thus did not give rise to enhanced judicial scrutiny under *Revlon* and *QVC*.

The first case, *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,\(^51\) is not so memorable for its holding, but for a number of interesting statements by Chancellor Chandler. The holding, that the court would refuse to enter a preliminary injunction that was sought by a third-party suitor against certain provisions of a merger agreement because, as the court stated, the stockholders of the constituent corporations could always vote against the merger, is not surprising (although it is relevant to the issues discussed in Part IV of this article). The interesting dicta that caught practitioners' attention re-

\(^{49}\) The court noted numerous times that its holding was specific to the facts before it and that certain contractual provisions may or may not be valid in other contexts. *Id.* at 37, 45, 48, 51, and nn.15, 19 & 20.

\(^{50}\) *Id.* at 49 n.19.

lated to two aspects of the merger agreement under consideration. First, the court characterized the size of the fee (6.3% of the transaction value) payable to the acquiring corporation if the merger agreement was terminated in the face of a competing bid as stretching the bounds of reasonableness, possibly to the breaking point. Second, and more to the point of this article, the court stated that the third-party bidder faced a reasonable likelihood on the success of its challenge to an agreement provision that not only prohibited the target corporation from soliciting third-party bids, but also from engaging in any discussions with, or providing confidential information to, a third party relating to an acquisition proposal, with no fiduciary out. In the words of the court, even though the target corporation was governed by *Time-Warner* and not by *Revlon*, this no-talk provision was "the legal equivalent of willful blindness, a blindness that may constitute a breach of the duty of care; that is, the duty to take care to be informed of all material information reasonably available." These strong words, given in the *Time-Warner* context, quickly received attention.

*ACE Ltd. v. Capital Re Corp.* came second in this trilogy of cases and confirmed that the *Phelps Dodge* ruling did not represent the views of a solitary judge. In an opinion written by Vice Chancellor Strine, the court refused to grant a temporary restraining order to prevent Capital Re Corporation from terminating its merger agreement with ACE Limited. The two parties had negotiated a stock-for-stock merger agreement that had two interesting provisions. First, in the face of hard times for Capital Re, ACE Limited invested in Capital Re in exchange for approximately 12% of its capital stock. Later, when it became apparent that this initial investment was not sufficient to turn the tide for Capital Re, its board of directors agreed for the corporation to be acquired by ACE Limited. Building on ACE Limited's initial toe-hold, the merger agreement was conditioned upon holders of approximately 34% of Capital Re's stock entering into voting agreements under which they were bound to vote for the merger if the corporation's board

52. *Id.* at *2.
53. The first aspect of the provision, the prohibition on solicitation, is often referred to as a "no-shop" provision; the second aspect, the absolute bar on engaging in any discussions with, or providing information to, the maker of an unsolicited bid, is referred to by the *Phelps Dodge* court and others as a "no-talk" provision. *Id.* at *1.
54. *Id.* at *2.
55. 747 A.2d 95 (Del. Ch. 1999).
did not terminate the merger agreement in accordance with its terms before the stockholders’ meeting. Second, the fiduciary out to the agreement’s no-talk provision arguably mandated the Capital Re board to base its decision that negotiating with a third party was required in order to avoid breaching its fiduciary duties to stockholders on written advice of legal counsel to that effect.

In the three months between execution of the merger agreement and the meeting of Capital Re’s stockholders to approve it, ACE Limited’s stock price declined dramatically, resulting in the value of the ACE Limited stock that each Capital Re stockholder would receive in the merger falling from over $17 per share to less than $10. On the day before the stockholders’ meeting, a third-party bidder publicly announced an all-cash offer for Capital Re with a per-share purchase price of $12.50. During a hastily convened emergency meeting of Capital Re’s board of directors, the corporation’s outside legal counsel gave the opinion that negotiating with the new bidder was “consistent with” the board’s fiduciary duties, but not that such negotiations were “required by” those duties, as ACE Limited argued the merger agreement required as a condition for the exercise of the fiduciary out. Nevertheless, the Capital Re board of directors itself determined that it was duty-bound to negotiate with the other bidder. As a result of these negotiations, a bidding war for Capital Re ensued between the two bidders, with ACE Limited finally putting a stop to it all by filing the court action.

