MERGER TERMINATIONS AFTER *BELL ATLANTIC*: APPLYING A LIQUIDATED DAMAGES ANALYSIS TO TERMINATION FEE PROVISIONS

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INTRODUCTION

The world is witnessing an unprecedented merger phenomenon.[1] No matter which industry one looks at, mergers and acquisitions are driving the way businesses compete in the global marketplace.[2] Mergers and acquisitions[3] are associated with growth, strategic long-term planning, competitiveness, and profit.[4] These factors are making mergers a daily occurrence of increasing importance in the business world.[5] In many indus-

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1. *See* David Whitford, *Sale of the Century*, FORTUNE, Feb. 17, 1997, at 92, 95 ("[C]ompanies are merging like never before for a surprisingly sensible reason. They have no choice. Thousands of companies today of every shape and size are facing the business climate equivalent of 100-year storms.").

2. Businesses in many different industries and markets are rushing to find merger partners. This year has seen mergers that set records for their size and scope, including the merger between Germany's Daimler-Benz and America's Chrysler in the auto industry (combined revenues of $130 billion, creating the world's fifth-largest car maker), Britain's British Petroleum and America's Amoco in the oil industry (a $48 billion transaction creating the world's third largest oil company), and Citicorp and the Traveler's Group in the financial services industry (a $160 billion merger, the world's largest merger to date). *See Breathtaking*, ECONOMIST, Apr. 11-17, 1998, at 5; *Mercedes Goes to Motown*, ECONOMIST, May 9-15, 1998, at 15; *Oil's Well that Ends Well*, ECONOMIST, Aug. 15-21, 1998, at 51.

3. For the purposes of this comment, unless otherwise noted, the terms "mergers" and "mergers and acquisitions" will be used interchangeably.

4. *See Compaq Goes After Big Blue*, ECONOMIST, Jan. 31-Feb. 6, 1998, at 66 (noting that Compaq's $9.6 billion purchase of Digital Equipment Corporation will make a company with combined revenues of approximately $38 billion, and will put it into "the same league as the world's number two computer company, Hewlett-Packard").

5. *See* Steven Lipin, *1997 Year-End Review of Finance: Murphy's Law Doesn't Apply: The Conditions Are Perfect for Continued Growth in Mergers*, WALL. ST. J., Jan. 2, 1998, at R6 (noting that 1997 "marked the third-consecutive year of record mergers and acquisitions activity in the U.S. and abroad, fueled by a favorable stock-market, regulatory and technological changes, and the desire by corporations to do big strategic transactions").

tries, mergers are necessary for businesses to grow, if not survive.[6]

Within this merger-rich environment, mergers and acquisitions are themselves subject to competition.[7] As an example, PacifiCorp and Texas Utilities engaged in a bidding war for Energy Group, Britain's largest electric utility.[8] Texas Utilities increased its bid twice,[9] and its final offer of $7.4 billion ultimately topped PacifiCorp's bids.[10] Such competition creates risks for corporations considering mergers and acquisitions. If a merger fails, a company may lose not only the time and money spent investigating a merger, but also the opportunity to profit from a strategic merger.[11] To minimize these risks, "bidders" and "targets"[12] frequently employ defensive measures.[13] Among these measures, one of the most common, yet hotly negotiated by the parties, is the use of termination fee provisions.[14]

Termination fee provisions serve a valuable function for bidders and targets who require protection from outside interference.[15] Hotly contested mergers often result in litigation, subjecting termination fee provisions to judicial scrutiny. The legal standard applied to directors' decisions, including decisions to employ termination fee provisions in merger agreements, often varies depending on the nature of the transaction and the

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6. *See Buy, Buy*, ECONOMIST, Apr. 25-May 1, 1998, at 73 ("The mood of the moment in American Banking is buy or be bought.").

7. *See Power Struggle*, ECONOMIST, Mar. 7-13, 1998, at 5.

8. *See id.*

9. *See id.*

10. *See id.*

11. *See infra* Part I.E.

12. The terms "bidder" and "target" are commonly used in the field of mergers and acquisitions. Bidder refers to a party making an offer to buy or acquire control of a particular corporation, the target. *See generally* Diane Holt Frankle, *Doing Deals: Understanding the Nuts and Bolts of Transactional Practice*, *in* COUNSELING THE BOARD OF DIRECTORS IN CHOOSING ALTERNATIVES 825 (PLI Corp. Law & Practice Course Handbook Series No. 1034, 1998).

13. *See infra* Part I.G.

14. *See infra* text accompanying notes 96-101.

15. Often the original parties to a merger agreement are subject to interference from an unsolicited intervenor (a third party bidder) that attempts to entice the target to sell to it rather than to the original bidder. In the merger and acquisition field, when the intervenor successfully gains control of the target and "breaks up" the original bidder's plan to acquire the target, this phenomenon is known as "deal-jumping." *See* Lee Meyerson, *Breaking up an Existing Deal*, *in* FINANCIAL INSTITUTIONS MERGERS AND ACQUISITIONS 639, 647 (PLI Corp. Law & Practice Course Handbook Series No. 973, 1996).

characteristics of the parties. Courts have, at times, invalidated termination fee provisions when they favored one bidder over another, or because they restricted shareholders' ability to exercise meaningful choices.[16] Uncertainty in how a court will respond to termination fee provisions can cause further uncertainty or instability in the financial marketplace, thereby increasing the costs of conducting mergers.[17] Ultimately, for parties to a merger, the legal enforceability of termination fee provisions is an important concern.[18]

In 1997, in the first major case of its kind, the Delaware Supreme Court employed a new test to determine the validity of a termination fee provision. In *Brazen v. Bell Atlantic Corp.*,[19] the court upheld a merger agreement containing a $550 million termination fee provision by applying a liquidated damages analysis to the provision rather than the traditional business judgment rule or the "enhanced" business judgment rule.[20] This decision has far-reaching implications for corporate lawyers and corporations considering mergers or acquisitions because it may suggest a more favorable means of drafting provisions for termination fees in order to bypass judicial scrutiny under the business judgment rule or the "enhanced" business judgment rule.[21]

In Part I, this comment discusses the business environment facing corporate directors who must plan for the next century of intense global competition.[22] This discussion focuses on the motives of corporate directors engaged in mergers and acquisitions, and analyzes the factors that influence their decision making during merger negotiations. Part II describes

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16. *See infra* Parts III.D, .E.2.
17. *See infra* Part III.E.3.
18. *See infra* Part III.
19. 695 A.2d 43 (Del. 1997).
20. *See id.* at 45; *see also infra* Part IV.
21. *See infra* Part V.
22. Global competition was one reason British Petroleum and Amoco decided to merge. *See Business: The Company: File BP and Amoco in Oil Mega-Merger*, BBC ONLINE NETWORK (Aug. 11, 1998) <http://news.bbc.co.uk/hi/english/business/the%5Fcompany%5file/newsid%5F149000/149351.stm>. BP's chief executive, Sir John Browne, stated: "International competition in the industry is already fierce and will grow more acute as new players emerge. In such a climate the best investment opportunities will go increasingly to companies that have the size and financial strength to take on those large-scale projects that offer a truly distinctive return." *Id.*

termination fee provisions and explains how these provisions benefit parties involved in mergers. Part III examines the complex legal framework currently applied by courts reviewing merger agreements. This part includes an explanation of the business judgment rule and reviews significant Delaware cases that have applied or modified this standard for reviewing mergers. Part IV examines the structure of the Bell Atlantic-NYNEX merger and discusses a lawsuit brought by the shareholders challenging the merger's termination fee provision as coercive. Part V explains why the *Bell Atlantic* decision is significant for future mergers, and provides a detailed analysis for drafters of termination fee provisions. This comment concludes that corporations should use termination fee provisions, drafted as liquidated damages provisions, to avoid the enhanced business judgment rule of *Unocal Corp. v. Mesa Petroleum Co.*,[23] and the corresponding fiduciary duties of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[24] during contested mergers.[25]

I. THE BUSINESS ENVIRONMENT OF MERGERS IN THE 1990S

A. Strategic Motives and Trends

Today's investors and corporate officers see mergers and acquisitions as a major trend of the 1990s, one that allows companies "to compete more effectively on a global basis."[26] In the United States, and throughout the world,[27] corporations are motivated to merge by long-term strategic goals.[28]

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23. 493 A.2d 946 (Del. 1985).

24. 506 A.2d 173 (Del. 1986).

25. The enhanced business judgment rule, as developed by *Unocal* and *Revlon*, subjects the target board's decisions to a greater level of judicial scrutiny, which may result in a finding that the target board's actions are invalid. *See infra* Part III.C-D.

26. Morton A. Pierce, *Mergers and Acquisitions in the 80's and 90's, in* CONTESTS FOR CORPORATE CONTROL 1997, at 279, 289 (PLI Corp. Law & Practice Course Handbook Series No. 972, 1997).

27. *See* Marcia Heroux Pounds, *Merger Mania 1997 Means Smarter, Bigger Entrepreneurs Reap Rewards as Firms Seek to Go Global*, SUN-SENTINEL (Ft. Lauderdale), Sept. 28, 1997, at G1. "The merger boom is not just a U.S. phenomenon. U.S. companies are buying European and vice versa. Alliances are being formed in Latin America and Asia with an eye toward consolidation." *Id.*

28. *See* Pierce, *supra* note 26, at 284.

> Today's combinations feature the strategic, as opposed to the financial, buyer whose goals are: (i) to produce economies of scale, (ii) to improve

In 1997, U.S. companies announced 11,029 mergers and acquisitions transactions worth a total of $908 billion.[29] This figure represents a forty-seven percent increase in the value of domestic transactions from 1996's record of $626 billion.[30] Internationally, 1996 saw over 10,000 mergers worldwide,[31] worth more than $1.14 trillion.[32] For 1997, worldwide mergers and acquisitions totaled $1.63 trillion, a forty-eight percent increase over 1996's record.[33] This figure included the WorldCom-MCI merger, worth $37 billion, which at the time was the largest merger in U.S. history.[34] Not surprisingly, several gigantic mergers have eclipsed the WorldCom-MCI merger in size, including the mergers of Daimler-Benz and Chrysler ($130 billion), British Petroleum and Amoco ($48 billion), and Citicorp and Traveler's Group ($160 billion), the world's largest merger to date.[35]

This wave of mergers is likely to continue[36] because companies facing the "global market" and increasing competition believe the "only way to prosper . . . is to become bigger faster by joining forces with a competitor."[37] Both large and small[38] corporations are feeling the pressure to merge or be left out of the

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channels of distribution, (iii) to gain access and clout in the globalized market, (iv) to develop or maximize the possibilities of new technologies and (v) to combine or repackage existing properties in new formats.

Id.

29. *See* James Aley & Matt Siegel, *The Fallout from Merger Mania*, FORTUNE, Mar. 2, 1998, at 26.

30. *See* Lipin, *supra* note 5, at R6.

31. *See* Whitford, *supra* note 1, at 92.

32. *See Sizzling World Economy Keeps Mergers Booming*, ARIZ. REPUBLIC, Oct. 4, 1997, at F2.

33. *See* Lipin, *supra* note 5, at R6.

34. *See* John J. Keller & Steven Lipin, *Wedding Bells: WorldCom, MCI Deal Could Rewrite Script for a New Phone Era*, WALL ST. J., Nov. 11, 1997, at A1.

35. *See supra* note 2 and accompanying text.

36. *See Taking the Mystery out of Mergers*, BBC ONLINE NETWORK (May 17, 1998) <http://news.bbc.co.uk/hi/english/business/the%5Fcompany%5Freports/newsid%5Ff91000/91472.stm> (noting that "the boom in the stock market has made mergers much more attractive because it is relatively cheap to acquire other companies by paying for them in (high valued) shares").

37. Laura M. Holson, *There's a Steady Rush to Corp. Altar*, J. REC. (Okla. City), Mar. 9, 1998, *available in* 1998 WL 11958259.

38. *See* Paul M. Barrett, *More and Bigger Mergers Ring in a Happy New Year at Law Firms*, WALL ST. J., Dec. 30, 1996, at B2 ("The current M&A boom is echoing at the smaller end of the spectrum as well . . . .").

consolidation trend.[39] This "search for a competitive advantage"[40] is especially active in industries that recently have been deregulated,[41] have the opportunity to benefit from economies of scale,[42] or involve new technologies.[43]

B. Mergers-of-Equals[44]

As a practical economic matter, corporations must grow to maximize their efficiency and market share on a global basis.[45] Increasingly, large corporations are focusing on long-term strategic mergers within their own industries to "consolidat[e] and reduc[e] expenses and debt."[46] Corporations that miss the opportunity to grow within their industry will suffer as other competitors seize the strategic advantage.[47] These "mergers-of-equals" tend to be friendly, and are typically financed by stock swaps rather than by debt.[48] However, although mergers-of-equals tend to be "friendly," they are increasingly subject to outside interference.[49]

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39. *See* Pounds, *supra* note 27.

40. *Id.*

41. *See Sizzling World Economy Keeps Mergers Booming*, *supra* note 32 ("Mergers are surging in the 1990's as financial services, telecommunications, utility, defense and health care companies combine to take advantage of less regulation and cope with increased competition.").

42. *See* James P. Miller, *Fred Meyer's Purchase of Ralphs Quality Food Adds a Lot to Debt*, WALL. ST. J., Nov. 10, 1997, at B4 (noting that supermarkets are consolidating to boost purchasing clout and gain economies of scale).

43. *See* Pierce, *supra* note 26, at 284-85.

44. "Mergers-of-equals" refers to a transaction in which both parties are roughly equal in size and decide to meld "the common equity interests of combining parties." Peter Allan Atkins, *Stocking up: Corporate Shopping, 1990s Style*, NAT'L L.J., Feb. 9, 1998, at B7.

45. *See* Pounds, *supra* note 27 ("There's very little room for smaller players that are less efficient. . . . And there are no longer opportunities in our boundaries. If you're going to [serve customers], you need to be global." (ellipses and brackets in original)).

46. Pierce, *supra* note 26, at 284.

47. *See id.* ("[W]hile there still is opportunity for the small entrepreneur and niche businesses, mid-sized businesses had better become allies, create joint ventures or merge with one another to become bigger companies or a super-big company is going to gobble them up.").

48. *See* Pierce, *supra* note 26, at 285; *Dynamics of the Marketplace*, MERGERS & ACQUISITIONS, Mar.-Apr. 1998, at 46, 47 (noting a 1997 study of 3,449 deals for which prices were disclosed revealed that 1,120 mergers and acquisitions used stock, 583 used a combination of stock and cash, and 1,746 used cash).

49. *See* Pierce, *supra* note 26, at 287 (noting that industry competition attracts unsolicited third parties to mergers and acquisitions, as in the contest between

This situation creates tension for corporate directors who must make strategic decisions that will have long-term impacts on their ability to compete. On one hand, the corporation should be cautious and thoroughly evaluate potential merger partners. The corporation must be cautious because the merger may fall short of the expected returns.[50] In addition, a merger may be aborted, leaving the parties saddled with legal expenses and exposed to reductions in stock value, and thus worse off than before the proposed merger. A dramatic example of this type of problem was the huge $21 billion reduction in the value of Glaxo Wellcome and SmithKline Beecham shares when their merger collapsed.[51] Also, when companies decide not to close their merger, their business suffers because they have exposed their trade secrets to rivals.[52] For example, after a merger is aborted, one party may use confidential information it acquired during negotiations to lure key executives away from the competing company.[53]

On the other hand, the corporation must act quickly before its competitors seize the limited merger opportunities within its industry and there are no more suitable partners to court.[54] As the merger trend continues, each industry experiences more consolidation and the number of merger opportunities shrinks, which further increases market competition.[55] As an example,

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Viacom Inc. and QVC Network Inc. for Paramount Communications Inc.); Robert E. Spatt, *Unsolicited Additional Bids: The Four Ring Circus*, M&A LAW., Feb. 1998, at 1, 2 (noting a number of large mergers that were disrupted by a second bidder and an increasing trend toward merger competition).

50. *See* Spatt, *supra* note 49, at 2 ("It may turn out that some of these acquisitions are bad. They may turn back around and sell them off. . . . It is said that sometimes the winner's curse is to actually win the deal.").

51. *See All Fall Down*, ECONOMIST, Feb. 28-Mar. 6, 1998, at 65. Since 1992, there have been 2,142 planned mergers that were not completed. *See id.*

52. *See* Elizabeth MacDonald & Joann S. Lublin, *In the Debris of a Failed Merger: Trade Secrets*, WALL. ST. J., Mar. 10, 1998, at B1 (noting that after the accounting firms Ernst & Young and KPMG Peat Marwick aborted a merger, KPMG planned to revamp its web site and intranet systems after acquiring competitive trade secrets from Ernst & Young).