In deciding ACE Limited’s breach-of-contract claim against Capital Re, the court took a two-step approach. First, it asked which interpretation of the merger agreement was a better reading: either whether the board, after receiving written advice of legal counsel (although equivocal on the issue), was itself justified in determining that its fiduciary duties to stockholders required it to entertain a higher offer or whether the board must base that decision on unequivocal legal advice that such a result is mandated. After finding that the former was a better reading of the contract language, the court nevertheless analyzed the enforceability of what ACE believed was its bargained-for interpretation that clear and unequivocal written legal advice was required. Citing a then-forthcoming law review article by Professor Paul Regan discussing

56. Id. at 103.
the tension in the law between the enforcement of the parties’ contractual expectations and the principles of agency and trust law that seek to protect a principal or a beneficiary when a contract is made on his or her behalf, the court stated that many times the parties’ expectations must give way to greater societal interests. Citing three of the four factors identified by Professor Regan, the court found that:

1. ACE was a sophisticated party that should have known that the no-talk provision, coupled with the voting agreements with a large percentage of Capital Re stockholders, would constitute a near-preclusive obstacle to any third-party bid;
2. because the merger had not yet closed, the court would not be put in a position of trying to unscramble it; and
3. the public policy of ensuring directors’ care and loyalty in significant corporate events such as mergers outweighs the protection of the acquirer’s contractual rights.

Vice Chancellor Strine’s lengthy and thoughtful opinion meant that Chancellor Chandler’s oral statements in Phelps Dodge could not be taken lightly.

The final case, In re IXC Communications, Inc. Stockholders Litigation, again revolved around, among other things, the no-talk provisions of a merger agreement. As in Phelps Dodge, the target corporation had agreed to a stock-for-stock merger that would not result in a controlling stockholder; thus, the enhanced scrutiny of Revlon did not apply to the judicial evaluation of the target board’s conduct. Unlike the context of QVC and Phelps Dodge, however, the target corporation had made public announcements before entering into the merger agreement that it was interested in entertaining offers for a merger or some other strategic alternative to remaining a stand-alone company. After engaging in discussions with a number of potential suitors, which ranged from mere indications of interest to actual negotiations, the target agreed to a merger with the only potential purchaser that had stuck with the process to the end.

58. ACE Ltd., 747 A.2d at 104.
59. The court did not find the fourth factor, whether ACE’s reliance interests under the merger agreement warranted protection, to be relevant to its analysis.
60. ACE Ltd., 747 A.2d at 109.
61. Id.
62. Id.
The plaintiffs challenged the merger agreement's mutual no-talk provision, which prohibited either party from entertaining alternative bids. Although the no-talk provision was later dropped in favor of a mutual no-shop provision with a fiduciary out (seemingly after the *Phelps Dodge* decision was handed down just one month before), Vice Chancellor Steele still felt compelled to state his view of the ill-fated provision: "Further, the assertion that the board 'willfully blinded' itself by approving the now defunct 'no-talk' provision in the Merger Agreement is unpersuasive, particularly considering how late in the process this provision came. Provisions such as these are common in merger agreements and do not imply some automatic breach of fiduciary duty." The strong language in *Phelps Dodge* began to look a little weaker, and practitioners became a little more uncomfortable in predicting the decisions of the Delaware courts.

Why did the *IXC Communications* court view the no-talk provision so differently than the court in *Phelps Dodge*? After all, hadn't the *IXC Communications* plaintiffs just parroted the language of the *Phelps Dodge* opinion in their arguments? The next section analyzes the body of Delaware caselaw on fiduciary outs and concludes that the apparent schism in the decisions may be explained by reference to two factors.

3. Analysis Of The Delaware Caselaw

On its face, this review of the Delaware caselaw looks rather bleak for counsel to an acquiring corporation when either negotiating a merger agreement with no fiduciary out for the target board of directors or arguing to a court that the deal-protection terms of such an agreement are valid. Even before the issuance of the trilogy of opinions of the Delaware Court of Chancery in late 1999, a substantial majority of practitioners and commentators would have relied on *QVC* and other cases and stated that the inclusion of a fiduciary out is an absolute legal requirement for a target corporation subject to the enhanced scrutiny of *Revlon*. After those three cases, many if not most would also believe that a fiduciary out is a must for a target corporation engaged in a strategic stock-for-stock merger not resulting in a controlling stockholder and thus governed by the more deferential standard of *Time-Warner*. After October 1999, it appeared that the Delaware courts had reached the

64. *Id.* at *6.
FIDUCIARY DUTIES IN NEGOTIATED ACQUISITIONS

finish line in the marathon that began in 1985 to extend their after-the-fact review of directors' conduct in the merger context to include all types of transactions, prohibiting any contractual measures that would substantially curtail a target board's ability to inform itself regarding unsolicited third-party offers that could provide a higher price to stockholders. Any target board of directors that did not include a fiduciary out in its merger agreement, whether governed by *Revlon* or *Time-Warner*, would do so at its own risk.65

Why, then, would such an eminent authority on Delaware corporate law as former Chancellor William Allen flatly state in early 2000 that "[n]ot every *Revlon* transaction requires a fiduciary out provision"?66 Note that Chancellor Allen referred to *Revlon*, where most had thought the issue settled the other way even before the fall of 1999, not to *Time-Warner*, where, at least before the trio of 1999 Chancery Court opinions, there was some vigorous debate on the issue. Perhaps the Delaware caselaw is not as clear as some would believe.