53. *See id.*

54. For an example of a suitor paying a significant premium to acquire a particular target, see *Bank Mergers: Friendly Hostility*, ECONOMIST, May 30-June 5, 1998, at 73, noting that the Dutch bank, ABN Amro, outbid rival Fortis, a Belgo-Dutch financial group, to acquire Generale de Banque, because, according to Amro's chairman, Jan Kalff, Generale de Banque was "the only remaining Belgian bank of any size." *Id.*

55. *See* Spatt, *supra* note 49, at 2.

pressure to find a merger partner in a shrinking industry was a major factor driving the $41.5 billion WorldCom acquisition of MCI, in which WorldCom defeated several other merger offers made by British Telecommunications plc and GTE corporation.[56]

C. *Information Costs*

The cost of obtaining reliable information about potential partners is an important consideration for all potential parties to a merger, especially in stock-for-stock mergers.[57] Parties, particularly bidders, must factor in the cost of conducting research when deciding whether to purchase, or merge with, a large corporation.[58] The end product of the bidder's research is either a decision not to bid on the target, or a bid that reflects the estimated value of the selected target after considering all the opportunities and liabilities.[59]

The typical acquisition agreement will include the target's representations concerning the structure of the corporation, financial statements disclosing liabilities, long-term sales and supply contracts, pending litigation, compliance with environmental regulations, tax compliance history, employee contracts, and employee benefits plans.[60] Any one of these factors may involve potential opportunities or liabilities, which may be worth

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56. *See id.* at 3.

57. *See* Theodore N. Mirvis et al., *Mergers and Acquisitions and Takeover Preparedness: 1997 Update*, *in* 29TH ANNUAL INSTITUTE ON SECURITIES REGULATION 405, 411-12 (PLI Corp. Law & Practice Course Handbook Series No. 1023, 1997).

> Stock rather than cash has been the predominant form of consideration. The preference for equity is a result of a number of factors, including relatively high stock market values . . . .
>
> Stock-for-stock mergers raise complex issues of valuation, price protection and market risk that must be considered by both the acquiror and the seller.

Id.

58. *See* Mark F. Hebbeln, *The Economic Case for Judicial Deference to Break-up Fee Agreements in Bankruptcy*, 13 BANKR. DEV. J. 475, 494 (1997). For example, the buyer of a company assumes responsibility for the liabilities of the acquired corporation, which may include claims alleging product liability, environmental contamination, and employment discrimination. Thus, bidders need to conduct a thorough investigation of the target corporation's financial health, including its potential liabilities. *See* DALE A. OESTERLE, THE LAW OF MERGERS, ACQUISITIONS, AND REORGANIZATIONS 276-317 (1991).

59. *See Fiat Goes Shopping*, ECONOMIST, July 11-17, 1998, at 61 (noting that after Fiat walked away from Chrysler, it considered deals with Volvo and BMW).

60. *See* Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779, 782-92 (1997).

billions of dollars to a bidder.[61] Accordingly, the bidder must research all aspects of the target's representations. This process is both time consuming and expensive,[62] because it requires expert analysis, fairness opinions by investment bankers commissioned by both the target and bidder, and due diligence reports by lawyers.[63]

The price an initial bidder is willing to pay for a target further provides valuable insight for third parties as to the financial viability and long-term prospects of the target. Thus, once the initial bidder has undertaken an expensive course of researching the target, other bidders ("free riders") may rely on the initial bidder's research without undertaking their own costly research. This situation puts the initial bidder at a disadvantage, for free riders can use the money they would have spent on research to outbid the initial bidder and acquire the target.[64]

D. Free Riders and Valuation Problems

The free-rider problem is an especially real threat to mergers-of-equals. On many occasions, these transactions "are structured as non-premium, 'at the market' mergers-of-equals."[65] If a higher competing bid is made to the target corporation, the initial bidder is forced to increase its offer to remain competitive.[66] The promise of "long-term synergies and strategic 'fits'" that attracted the initial bidder may not impress the stockholders and arbitrageurs[67] who may prefer "an offer that

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61. In 1990, Fiat backed out of a proposed merger with Chrysler upon discovering a $2.5 billion pension liability. *See Fiat Goes Shopping*, *supra* note 59.

62. *See* Hebbeln, *supra* note 58, at 494 ("The amount of time and money spent conducting due diligence is not insignificant in the purchase of a large corporation.").

63. *See id.* at 494 n.136 ("Due diligence includes, inter alia, checking loan commitments, compliance with state and federal environmental laws, SEC compliance and conducting title searches.").

64. *See* Hebbeln, *supra* note 58, at 495.

65. Meyerson, *supra* note 15, at 647.

66. *See Bank Mergers: Friendly Hostility*, *supra* note 54.

67. Arbitrageurs are individuals who buy the stock of a target company but intend to sell quickly and profit from the control premium associated with a pending merger or acquisition. Typically, arbitrageurs are not interested in the long-term viability of a company or transaction. Their profit is derived from capitalizing on the demand of a stock rather than on the health of the company. *Barron's Dictionary of Finance and Investment Terms* defines "arbitrageur" as a person or firm who "attempt[s] to profit when the same security or commodity is trading at different prices in two or more markets. Those engaged in RISK ARBITRAGE attempt to

represents an immediate and significant premium to current trading prices."[68]

Both initial and subsequent bidders face an additional complication if their offers include stock. When a bidder decides to acquire a target company of substantial size or importance in its industry, this decision will likely affect the long-term operations of the bidder. As a result, the bidder's stock price may fluctuate as the market evaluates the potential effects of the transaction.[69] During the competition for the target, which may last for several months, the stock prices of all bidders may fluctuate. With this price fluctuation, the value of one bidder's offer may change relative to the other.[70] For the directors of the target corporation, these fluctuations in value make it extremely difficult to assess the true value of both the initial and subsequent bidders' stocks.[71]

Understandably, a target must exercise caution in picking which bid to accept. While the target takes its time to decide this difficult question, the initial bidder is particularly vulnerable to competition from other bidders.

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profit from buying stocks of announced or potential TAKEOVER targets." BARRON'S DICTIONARY OF FINANCIAL AND INVESTMENT TERMS 26 (4th ed. 1995). These arbitrageurs may play a significant role in determining whether a bidder's offer will be successful. *See* Martin Lipton, *Mergers and Acquisition Activity Continued at Record Pace in 1997, reprinted in* L.J. EXTRA (visited Oct. 13, 1998) <http://www.ljextra.com/practice/mergers/0202ma97.html> ("Arbitrageurs, together with hedge funds, have aggregate capital available for arbitrage sufficient to be a major factor even in the biggest mergers, and arbitrage continues to be a key factor in mergers and takeovers.").

68. Meyerson, *supra* note 15, at 647.

69. *See id.* at 645.

70. *See id.* In addition, after the deal has closed, the winning bidder must face yet another valuation complication, the "victory paradox." This term refers to the phenomenon that often results when the winning bidder uses its own securities as consideration for the target, and the announcement of victory is followed by a drop in the value of the bidder's stock. *See Keeping Acquirers and Sellers on the Right Legal Track*, MERGERS & ACQUISITIONS, Mar.-Apr. 1995, at 11, 12 ("The market price of the winning bidder's securities in contested change-in-control situations is likely to be hammered immediately following announcement of the 'victory.'").

71. *See Why Strategies of Survival Drive M&A Dealmaking*, MERGERS & ACQUISITIONS, May-June 1996, at 14, 18.

> Because buyers now pay with stock so much more often, it's harder to pinpoint a deal's true value. You think you know what the seller's shares are worth, but then you start to wonder if the seller is being valued by investors who link the deal's value to the buyer's shares to be offered in a swap. The deal valuation issue is much tougher now, in an equity-driven marketplace.

Id.

E. The Risks Faced by an Initial Bidder

In addition to being vulnerable to valuation problems and competition from subsequent bidders, an initial bidder's risk of being rejected by a target is quite real. One study of mergers involving competitive bidding reveals that the second bidder is likely to win in a "substantial majority" of merger contests.[72] Even though the initial bidder may have entered into a merger agreement with the target, the agreement may only serve to attract attention to the target. For the target corporation, the initial bid is free advertising—a market signal that conveys the attractiveness of the target to other bidders.[73] This "market signal" may entice other bidders who originally would not have considered the target, or the target's management might "initiate negotiations with a second party before presenting the initial bid to the shareholders."[74]

In sum, the initial bidder faces a substantial risk that its merger will not consummate, it will lose the money it spent gathering information on the target, and perhaps most injurious, the competition will consummate a merger with its information costs subsidized by the initial bidder's research. It is critical, therefore, that the initial bidder protect its investment of time and research by minimizing the risk that other bidders will enter the competition or that the directors of the target will erect defensive obstacles to prevent its acquisition.

F. The Target's Defensive Position and Tactics

A board that perceives a bid offer to be hostile, undervalued, or otherwise unacceptable has many defensive weapons which could thwart even the most ambitious bidder.[75] These weapons include: changing corporate charter provisions to allow removal of directors "for cause" only; limiting voting rights of the acquirer;

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72. *See* Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 242 (1990) (relying upon Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141, 147 (1983) (noting that second bidders prevailed in 75% of the 48 cases examined)).

73. *See* Hebbeln, *supra* note 58, at 497-500.

74. Bainbridge, *supra* note 72, at 242.

75. For an overview of possible defense strategies see Steven Lipin, *Firms Find New Ways to Fight Takeovers*, WALL. ST. J., Mar. 10, 1998, at A2.

enacting fair price requirements for tender offers; requiring a supermajority for merger approval;[76] issuing two-tiered voting stock;[77] issuing severance payments to managers and employees contingent upon control changes (golden or tin parachutes);[78] reorganizing the corporation by issuing debt with restrictive covenants; selling off key assets (crown jewel defense); issuing generous dividends to deplete the acquirer's ability to leverage the target; acquiring other corporations which would cause antitrust concerns for the acquirer;[79] and issuing rights plans (poison pills).[80]

The most popular and effective[81] of these defenses is the poison pill plan.[82] Since 1985, these poison pill plans have been legally recognized and growing in popularity.[83] Poison pill plans "have been adopted by more than sixty percent of the Standard and Poors 500 companies, more than half the Fortune 100

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76. *See* OESTERLE, *supra* note 58, at 464 (noting that supermajority vote provisions require more than a simple majority of shareholders to approve "all business combinations between a controlling shareholder and the firm if the controlling shareholder acquired control without the specific approval of a preexisting board of directors").

77. *See id.* (noting that corporations can create two-tiered voting by using a stock exchange offer without a charter amendment). "The firm offers stock with diluted voting power and concentrated claims on equity for its outstanding common stock. The insiders do not tender, the outsiders do, and the insiders end up with concentrated voting power." *Id.*

78. "Golden parachutes are employment contract provisions that guarantee high ranking executives significant employment, cash payment, or stock benefits in the event of a change in corporate control." Dennis J. Block et al., *Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals*, 51 U. MIAMI L. REV. 623, 656 (1997). Tin parachutes are employment contract provisions for lower management and regular employees that guarantee similar cash or stock benefits in the event of a change in corporate control. *See id.* at 657.

79. *See* OESTERLE, *supra* note 58, at 465 (discussing how a target can make acquisitions of other companies which would cause an antitrust problem for potential bidders).

80. *See id.* at 462-69.

81. *See* Meyerson, *supra* note 15, at 674.

82. *See* R. FERRARA ET AL., TAKEOVERS 337-43 (1987).

> The two principal types of rights plans are (a) a 'call' plan, under which a holder of a right can buy securities at a discount under certain circumstances, and (b) a 'put' or 'back-end' plan, under which the holder of a right can require the rights issuer or the acquiring company to purchase securities under certain circumstances.

Id.

83. *See id.* at 675 n.31 (citing Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985)).

companies, and more than two hundred banks, thrifts, and other depository institutions."[84]

Even if the directors of the target do not initially rebuff a bidder, that bidder must still be able to protect its offer from other bidders. If competitors are willing to enter a bidding contest, the initial bidder may lose favor with the target, and the target may accept the other offer.[85] This becomes more likely as the supply of suitable merger partners shrinks, demand for mergers increases, and the price a competitor is willing to pay increases.[86]

G. The Initial Bidder's Options For Risk Reduction

As discussed in detail below, the initial bidder has many options for securing the target's continued acceptance and deterring competitors from bidding, including the use of: (1) a pre-emptive bid; (2) a window-shop or no-shop provision; (3) an irrevocable stock option; (4) a topping fee; (5) an asset option; (6) an expense reimbursement provision; and (7) a termination fee provision.

The most obvious way for an initial bidder to protect itself is to offer the target a "pre-emptive" bid, a bid with a very large premium.[87] The pre-emptive bid may appeal to the target's board of directors because it allows them to provide their stockholders with an immediate and significant premium. Additionally, if the board can quickly accept an initial bid that offers a significant premium, it can avoid a long, drawn out auction of the company. This also avoids the problems of evaluating competing bids, which may not be easy.[88]

Another common tactic is to include "no-shop" or "window-shop" provisions in the merger agreement, which "limit the board's ability to solicit or communicate with other potential bidders."[89] However, the effectiveness of this approach is un-

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84. Meyerson, *supra* note 15, at 674.

85. *See Business This Week*, ECONOMIST, Jan. 24-30, 1998, at 5 (noting that initial bidder Hercules unsuccessfully raised its offer twice in one day attempting to acquire Allied Colloids instead of losing to a competing friendly bid of $2.3 billion by Ciba Specialty Chemicals).

86. *See supra* text accompanying notes 54-55.

87. *See* Pierce, *supra* note 26, at 289.

88. *See* Hebbeln, *supra* note 58.

89. Vincent F. Garrity, Jr. & Mark A. Morton, *Would the CSX/Conrail Express*

certain. Although not "per se illegal," courts will review this type of provision with close scrutiny because it may significantly limit the board's ability to pursue other possible offers.[90]

The third approach is for the initial bidder to request an irrevocable stock option to purchase "a substantial portion of the company's stock."[91] This ensures the bidder the chance to profit from an increase in the target's stock value even if another bidder prevails. Although this may offset the initial bidder's cost of researching and bidding, it may not completely deter other bidders who may be willing to pay their competitor a premium to gain a strategic merger.

Fourth, the bidder may ask the target to pay a "topping" fee if it accepts another bidder's offer. The topping fee requires the target to pay a "negotiated percentage of the amount by which the subsequent offeror's bid exceeds the original bid."[92]

Fifth, the initial bidder may obtain an asset option or "crown jewel defense" with the target, enabling it to buy the target's most desirable assets at a favorably negotiated price.[93] This option not only compensates the bidder, but makes the target less appealing to competitors, who often lose interest in the target if it has been stripped of its more valuable assets.[94]

Have Derailed in Delaware? A Comparative Analysis of Lock-up Provisions Under Delaware and Pennsylvania Law, 51 U. MIAMI L. REV. 677, 690 (1997). The no-shop and window-shop provisions are designed to prevent the target's board from soliciting bids from other bidders. Typically, such provisions state that the target's board will not

> solicit, encourage, discuss, negotiate, or endorse any competing transaction unless: (a) third party 'makes an unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing'; and (b) the [target board] determines that discussions or negotiations with the third party are necessary for the [target board] to comply with fiduciary duties.

Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 39 (Del. 1994).

90. *See* Garrity & Morton, *supra* note 89, at 699. In *Mills Acquisition v. MacMillan Inc.*, the Delaware Supreme Court stated, "[i]f the grant of such an auction-ending provision is appropriate, it must confer a substantial benefit upon the stockholders in order to withstand exacting scrutiny by the courts." 559 A.2d 1261, 1284 (Del. 1988).

91. Garrity & Morton, *supra* note 89, at 690.

92. *Id.*

93. *See* Block et al., *supra* note 78, at 654. ("If a target is concerned about an imminent hostile takeover, it can provide a third party (the white knight) the option to buy the target's most valuable assets or businesses (the 'crown jewels') at a favorable, yet supportable, price.").

94. Often a large component of a target's value is based on the assets it owns including intellectual properties rights, factories, or long-term sales contracts. "This

Sixth, a very straightforward, but less robust, means of protecting the initial bidder's investment in the bidding process is to ask for an expense reimbursement provision covering the bidder's "actual or estimated out-of-pocket expenses in the event another bidder ultimately prevails."[95]

Finally, and most importantly for the purposes of this comment, the initial bidder may negotiate a termination or "break-up" fee to be paid by the target if it does not close the merger.