Although not every court is as candid and explicit on the topic as the Delaware Supreme Court in *QVC*,67 the Delaware caselaw on fiduciary outs is highly fact-specific. Even the *Revlon/Time-Warner* distinction, in which some find comfort as a bright-line rule, often creates a false dichotomy that only holds true at the polar opposite ends of the change-of-control continuum on which merger-and-acquisition transactions may fall.68 Although the specific facts in *QVC* or *Phelps Dodge* may have led the court to the correct result,

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65. The "risk" referred to is almost exclusively the risk of equitable relief, either an injunction that would delay the transaction or the declaration that certain contractual terms are unenforceable. After a merger has occurred and the "eggs have been scrambled," a court would almost never unwind the transaction. McMillan v. Intercargo Corp., No.CIV.A. 16963, 2000 WL 516265, at *5 (Del. Ch. Apr. 20, 2000). In addition, few directors face personal liability for damages resulting from the breach of the duty of care, as most corporations take advantage of the Delaware statute that allows a corporation to eliminate such liability in its certificate of incorporation. Del. Code Ann. tit. 8, § 102(b)(7)(1999). Looking at what actually happens in practice, one can observe that few boards of directors are willing to take the risk of even equitable relief, however. A 1997 article noted that virtually every merger agreement involving a publicly held target includes a fiduciary out. Johnston & Alexander, supra note 11. Some of the reasons why are discussed in Part IV.


67. Supra note 49.

those cases may not have produced the clear legal standards that some were hoping they did. 69

The leading cases on fiduciary outs focus on the board of directors’ duty of care, not its duty of loyalty. The cases turn on an analysis of the directors’ conduct and diligence in the process of investigating the acquisitions market and negotiating the merger agreement, not in the fairness to the stockholders of the underlying transaction due to some conflict of interest of the directors or management. A common theme runs through the cases that have found violations of this duty of care: the target board of directors’ lack of information on the market for control of the corporation. Putting aside the “rubber stamp” procedures of the board of directors in Van Gorkom, 70 the cases routinely present boards of directors that agree to a merger agreement containing no-talk and lock-up provisions without sufficient information. In QVC, for example, Paramount’s board of directors agreed to the corporation’s acquisition by Viacom without informing itself as to what another bidder might pay, even though it already knew that QVC was interested in an acquisition. Moreover, the merger agreement contained a no-talk provision and a “draconian” stock option that effectively precluded consummation of any third-party offer, no matter how much better for the Paramount stockholders. In Phelps Dodge, the transcript of the oral ruling is not detailed enough to know how well the boards of the two merger partners analyzed the market, but one may infer that they pursued the transaction for strategic reasons and did not actively consider acquisitions by other parties. What one can be sure of, however, is that, besides the no-talk provision, the court looked with disfavor upon the size of the termination fee that the parties had negotiated. Finally, in ACE Ltd., the Capital Re board of directors, without actively considering other potential suitors, agreed that the corporation could be acquired by one who was already a substantial stockholder and who had voting agreements with other major holders that made the stockholder-

69. Most practitioners would not care how the courts came out on the question of fiduciary outs, just so they handed down a clear rule. The present fact-based body of decisions requires additional expense of lawyers’ time and efforts in negotiating merger agreements and increases the risk that after-the-fact judicial review will prove their advice wrong.

70. Van Gorkom, 488 A.2d at 864-69 (discussing that the board of directors approved a merger agreement with little deliberation and without questioning the per-share acquisition price that the corporation’s Chief Executive Officer had come up with himself).
approval process a mere formality. In each case, the target board of directors entered into a merger agreement containing terms (other than a restrictive fiduciary out or the absence of one altogether) that completely or substantially precluded any superior offer. Moreover, the board agreed to such terms without a meaningful check of the market for control of the corporation.

One may contrast these cases with *IXC Communications*, in which the court found no violation of the target board's duty of care in agreeing to a no-talk provision. Not only did the court make this finding, but also its entire tone in discussing the concept of such a provision was far different from the other cases discussed above. Contrast the court's statements in *IXC Communications*: "[p]rovisions such as these are common in merger agreements and do not imply some automatic breach of fiduciary duty" with those in *Phelps Dodge*: "this is the legal equivalent of willful blindness, a blindness that may constitute a breach of the board's duty of care ...." At the heart of the court's decision in *IXC Communications* is that the no-talk provision of the merger agreement was agreed to "late in the process," after *IXC Communications* had hired an investment banker to discretely, but widely and publicly, announce that the corporation was for sale and after it had negotiated with a number of possible buyers.