II. MERGER TERMINATION FEE PROVISIONS

A termination or break-up fee is a fee

> paid by the seller of a business to a potential acquiring party in the event that a contemplated transaction is not consummated. It is intended as a form of protection for the potential purchaser of the business, who often invests a great deal of time and money in the process of valuing the target company.[96]

Termination fee provisions enable boards of directors to select competing offers with the cost of a failed merger predetermined. These provisions are critical for today's mergers, especially in "deals in regulated industries or stock-for-stock transactions because the time lag between agreement and completion may be lengthy."[97]

Termination fee provisions have become "the most intensely negotiated provisions in these acquisitions,"[98] and are becoming an expected part of negotiating a merger.[99] These provisions

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kind of option make the target significantly less attractive to a competing bidder because the target no longer owns these valuable assets." *Id.*

95. Garrity & Morton, *supra* note 89, at 690 (citing Kahn v. Dairy Mart Convenience Stores, Inc., No. CIV.A.12489, 1996 WL 159628, at *3 (Del. Ch. Mar. 29, 1996)).

96. Hebbeln, *supra* note 58, at 475.

97. *Keeping Acquirers and Sellers on the Right Legal Track*, *supra* note 70, at 11.

98. Kling et al., *supra* note 60, at 807.

99. *See Law Firms Report Record M&A Activity for 1995*, MERGERS AND ACQUISITIONS REPORT, Jan. 22, 1996, *available in* 1996 WL 8300372. ("[T]here's little debate these days over break-up fees. When lawyers sit down to negotiate, everyone at the table pretty much knows what's going to happen. . . . 'Every buyer expects to get it, and every seller expects for it to be asked for.'").

serve several specific functions. For the bidder, termination fees serve as insurance on its initial investment. They also deter potential competitors from intruding on the merger by raising the costs of a failed deal. For the target board, the break-up fee may be necessary in order to attract serious bidders.[100] However, the target board must have an agreement that allows it flexibility to pursue other bids without compromising its duty to act on behalf of the shareholders and exposing the corporation to liability for breaking deals.[101]

As discussed below, however, both the bidder and the target generally may benefit from a merger agreement that uses termination fees.

A. How the Bidder Benefits

For the bidder, a termination fee may serve three purposes. First, a termination fee can assess the willingness and seriousness of potential targets to engage in negotiations.[102] A target that is disinterested or likely to entertain other suitors would not be receptive to a termination fee agreement that would increase transaction costs for other suitors. Second, a termination fee can be used as insurance for the bidder, protecting the information costs and lost opportunity if its bid is rejected by the shareholders, or if a rival bidder emerges as the winner of a heated contest.[103] Third, a termination fee can deter competing bidders who may not be willing or able to pay the additional expense in order to win the contested merger.[104]

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100. An initial bidder may insist on a termination agreement before it commits itself to the expensive research process. *See supra* notes 58-64 and accompanying text.

101. Break-up fees are now more likely to be used than lock-ups. *See Keeping Acquirers and Sellers on the Right Legal Track*, *supra* note 70, at 11. In the field of mergers and acquisitions, there is a broad and narrow definition of lock-ups. Broadly defined lock-ups may include stock options, termination fees, and no-shop provisions. *See* Garrity & Morton, *supra* note 89, at 712. This comment uses a narrower definition of lock-ups, which limits lock-ups to transfers of or options on stocks or assets of the target company made to a favored bidder in order to deter an unwanted bidder. *See* Block et al., *supra* note 78.

102. *See* Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 350-51 (1984) (noting that stipulated damages may be the most efficient means of conveying information about reliability and ability of parties).

103. *See supra* Part I.G (discussing how termination fees are employed).

104. *See* Frankle, *supra* note 12, at 825 (noting that the size of the break-up fee

B. How the Target Benefits

For the target board, the termination fee may serve three purposes as well. First, the termination fee may be necessary to attract a serious bidder.[105] By accepting a termination fee provision, the target can demonstrate that it is receptive to the bidder's offer and willing to proceed in good faith with negotiations. Second, the target's board of directors is able to preserve its fiduciary responsibility to its shareholders at a known cost. The target's board can examine other bidders' offers without losing credibility or deterring the initial bidder.[106] Finally, the target can protect its own opportunities by requiring a termination fee provision that is reciprocal. If the initial bidder becomes disinterested or pursues another target after tying up the resources of the initial target, it must pay the target for wasting its time and potentially reducing its opportunity to engage in a merger with another corporation.

III. THE LEGAL FRAMEWORK OF MERGER AGREEMENTS

Despite their appeal to merger parties, termination fees and other options used by bidders and targets to protect their interests in a merger agreement are subject to judicial scrutiny, and are not always upheld by courts. For example, termination fees may be invalidated if they are "part of an overall plan to thwart" a disfavored bidder's efforts.[107] This part describes the evolution of the traditional legal standards and their application to challenges to boards of directors' decisions.

A. Directors' Fiduciary Duties

It is a fundamental principal of corporate law that directors of corporations are accountable to their shareholders to act under certain well-recognized duties, including loyalty, "good faith," and

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may deter other bidders).

105. *See supra* Part I.G (discussing why targets agree to termination fees).

106. *See* Ulen, *supra* note 102, at 347 (noting that reputation is probably the most important nonlegal market force ensuring performance of contractual duties).

107. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).

"prudent conduct."[108] By 1940, these duties, which together constitute the directors' fiduciary duties, were carefully articulated and received prominent recognition in the legal community.[109]

One of the most common definitions of the directors' fiduciary duties is outlined in the Model Business Corporation Act ("Model Act").[110] In section 8.30(a), the Model Act defines a director's fiduciary duties to the corporation as follows:

> A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.[111]

Over two-thirds of the states have relied upon the Model Act to enact their own statutory definitions of the directors' fiduciary duties.[112]

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108. *See* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 974 (1994). The duty of loyalty requires each director to act in the best interests of the corporation without regard for his or her own interests. *See* Curtis Huff, *Fiduciary Obligations of Directors in Considering and Responding to Acquisition Proposals*, *in* UNDERSTANDING THE SECURITIES LAWS 1997, at 561, 566 (PLI Corp. Law & Practice Course Handbook Series No. 1013, 1997) ("The duty of loyalty requires an undivided and unselfish loyalty by the director to the corporation and demands that there not be any conflict between the director's duty to the corporation and the self-interest of the director.").

109. *See, e.g.*, Horsey, *supra* note 108, at 975-76, (citing Litwin v. Allen, 25 N.Y.S.2d 667, 677-78 (N.Y. Sup. Ct. 1940)).

> It is clear that a director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising.

Id.

110. *See* James H. Cheek, III, *The Business Judgment Rule and Due Care in M&A Matters*, A.L.I., July 28, 1994, at 317.

111. REVISED MODEL BUS. CORP. ACT § 8.30(a) (1984).

112. *See id.*

Delaware's courts[113] have recognized a definition of the directors' fiduciary duties that is similar to the Model Act's definition.[114] The Delaware General Corporation Law allows the corporation to establish the powers and duties of its board of directors in the corporation's certificate of incorporation.[115]

A tension exists between the directors' fiduciary duties to the shareholders and the directors' contractual agreements with potential acquirers. While directors require flexibility to make difficult and complex business decisions, such as merger or acquisition agreements, they also are charged with acting in the shareholders' best interests. The courts have struggled with implementing a workable legal standard that appropriately balances these interests. The most common test applied to challenges to directors' decisions is the business judgment rule.

B. The Business Judgment Rule

The business judgment rule establishes a presumption in favor of directors' decisions, protecting them from judicial second-guessing. If directors can demonstrate that they acted on an informed basis, in good faith, and without self-interest, the courts, applying the business judgment rule, will respect the board's decisions without holding the directors liable for unanticipated losses.

While there is no single definition of the business judgment rule, it has been refined by several Delaware Supreme Court decisions.[116] In 1972, the Delaware Supreme Court discussed the business judgment rule in the following way:

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113. Delaware case law is particularly influential because many other jurisdictions give Delaware decisions great weight in matters of corporate law. *See* OESTERLE, *supra* note 58, at 41.

> Since the beginning of this century the tiny state of Delaware has been the most popular jurisdiction of incorporation for multistate corporations. Almost half of our largest five hundred corporations and almost a third of the corporations listed on the New York Stock Exchange are Delaware corporations.