Why the difference in these two cases, which were decided within a thirty-day period and which were ostensibly governed by the same overarching legal doctrine of the Delaware Supreme Court?

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74. Even the *ACE Ltd.* court acknowledged that it might view a no-talk provision differently in the context where the target board of directors had sufficiently canvassed the market. *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107 n.36 (Del. Ch. 1999). Another factor that may have influenced the court is that no third-party bidder came forward to challenge the merger in *IXC Communications*, in contrast to *ACE Ltd.* and *Phelps Dodge*. The absence of a challenger would be a rather unreliable factor on which a court would base its decision, however, since a preclusive merger agreement may cause a bidder to forgo making a challenge altogether and instead set its sights on an easier target. One could be left with the paradoxical result that the more preclusive the merger agreement, the less likely it will be subject to judicial review.
Court’s opinion in *Time-Warner*? The difference appears to turn on two factors: first, the extent of the target board’s pre-signing information on the market for control of the corporation; and second, the other provisions of the merger agreement that may deter or even preclude third-party bids. A target board of directors that enters into a merger agreement with no fiduciary out faces a substantial risk of after-the-fact judicial review if it did not have sufficient information on the market for acquisition of the corporation and, perhaps more importantly, if there are substantial impediments to consummation of third-party offers because of financial, stock, asset, or voting lock-ups. The lack of a fiduciary out, analyzed in isolation, has never been the basis of a reported decision of a Delaware court enjoining or invalidating the deal-protective terms of a merger agreement.

Regardless of whether a board of directors’ actions are analyzed under the deferential standards of *Time-Warner* or the more exacting standards of *Revlon*, the answer to the question of whether the inclusion of a fiduciary out in a merger agreement is legally required in every instance is no. Not by statute or by Delaware case-law; not by *QVC*, not even by *Phelps Dodge*. The impact of this conclusion and the reasons why many boards of directors of targets (and sometimes acquirers) will nevertheless very often demand and receive fiduciary outs is discussed in Part IV.

IV. THE EFFECTS AND THE REALITY

Two important questions are raised by the conclusion that fiduciary outs are not legally required in every merger agreement.

75. Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court’s Takeover Jurisprudence*, 19 J. CORP. L. 583, 605 (1994) (explaining the *Revlon* and *QVC* decisions as the Delaware courts presenting target boards with the choice of giving stockholders a meaningful opportunity to reject the directors’ decision or of facing enhanced review of their actions); Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 249 (1990) ("The critical issue thus is not whether the target board has the power to grant exclusivity provisions, but what the board can do to prevent competing bids.").

76. One must be careful to distinguish among fiduciary outs to the four different contractual provisions discussed above, however. A court would likely look more favorably on the absence of the target board’s ability to terminate the agreement in the face of a higher offer than it would on the absence of a fiduciary out from the board’s agreement to recommend that stockholders vote to approve the merger agreement or to refrain from providing confidential information to potential other bidders.
First, if that conclusion differs from widely held beliefs in the mergers-and-acquisitions market, as this author believes is true, then what will be the effects on the players in that market, including acquiring and target corporations and their stockholders? Second, given the fact that fiduciary outs were often included in non-
Revlon transactions before the Delaware Chancery Court gave practitioners a reason to be more vigilant in this area, isn’t that evidence that there may be valid reasons why parties to a merger agreement would include a fiduciary out for the target board of directors, even if not required by law to do so? The final part of this article will analyze these two questions.

A. The Effects

1. Bargaining Power And Stockholders’ Interests

The first effect of recognizing the conclusion that a fiduciary out is not a legally mandated requirement for every merger agreement may be a shift in bargaining power from target corporations to acquirers. If the parties begin their negotiations with the premise that, by law, there must be a fiduciary out, the target board does not have to “give up” anything to get it. The parties may still negotiate the exact wording of the fiduciary out from the many forms available, but the initial inclusion of such a provision will not be fought over; it will be taken as a given. In contrast, if the parties start from the default position that no fiduciary out is required, the target corporation will have to bargain for the benefits of the out: increased information regarding the acquisition market for the corporation, the possibility of increased value for its stockholders, and the decreased chance of expensive litigation that may consume directors’ and management’s time and attention and delay consummation of the transaction. The receipt of these benefits is not free, however. To obtain them, the target corporation may have to settle for a lower purchase price or more disadvantageous terms of the merger agreement.

The magnitude of this shift in bargaining power, and even its existence at all, is an empirical question that is beyond the scope of this article. It bears noting, however, that whether such a shift would indeed be forthcoming is open to debate. Potential acquirers, with greater certainty that their contractual expectations will be enforced, may be enticed to make their initial acquisition offers at
a higher value. A acquiring corporations would not have to discount their initial offer prices because they would no longer be dealing with such “unreliable contracting partners.” Target stockholders may also benefit from the absence of a phenomenon that is presently not observable: at the margin, some potential acquirers may currently be deterred by the uncertainty of after-the-fact judicial review from entering into a merger agreement in the first place.

The board of directors of the target corporation also has an interest in reducing the ability of the acquiring corporation (in the absence of a successful third-party bidder) to abandon the merger. Except in rare instances, the acquiring corporation’s “outs” are couched in terms of financing contingencies or a requirement that no material adverse changes to the target corporation shall have occurred between executing the merger agreement and closing. If the acquiring corporation exercises any of these outs, the effects on the target corporation can be disastrous: even if wholly unwarranted, it may be seen as “damaged goods,” for which no other potential acquirer would pay nearly the same acquisition price. To the extent that a target board may substantially reduce the ability of the acquiring corporation to terminate the merger agreement by eliminating the target’s fiduciary out, the target corporation’s stockholders should benefit.

The overriding concern of the courts in cases such as Revlon and QVC is ensuring that target stockholders obtain the highest value reasonably obtainable for their shares. A merger is an extraordinary event in the life of a corporation and the sale of control and the resulting payment of a control premium is even more extraordinary. For target stockholders in the Revlon zone, the proposed merger results in a double whammy: the end of their invest-

77. Jewel Cos. v. Pay Less Drug Stores N.W., Inc., 741 F.2d 1555, 1563 (9th Cir. 1984); Bainbridge, supra note 75, at 285; Taylor, supra note 33, at 625-26. This, of course, assumes that, unlike in Van Gorkom, there is true arm’s-length bargaining and that the board of directors of the target corporation has engaged in something more than a mere cursory review of the acquisitions market before the agreement is executed.
78. Johnston & Alexander, supra note 11, at 19.
81. Id. at *6-7 (deciding that acquirer’s ability to terminate in response to a material adverse change was weakened in exchange for no-talk provisions binding the target); Bainbridge, supra note 75, at 284-85.
ment in the corporation in which they had initially invested and the sale of an asset that is uniquely theirs: the control premium for their shares. If there is indeed a shift in bargaining power from targets to acquirers, what kind and degree of harm will befall these stockholders? The answer is not clear. Intuitively, one would think that the heightened judicial scrutiny of Van Gorkom, Revlon, and QVC would serve as a strong deterrent against director negligence. It would seem to follow that anything that weakens this deterrent effect would hinder the goal of price maximization, so crucial to the Delaware courts in the change-of-control context. Briefly mentioned above, however, were certain factors that could cause an exclusive merger agreement to result in a net benefit, rather than a loss, for target stockholders. First, there is the possibility that acquiring corporations will no longer discount their offer prices to reflect the uncertainty of a non-exclusive merger agreement or a highly fact-based judicial review. Second, there is the possibility that more acquisitions, and thus the greater likelihood of the payment of a control premium to the target stockholders, will occur at the margin. Either of these two benefits may offset the costs associated with the shift in bargaining power. But are there other offsets that may occur when the cost/benefit analysis is performed at the macro level?

One may assume that there is a construct called "target stockholders," made up of persons that somehow invest only in corporations that will, sooner or later, find themselves offered an acquisition proposal that their boards of directors determine is too good to refuse. These stockholders may be harmed by weakened judicial scrutiny in that acquirers will not be compelled to offer maximum acquisition premiums. Perhaps these stockholders will

82. Under Delaware law, most believe that a target board of directors, exercising its business judgment, may always "just say no" to an unwanted acquisition bid, so long as it says "no" to all acquisition bids. Paul L. Regan, The Unimportance of Being Earnest: Paramount Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers, 46 HASTINGS L.J. 125, 146 n.85 (1994) (citing various authorities). This results in the paradox that the courts take a greater interest when the choice is between the receipt of a given premium and the receipt of a slightly larger premium than they do when the choice is between a given premium and none at all. In the first scenario, the stockholders always have the final say (in the absence of preclusive lock-ups); in the second, their only option is to wage an expensive proxy contest to replace the directors with persons more receptive to an acquisition offer, assuming that the target stockholders know about the rejected bid. It seems that the courts' attention in this area may be misplaced.

83. The theory that the acquisitions market, rather than the courts, will nev-
come out even because the possible costs and benefits of the determination that fiduciary outs are not always legally required will cancel one another out. Or perhaps, for the reasons discussed above, the potential benefits will outweigh the perceived costs. Without empirical evidence, one cannot be sure.