Id. In Delaware, however, directors' fiduciary duties are not defined by statute. *See id.*

114. *See* Horsey, *supra* note 108, at 988.

115. *See* DEL. CODE ANN. tit. 8, § 141(a) (1991).

116. *See* Huff, *supra* note 111, at 567.

> A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.[117]

In 1984, The Delaware Supreme Court stated:

> [The rule] is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a) . . . . It 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 . . . . Absent abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption . . . .[118]

Although the business judgment rule has been accepted and applied often, it is not entirely clear how it functions in the merger-rich environment of the 1990s.[119] Directors of both acquiring and target corporations are faced with complex business decisions for which liability could be enormous. Likewise, the potential for abuse of discretion or self-dealing by directors is also present during acquisitions or mergers.[120] As explained in the next section, the Delaware Supreme Court addressed these concerns by creating a stricter standard of review—the "enhanced" business judgment rule.

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117. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1972).

118. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). This definition of the business judgment rule became the "keystone" for two noteworthy cases involving change of control decisions. *See* Horsey, *supra* note 108, at 997 (noting that *Aronson* was the "keystone" for the rulings in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and *Cede & Co. v. Technicolor*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994)).

119. *See* Cheek, *supra* note 110, at 317.

> No concept has been more elusive to define precisely or more elastic in its judicial application than the Business Judgment Rule. . . . Merger and acquisition transactions particularly have presented the courts with factual situations which have eroded to some extent the historic protection provided to directors by the Business Judgment Rule.

Id.

120. *See* Ronald J. Gibson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 247 (1989) ("A hostile takeover creates a potential conflict of interest, no matter what response it evokes from management.").

C. Unocal's *Enhanced Business Judgment Rule*

In *Unocal Corp. v. Mesa Petroleum Co.*,[121] the Delaware Supreme Court "revolutionized Delaware takeover law."[122] The court reviewed the actions of the Unocal board of directors, which had rejected what it considered an "inadequate" two-tiered, front-end-loaded tender offer from Mesa Petroleum.[123] The Unocal board did not attempt a standstill agreement[124] with Mesa; instead it approved a self-tender offer for forty-nine percent of Unocal's outstanding shares, excluding Mesa from the opportunity to tender.[125] Before the court was willing to apply the business judgment rule to shield Unocal's board of directors from liability, it required an additional "threshold level of scrutiny."[126]

Before *Unocal*, the threshold level of scrutiny applied by Delaware courts required only that the board prove "reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the [insurgent] stock ownership."[127] In addition to requiring the identification of a threat, *Unocal* added a second test for the business judgment rule to apply in deference to the board of directors.[128] The second test required that the board's action "be reasonable in relation to the threat posed"[129] by, for example, a hostile takeover. While the focus of the first test was on how the hostile acquirer's offer affects the target corporation,[130] the second test focused on the nature of the target

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121. 493 A.2d 946 (Del. 1985).

122. Gregory W. Werkheiser, Comment, *Defending the Corporate Bastion: Proportionality and the Treatment of Draconian Defenses from* Unocal *to* Unitrin, 21 DEL. J. CORP. L. 103, 103 (1996).

123. *See Unocal*, 493 A.2d at 956.

124. A standstill agreement is an "accord by a raider to abstain from buying shares of a company for a specified period." BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 554 (4th ed. 1995).

125. *See Unocal*, 493 A.2d at 951.

126. *See* Werkheiser, *supra* note 122, at 105-06 (relying upon Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962)).

127. Werkheiser, *supra* note 122, at 106 (citing Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)).

128. *See Unocal*, 493 A.2d at 955.

129. *Id.*

130. *See id.*

board's response.[131] It required "proportionality" between the threat and the response.[132]

Although the court ultimately upheld the decision of the board to execute a self-tender and reject Mesa's hostile offer, subsequent Delaware courts have used the *Unocal* two-part test to enjoin a target board's defensive responses to hostile tender offers.[133] Under *Unocal*'s "enhanced" business judgment rule, Delaware courts have enjoined defensive measures if they are "coercive in that they leave shareholders with no rational choice but to accept the alternative presented by the board," or if they are "preclusive responses that bar shareholder choice by denying them the opportunity to receive offers."[134]

By raising the level of judicial scrutiny, therefore, the *Unocal* test significantly influences the choice of responses available to target boards facing an acquirer's offer. Target boards must first identify a threat and then respond proportionately without coercively or preclusively affecting the shareholders' ability to exercise their choice. The *Unocal* standard has since been interpreted and revised by courts when confronting the difficult task of evaluating change of control situations and fiduciary duties of directors.[135]

D. Revlon *Duties*

In 1986, the Delaware Supreme Court applied the *Unocal* standards in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[136] This was the first time a Delaware court had addressed the "role of corporate directors in contested mergers and, particularly, the circumstances in which a board may properly grant a 'lock-up' option in such a transaction."[137] It is helpful to

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131. *See id.*

132. *See id.*

133. *See* Werkheiser, *supra* note 122, at 109-14 (discussing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (enjoining board's self-tender offer as "coercive"); City Capital Assocs. Ltd. Partnership v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988) (enjoining board's refusal to redeem poison pill plan as "preclusive" of other offers)).

134. *Id.* at 109.

135. *See infra*, Part III.E.2-3.

136. 506 A.2d 173 (Del. 1986).

137. Kenneth J. Nachbar, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.—*The Requirement of a Level Playing Field in Contested Mergers, and its Effect on Lock-ups and Other Bidding Deterrents*, 12 DEL. J. CORP. L. 473 (1987).

examine the facts of this case because they demonstrate both the complexity of the negotiated merger process and the difficulty of implementing a workable legal standard that protects shareholders while allowing directors the flexibility to make difficult business decisions.

In June 1985, MacAndrews approached Revlon's board, proposing to acquire the corporation for a price of $40 to $50 per share.[138] Revlon's board rejected MacAndrews's first and second offers and then, in response to MacAndrews's possible hostile tender offer to Revlon's shareholders, tried to stop the takeover by enacting a rights plan (poison pill) and authorizing a management repurchase of "up to five million of Revlon's nearly thirty million outstanding shares."[139] On August 23, 1985, MacAndrews initiated "a cash tender offer for any and all Revlon shares at $47.50 per common share and $26.67 per preferred share," contingent upon redemption or voiding of the rights issued pursuant to the rights plan.[140] Three days later, Revlon offered to repurchase up to ten million of its own shares using promissory notes with restrictive covenants which could be waived by Revlon.[141] In September, the Revlon board met again and authorized its management to negotiate with other potential acquirers.[142] By October, MacAndrews had raised its offer to $53 per share, while Revlon had entered negotiations with another potential acquirer, Forstmann, Little & Co. Forstmann offered to acquire Revlon for $56 per share, while Revlon would waive the note covenants and redeem the rights plan.[143] In response to Forstmann's offer, MacAndrews raised its bid to $56.25 per share, subject to the same waivers and redemptions.[144] Forstmann yet again raised its offer, to $57.25 per share, subject to the following conditions:

> (1) a 'lock-up' option to purchase two of Revlon's divisions for a favorable price ($100-175 million below the value ascribed to them by Revlon's investment banker);
> (2) acceptance of a 'no shop' provision; and

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138. *See id.* at 473-74.
139. *Revlon*, 506 A.2d at 176-77.
140. *Id.* at 177.
141. *See id.*
142. *See id.*
143. *See id.* at 177-78.
144. *See id.* at 178.

> (3) placement in escrow of a $25 million fee payable to Forstmann if the agreement terminated or another acquiror obtained more than 19.9% of Revlon's stock.[145]

Revlon agreed to these terms, and MacAndrews promptly sued Revlon to have these conditions invalidated.[146]

The Delaware Supreme Court granted MacAndrews's request for injunctive relief from these conditions, noting that when Revlon's board authorized its management "to negotiate a merger or buyout with a third party [it] was a recognition that the company was for sale."[147] In reaching this decision, the court announced a new standard that target boards would have to meet during contested acquisitions: "The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."[148] Consequently, if these measures by Revlon had been enacted in order to foster competitive bidding, they would have been enforceable as a valid exercise of the board's business judgment.