One could also assume that there is a construct called "acquiring stockholders," made up of persons that somehow invest only in corporations that always acquire other corporations and are never themselves the subject of acquisition proposals. How would these stockholders fare if fiduciary outs were not recognized as being mandated in every instance? In essence, the possibilities are the reverse of those listed above for target stockholders. The stockholders may benefit, especially if acquiring corporations are routinely overpaying in acquisitions and this recognition would reduce the amount of acquisition premiums. They may be harmed if the number of acquisitions or the premiums paid actually increase instead and if such acquisitions and payments do not create value for the acquiring corporation, but merely represent a wealth transfer from the acquiring to the target stockholders. And, like target stockholders, they may also come out unaffected.

Without empirical evidence, how can one know if the conclusion expressed in Part III is a good thing or a bad thing for stockholders? First, there is the rather unhelpful answer that one may never know. There are too many variables that cloud the analysis and prevent the making of any meaningful empirical conclusions. Second, however, is the theory that it does not matter. The constructs created above are not realistic. There are no distinct groups of target stockholders and acquiring stockholders. Because of the prevalence of merger transactions, one who holds a diversified portfolio of equity securities should, over time, hold shares in roughly an equal number of targets and acquirers. Just as holding a diversified portfolio will mitigate or eliminate economic or business risk unique to a particular corporation (as opposed to general

84. The January 2001 Time Warner/America Online merger, valued at approximately $103.5 billion (or $165 billion when the deal was signed in January 2000), is evidence that no corporation is too large to be acquired, however (absent antitrust concerns).

85. Miriam P. Hechler, Toward a More Balanced Treatment of Bidder and Target Stockholders, 1997 COLUM. BUS. L. REV. 319, 322-26 (discussing the absence of protections for acquiring stockholders from their corporation paying too much).
market risk), so too should it mitigate or eliminate the risk of any additional costs imposed on target or acquiring stockholders in a given instance. Stockholders with diversified portfolios should only be concerned that a merger creates rather than destroys wealth, not how the created wealth is allocated between the acquiring and target corporations and their stockholders. In the words of two respected commentators: “Any attempt to set fair prices for corporate control transactions, in the name of protecting investors who chose not to diversify, penalizes other investors who eliminate risk through diversification, and in the process it reduces the number of value-increasing transactions.”

If portfolio diversification means that there are no real economic effects of concluding that fiduciary outs are not legally mandated in all instances, then isn’t this, in the words of Chancellor Allen, “much ado about not very much?” The remainder of this article will contend that it is not.

2. The Judicial System

As was noted above, the vast majority of cases challenging directors’ conduct in the merger context allege violations of the directors’ duty of care. Much of the judicial system’s time and effort is expended in second-guessing directors’ actions. The deference of the business judgment rule under Delaware and other states’ corporate laws recognizes that judges are not businesspeople and that they are poor in reviewing the reasonableness of directors’ business judgments. Thus, a good deal of judicial resources are used attempting to tackle a problem where the courts’ prowess does not lie.

The question of how much information on the acquisition market for a corporation is enough before entering into a merger agreement is a business judgment, in which the target board of di-

88. The debate on this topic is voluminous, continuing to develop, and beyond the scope of this article. For a recent summary of the debate, see generally Hechler, supra note 85.
89. Easterbrook & Fischel, supra note 87, at 713.
90. Id.
91. Allen, supra note 35, at 659.
rectors and its advisers' experience and expertise overshadow that of judges, similar to other agreements a corporation may enter into. Also a business judgment for the directors and their advisers is the question of when and if the absence of a fiduciary out is necessary to avoid losing the interest of a prospective acquirer. So too is the analysis of the costs, in terms of less favorable contractual terms, of a target corporation bargaining for a fiduciary out. As long as there is no self-dealing by directors and as long as stockholders remain free to vote against the merger, courts should not second-guess directors' business judgments regarding these questions. In the words of the Jewel court, "[f]ull discretion regarding the terms of the agreement lies with the board, the ultimate determination with the stockholders." This, of course, requires that directors actually exercise their business judgment in good faith. The rare instances of egregious shirking by directors should be easier for courts to decide than the true judgment calls that are more prevalent in complex business transactions such as mergers.