However, the *Revlon* court invalidated the lock-up, no-shop, and cancellation fee provisions as measures that were designed to frustrate a disfavored bidder while favoring the management's preferred bidder.[149] In reaching this decision, the *Revlon* court further defined a target board's duty as follows: "[T]he directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity."[150] The court made it clear that conditions within merger agreements which favor one bidder over another may be denied enforcement.

In contested negotiations, therefore, *Revlon* forces a target board to justify its responses and maintain a level playing field for all bidders. Especially vulnerable to court interference are no-shop and lock-up provisions, like those at issue in *Revlon*, that limit alternate bidders' chances for competing.[151]

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145. *Id.*
146. *See id.*
147. *Id.* at 182.
148. *Id.*
149. *See id.* at 184.
150. *Id.*
151. *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1284 (Del.

E. Applying the Revlon *Duties:* Time, QVC, *and* Unitrin

1. Defining the Duties Under *Time*

In *Paramount Communications, Inc. v. Time, Inc.*,[152] the "Time Warner" case, the Delaware Supreme Court determined that two general circumstances trigger *Revlon* duties.[153] First, a target board must fulfill *Revlon* duties "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company."[154] Second, if the board responds to a bidder's offer by "abandon[ing] its long-term strategy and seek[ing] an alternative transaction involving the breakup of the company,"[155] then the directors would also have *Revlon* duties. In *Time*, however, the court did not impose *Revlon* duties because the proposed "stock-for-stock merger between Time and Warner Communications did not make a 'sale' of Time 'inevitable.'"[156] Accordingly, the court stated that the Time directors' decision was protected by the business judgment rule and their defensive measures were subject only to the *Unocal* analysis,[157] not the more demanding *Revlon* duties.

2. Revisiting *Revlon*'s Fiduciary Duties: *Paramount v. QVC*

In *Paramount Communications, Inc. v. QVC Network Inc.*,[158] the Delaware Supreme Court revisited the issue of directors' fiduciary duties during contested merger negotiations. This case began when the Paramount board decided to enter into a merger agreement with Viacom Inc. Viacom agreed to acquire Paramount through a tender offer followed by a second-step merger.[159]

1989). Relying on *Revlon*, the court enjoined a lock-up option, stating that the lock-up agreement "must confer a substantial benefit upon the stockholders." *Id.*

152. 571 A.2d 1140 (Del. 1989).

153. *See id.* at 1150.

154. *Id.*

155. *Id.*

156. Block et al., *supra* note 78, at 630-31 (1997) (citing *Time*, 571 A.2d at 1151).

157. *See Time*, 571 A.2d at 1151.

158. 637 A.2d 34 (Del. 1993).

159. *See id.* at 38-39. For a description of the second-step merger, see *infra*

The merger agreement between Paramount and Viacom included a "'no-shop' provision, a termination fee and a stock option agreement, which, according to the court, were 'designed to make it more difficult for a potential competing bid to succeed.'"[160]

Upon learning of the proposed Paramount-Viacom merger, QVC made a more valuable tender offer to acquire Paramount and filed suit for injunctive relief from the original Paramount agreement with Viacom.[161] In response to QVC's competing offer, Paramount and Viacom amended their original agreement to increase Viacom's bid.[162] In turn, QVC also increased the value of its offer[163] and sought to enjoin Viacom from completing the merger, alleging that the Paramount board breached the fiduciary duty imposed by *Revlon*.[164] Paramount responded to QVC's suit by arguing that its actions should only be subjected to the *Unocal* standard, not the more demanding *Revlon* duties.[165]

The *QVC* court rejected Paramount's argument and distinguished its reasoning in the *Time* case.[166] The *QVC* court held that, unlike *Time*, *Revlon* duties attached to the proposed merger between Paramount and Viacom because the merger would cause "a majority of a corporation's voting shares [to be] acquired by a single person or entity, or by a cohesive group acting together, [causing] a significant diminution in the voting power of those who thereby become minority stockholders."[167] The *Time* decision was distinguished because both "Time and Warner were publicly traded corporations and the surviving entity was also a public traded corporation which was not controlled by a single shareholder or group . . . trigger[ing] the Revlon duties since it did not result from a sale of control."[168]

Applying the *Revlon* standards, the *QVC* court determined that the no-shop provision, the stock option agreement, and the termination fee provision in the Paramount-Viacom merger were not "reasonable and in the best interests of the Paramount stock-

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notes 196-98 and accompanying text.

160. Block et al., *supra* note 78, at 631 (citing *QVC*, 637 A.2d at 38-39).
161. *See QVC*, 637 A.2d at 40.
162. *See id.*
163. *See id.* at 41.
164. *See* Cheek, *supra* note 110, at 325.
165. *See QVC*, 637 A.2d at 46.
166. *See id.* at 46-48.
167. *Id.* at 42.
168. Cheek, *supra* note 110, at 326.

holders."[169] The court further held that these defensive measures violated the board's *Revlon* duties because they inhibited Paramount from negotiating with other potential bidders to obtain the highest sale price for its stock.[170]

Since 1993, the *QVC* decision has been criticized for creating "substantial uncertainty as to the validity of contracts, driving up the cost of contracting [and] encouraging litigious behavior by strangers to a contract."[171] Critics also argue that *QVC* "encourages judges to make business decisions for which they are ill-equipped."[172] The most severe criticism is that *QVC* "continues to obscure rather than clarify the standard of care applicable to directors' fiduciary duties . . . caus[ing] more litigation than it prevents."[173] If this criticism proves to be true, directors may be unable to act decisively for fear that their actions will be scrutinized harshly by courts that are willing to invalidate agreements and expose directors to endless liability.

While known for judicial expertise in corporate law,[174] as discussed below, the Delaware courts' ever-changing interpretations of directors' actions in mergers and acquisitions negotiations have created uncertainty for directors negotiating termination fee provisions.[175]

3. *Unitrin* and Uncertainty

In *Unitrin, Inc. v. American General Corp.*,[176] the Delaware Supreme Court reformulated *Unocal*'s proportionality test and, ironically, created further uncertainty.[177] The issue presented to the court was whether to uphold Unitrin's defensive response to American General's offer to acquire Unitrin at a thirty percent

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169. *QVC*, 637 A.2d at 48, 50.

170. *See id.* at 48-49, 51.

171. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 891 (1996).

172. *Id.*

173. *Id.*

174. *See* OESTERLE, *supra* note 58, at 41 ("Relative to other states Delaware's corporate code gives more leeway to corporate managers in their operation of the firm's business, and Delaware has a more developed and sophisticated body of precedent on corporate law issues, because of the expertise of a specialized court for corporations, the Delaware Chancery Court.").

175. *See infra* notes 177-78 and accompanying text.

176. 651 A.2d 1361 (Del. 1995).

177. *See* Werkheiser, *supra* note 122, at 114.

premium over its market price.[178] Although the court found a sufficient basis for upholding Unitrin's actions under the existing *Unocal* standards, the court modified *Unocal*'s proportionality analysis, breaking it into two separate questions.[179] First, the court considered whether the defensive measures were "draconian such that they either are inherently coercive or preclusive in their effects on the corporation's stockholders."[180] This focus on the "draconian defenses" suggests "greater respect for shareholder choice, particularly in the exercise of the shareholder franchise."[181] If the defensive measures were not draconian, the second inquiry determines whether they "conform to the 'range of reasonableness.'"[182] This question recognizes that the board of directors needs latitude in discharging its fiduciary duties to the corporation and its shareholders.[183]

Ultimately, the Delaware Supreme Court found that Unitrin's defensive measures were neither coercive nor preclusive and remanded the case to the chancery court to examine whether the defenses were within the range of reasonableness.[184]

Although many commentators are unsure what long-term effects the *Unitrin* decision will have on Delaware takeover law, there are two possible results. First, *Unitrin* "may represent no more than a restatement and clarification of existing precedent."[185] Alternatively, *Unitrin* may be "a meaningful revision to proportionality review as either a per se rule against or as a heightened level of scrutiny of draconian responses."[186] For corporate directors, the *Unitrin* decision presents another area where uncertainty in fiduciary duties increases the risk and expense of mergers and acquisitions.