Although dwarfed in number and attention by the landmark cases involving directors' duty of care, violations of the duty of loyalty and the ancillary duty of candor to stockholders are both more threatening to a well-working and informed market for corporate control and more in line with questions that courts are proficient in deciding. Given this, courts should save their enhanced scrutiny for two scenarios that throw a wrench into the market for acquisition of a target corporation and prevent stockholders from making an informed decision on whether or not to approve a merger. The first situation is when there are allegations that the target directors or members of senior management have undisclosed self interests

92. Delaware statutory law provides that directors may rely on expert opinions, assuming such reliance is justified. DEL. CODE ANN. tit 8, § 141(e) (1999). The corporation statutes of other states contain similar provisions. E.g., MINN. STAT. § 302A.251, subd. 2 (2000).
93. A number of commentators, however, emphasize the qualitative distinctions between ordinary "enterprise" contracts, relating to the corporation's day-to-day business affairs, and "ownership" contracts, such as merger agreements. E.g., Regan, supra note 57, at 90-100.
94. Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 285 (2d Cir. 1986) (New York law) (Kearse, J., dissenting) (stating that "[t]hus, absent evidence of bad faith or fraud ... the courts must and properly should respect [corporate directors'] determinations.").
96. Van Gorkom, 488 A.2d at 873 (recognizing a board of directors may not abdicate its duties just because stockholders will make the final decision).
in the proposed merger. Such interests may well constitute a hidden side payment that diverts part of the acquisition premium from stockholders to their fiduciaries. If disclosed, stockholders may make up their own minds on whether the interests are legitimate; if undisclosed, the stockholders are being cheated. Second is the analysis of whether the provisions of the merger agreement designed to protect the acquirer’s investment are reasonable attempts to quantify the monetary and opportunity costs incurred by the acquirer should it lose out to a third-party bidder. These provisions may be so draconian or preclusive of other acquisition offers that the stockholders’ vote is a foregone conclusion, not because the deal is so attractive, but rather because there is no other alternative or because the effects of a negative vote would be economically disastrous. If an alternative transaction is truly better for the target stockholders, and if they are free to vote down the first offer to accept the alternative, one may be sure that competing bidders will use their substantial resources in an attempt to persuade the stockholders; courts need not interfere. In the words of Chancellor Chandler, “when the arsenals of all parties have been unleashed so

97. Termination fees are often analogized to liquidated-damages provisions, which courts are accustomed to reviewing. A termination fee may be more likely to be upheld if it meets the court’s criteria for liquidated damages instead of a penalty provision. QVC Network, Inc. v. Paramount Communications, Inc., 635 A.2d 1245, 1271 (Del. Ch. 1993), aff’d on other grounds, 637 A.2d 34 (1994) (holding that a $100 million termination fee “represent[ed] a fair liquidated amount to cover [the acquirer’s] expenses should ... the merger not be consummated”). In Delaware, liquidated damages are evaluated using a two-prong test: whether “the damages are uncertain and the amount agreed upon is reasonable ....” Lee Builders, Inc. v. Wells, 103 A.2d 918, 919 (Del. Ch. 1954). The law of other states is similar.

98. The question of the permissible bounds of lock-ups is unsettled and beyond the scope of this article. For two sides of the debate on this question, compare Marcel Kahan & Michael Klausner, Lockups and the Market for Corporate Control, 48 STAN. L. REV. 1539, 1564-66 (1996) (suggesting that courts closely scrutinize “second-bidder” and “anticipatory” lock-ups but grant deference to “first-bidder” lock-ups), with Stephen Fraidin & Jon D. Hanson, Toward Unlocking Lockups, 103 YALE L.J. 1739, 1834 (1994) (arguing that courts should uphold all lock-ups). A substantial termination fee is more likely to be looked favorably upon if it is conditioned upon the target stockholders receiving the benefits of a superior third-party offer, rather than just voting down the first offer. McMillan v. Intercargo Corp., No. CIV.A.16963, 2000 WL 516265, at *10 (Del. Ch. Apr. 20, 2000).

99. Again, the stockholders’ vote must be informed. Of the four types of fiduciary outs, the outs from the target board’s agreements to recommend that stockholders vote for the merger and to avoid providing confidential information to third parties are the most important to an informed vote and thus likely to be required in most, but not all, merger agreements that contain such agreements.
as to fully and completely educate the stockholders of their choices, it is not for this Court to ride to their rescue. 100

Even if courts give less attention and more leeway to the processes followed by boards of directors in approving a merger agreement, and more attention and heightened scrutiny to protecting the stockholders’ free and informed exercise of their franchise, the inclusion of fiduciary outs will likely continue to be common practice. The next section discusses why.

B. The Reality

First, it is false distinction to say that fiduciary outs only benefit target stockholders and that only target boards of directors will seek their inclusion in a merger agreement. Depending on the circumstances, both the target and the acquiring corporation may have a common interest in providing for a fiduciary out for the target board of directors. If the termination fee payable by the target and the other consequences of exercising the fiduciary out are reasonable approximations of the costs incurred by the acquiring corporation, and assuming that the target stockholders are free to vote against the merger, then the parties’ interests are aligned. The target corporation wants to be able to negotiate with the bidder that comes out of the woodwork to offer a higher price for the corporation lest that bidder move on to other potential targets. The acquiring corporation, in the absence of preclusive lock-up devices in the merger agreement, knows that the stockholder vote would be a foregone conclusion and that the merger agreement it has negotiated will be rejected. Given this, the acquiring corporation would rather cut its losses, receive its termination fee sooner rather than later, and focus on its business or the next potential target. The fiduciary out is a benefit for both parties.

Second, a target board of directors may not have been able to undertake an adequate analysis of the acquisitions market before entering into the merger agreement, thus may wish to include a fiduciary out. Many legitimate reasons may account for this failure. First, the fear of information leaks, which may drive up the target corporation’s stock price, making the acquisition price appear to the target stockholders to represent only a small premium, and which may foster fear and rumors among the target’s employees,

customers, and suppliers. Second, the uncertainty among key executives and others involved in the acquisition process, who may be severely distracted from their regular duties and who may fear for their own future in the combined organization. Third, timing pressure from the acquiring corporation, which, in addition to the concerns expressed in Part II above, may wish to have the transaction signed and closed by the end of its fiscal year or some other key date.

Because of these pressures, the target board of directors may justifiably be unable to gauge the interests of possible acquisition prices payable by other potential acquirers. A target board that finds itself in this situation will reasonably fear an after-the-fact judicial review of its compliance with the duty of care, even under a more deferential standard of review. Directors in such a situation may bargain for a fiduciary out to obtain more information about the acquisitions market and to consider higher offers. In exchange, however, the board will often have to give something up, such as a higher termination fee payable if a third-party offer is accepted or other pro-acquirer provisions of the merger agreement.

Third, fiduciary outs will generally be included because in questions involving directors' fiduciary duties, the Delaware courts have broad equitable powers to do what is "right" in a given case, even if there is no clear precedent for their actions. The equitable principles that govern the courts' actions lead to fact-specific rulings, as discussed above, and not to bright-line rules that may guide the actions of future parties to merger agreements. 101 Thus, there is always a risk in predicting how a court will rule in this area. Indeed, the current state of the law is in flux regarding what standard of review the courts will apply to exclusive merger agreements, even under the deferential standard of Time-Warner. 102 A fiduciary out may lessen this risk by avoiding the possibility of suit in the first place, because the possibility of a superior third-party offer is expressly recognized and the procedures and consequences regarding its consideration and acceptance are clearly set out. The inclusion of a fiduciary out may also lessen the risk faced by the target

102. Cf. Phelps Dodge, 1999 WL 1054255, at *2 (recognizing no-talk provision without a fiduciary out was viewed with a highly critical eye); In re IXC Communications, Inc. Stockholders Litig., Nos. C.A. 17324, C.A. 17334, 1999 WL 1009174, at *7 (Del. Ch. Oct. 27, 1999) (recognizing no-talk provision given deference under the business judgment rule).
board because it may have the effect of causing the court to apply the more deferential business judgment rule, thereby shifting the risk of judicial error to plaintiffs. Finally, a fiduciary out may protect target directors by delaying the time at which they have to make a final decision on the advisability of one transaction over all others until such time as all the relevant information has come to light. Many times, no third-party offer will be forthcoming and the directors will not have to make such a decision at all.

For these reasons, parties to merger agreements may ignore the legal analysis of courts and some commentators, may put aside their attorneys’ negotiating positions on whether or not a fiduciary out is a legally required term of a merger agreement, and may instead find a fiduciary out to be a practical solution to market risks and the problem of limited information.

V. CONCLUSION

Fiduciary outs are important and heavily negotiated provisions of merger agreements. Unfortunately, the Delaware courts have led many to believe that they are required terms in all merger agreements involving publicly held corporations. Instead of often-artificial distinctions driven by whether or not the target corporation is engaging in a sale-of-control transaction, the courts’ decisions appear to turn on two factors: the extent of the target board’s information on the market for control of the corporation and the other provisions of the merger agreement that may deter or even preclude third-party bids. Recognizing that fiduciary outs are not legally required in every merger agreement may be seen to cause a shift in bargaining power from target corporations to acquirers, but in reality this should have little or no impact on stockholders holding a diversified portfolio of equity securities in a number of companies. It is hoped that this recognition will cause courts to spend less time and resources in analyzing directors’ compliance with the duty of care and instead focus their energies on wrongs that they are better equipped to analyze and that truly create an adverse impact on a well-working acquisitions market: directors’ violations of their duty of loyalty and agreement provisions that preclude stockholders from accepting an unsolicited topping bid.

103. Allen, supra note 35, at 559.
104. Id. at 660.