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178. *See Unitrin*, 651 A.2d at 1367.
179. *See id.* at 1387-88.
180. Werkheiser, *supra* note 122, at 119.
181. *Id.* at 132.
182. *Unitrin*, 651 A.2d at 1389.
183. *See id.* at 1388.
184. *See id.* at 1389-90.
185. Werkheiser, *supra* note 122, at 132.
186. *Id.*

F. The Import of Judicial Scrutiny: An Inherent Risk to Parties

Beginning with *Unocal*, the line of Delaware cases discussing directors' fiduciary duties during mergers and acquisitions makes it clear that drafters of merger agreements must carefully consider how to structure merger agreements in order to avoid judicial intervention and the uncertain risks inherent in litigation. Corporate directors must recognize that the nature of the transaction may affect what legal standards a court will use when examining their conduct.

Regardless of what standard of review may be applied, however, the directors of target corporations will always face a tension between their fiduciary duties to the corporation and its shareholders, and their contractual agreements with potential acquirers. While a target board cannot eliminate this tension entirely, it can require termination provisions within the merger agreements that allow the target directors to make recommendations consistent with their fiduciary duties by maintaining the flexibility to consider other offers.[187] Although such "judicially-imposed escape hatches [as termination fee provisions] might be thought to benefit the owners of [target corporations], they . . . often work to their detriment, making such entities unreliable contracting partners."[188]

Likewise for bidders, judicial intervention in mergers and acquisitions means increased risk and expense. Although judicial oversight of merger transactions is necessary to ensure a level playing field for all potential bidders, it may function to invalidate agreements upon which parties have legitimately relied to reduce the risk of conducting research and making bids.

Ultimately, the bidding and target corporations would each benefit the most from a system of judicial analysis that produces predictable and consistent results while recognizing the rights and risks of all the involved parties. The *Bell Atlantic* case, discussed in the next part, potentially serves as a step toward

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187. *See* A. Gilchrist Sparks, III, *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*, 51 U. MIAMI L. REV. 815, 821 (1997) (noting that "Delaware merger law implies no fiduciary outs and *Van Gorkum* makes clear that such an 'out' must be clearly stated to be effective").

188. John F. Johnston & Frederick H. Alexander, *Fiduciary Outs and Exclusive Merger Agreements—Delaware Law and Practice*, 51 INSIGHTS 15, 19 (1997).

predictable and consistent judicial scrutiny that balances shareholder interests with respect for the careful choices made by sophisticated parties contemplating complex mergers and acquisitions.

IV. THE *BELL ATLANTIC* CASE

A. The Parties

In 1995, Bell Atlantic Corporation and NYNEX Corporation began negotiating a merger.[189] Bell Atlantic, which provided telecommunication services for customers in New Jersey, Pennsylvania, Delaware, Maryland, Virginia, West Virginia, and Washington D.C.,[190] served over twenty million customers in the United States. It also had telecommunications investments in New Zealand, Mexico, Italy, Slovakia, Indonesia, and the Czech Republic.[191] NYNEX was a local exchange carrier serving New York, New Hampshire, Vermont, Maine, Massachusetts, Rhode Island, and Connecticut.[192] It served approximately eighteen million customers in the United States and maintained telecommunication investments in the United Kingdom, Gibraltar, Greece, Poland, Slovakia, the Czech Republic, Thailand, Indonesia, and the Philippines.[193] Both public companies were traded on the New York Stock Exchange.[194] When merged, these two corporations would create the "second-largest U.S. phone company, with a territory stretching from Maine to Virginia."[195]

During negotiations, Bell Atlantic and NYNEX "determined that the merger should be a stock-for-stock transaction and be treated as a merger-of-equals."[196] The agreement provided that Bell Atlantic would form a new subsidiary and merge the

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189. *See* Brazen v. Bell Atl. Corp., 695 A.2d 43, 45 (Del. 1997).

190. *See* Walt Sapronov & Amy Lin Meyerson, *State Regulation of Telecommunications Financing, Mergers and Acquisitions*, *in* FINANCING, MERGERS & ACQUISITIONS IN THE TELECOMMUNICATIONS INDUSTRY 123, 163 (PLI Corp. Law & Practice Course Handbook Series No. 1014, 1997).

191. *See id.*

192. *See id.* at 162.

193. *See id.*

194. *See* Bart Ziegler & Gautam Naik, *Hefty Fees Set if Nynex Deal Comes Undone*, WALL ST. J., Apr. 24, 1996, at A3.

195. *Id.*

196. *Bell Atlantic*, 695 A.2d at 45.

subsidiary into NYNEX.[197] NYNEX, the surviving corporation, would then become a wholly-owned subsidiary of Bell Atlantic.[198] After the merger, fifty-six percent of Bell Atlantic's shares would be held by the original Bell Atlantic shareholders and forty-four percent would be held by the NYNEX shareholders.[199]

B. Regulatory Approval

Before the corporations could merge, however, they had to meet regulatory requirements. Notably, the companies would have to satisfy the provisions of the Telecommunications Act of 1996,[200] which has had a profound effect on merger and acquisition activity.[201] Although the changes in the regulatory framework resulting from the enactment of the Telecommunications Act created the incentive for the phone companies to merge, it did not remove the complex process of regulatory approval required to close a merger deal. As both Bell Atlantic and NYNEX knew, "the task of securing regulatory approvals often becomes the linchpin to closing a telecommunications transaction."[202]

Given the overlapping requirements for regulatory approval, the Bell Atlantic-NYNEX merger was significantly more complicated and much riskier than average mergers, which take only two to four months to conclude.[203] Both parties to the transaction were aware that this regulatory approval process would be lengthy. Due to the geographic coverage of the two companies, approval for this merger was subject to twelve state regulatory agencies.[204] Additionally, the Federal Communications Commission ("FCC") had authority to review the merger under a public interest standard.[205] This approval was independent of the review conducted by the United States Department of Justice or the Federal Trade Commission, under Hart-Scott-Rodino[206] proce-

197. *See* Sapronov & Meyerson, *supra* note 190, at 165.
198. *See id.*
199. *See id.*
200. 47 U.S.C. §§ 151-614 (1996).
201. *See* Sapronov & Meyerson, *supra* note 190, at 125 (noting "the pace of deals in this industry has become frenetic").
202. *Id.* at 126.
203. *See* Bainbridge, *supra* note 72, at 241.
204. *See* Ziegler & Naik, *supra* note 194, at A3.
205. *See* Sapronov & Meyerson, *supra* note 190, at 132.
206. The Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C.A.

dures.[207] In fact, anticipating significant regulatory scrutiny, the merger agreement allowed the deal to remain open until April 22, 1997, and to be extended until September 30, 1997, if necessary.[208] Ultimately, after fifteen months of waiting for regulatory approval, the FCC approved the Bell Atlantic-NYNEX merger.[209]

C. The Termination Agreement

In order to protect their investments in time and money, and to compensate the other party for lost opportunities if the deal were to fail, the parties drafted an agreement that provided for two-tiered termination fees.[210] The termination fees were divided into two separate parts:

> First, either party would be required to pay $200 million if there were both a competing acquisition offer for that party and either (a) a failure to obtain stockholder approval, or (b) a termination of the agreement. Second, if a competing transaction were consummated within eighteen months of termination of the merger agreement, the consummating party would be required to pay an additional $350 million to its disappointed merger partner. [211]

If both parts of the termination fee provision were triggered, either party would be required to pay a total of $550 million to the other.[212] Additionally, and perhaps most importantly, Bell Atlantic and NYNEX included a statement in the merger agreement that the termination fees "are an integral part of the

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§§ 15(c)-(h), 18(a), 66 (1994), requires merger and acquisition transactions in excess of $15 million to be reported in advance to the Justice Department's Antitrust Division and to the Federal Trade Commission to determine whether the transaction will pose antitrust concerns in violation of the Clayton Act, 15 U.S.C. § 18 (1984). *See* Philip A. Proger, *The Antitrust Beat—Getting the Deal Through*, M&A LAW. 11, 12 (Feb. 1998).

207. *See* Sapronov & Meyerson, *supra* note 190, at 133.

208. *See* Ziegler & Naik, *supra* note 194, at A3.

209. *See Bell Atlantic-NYNEX Merger Gets Go-Ahead Clearance from FCC*, WIRELESS MESSAGING REP., Aug. 19, 1997, at 16.

210. *See* Brazen v. Bell Atl. Corp., 695 A.2d 43, 45 (Del. 1997).

211. *Id.*

212. *See id.*

transaction contemplated by this Agreement and constitute liquidated damages and not a penalty."[213]

D. The Shareholder Challenge and the Court's Holding

The *Bell Atlantic* case began when a Bell Atlantic stockholder filed a class action lawsuit against Bell Atlantic and its directors for declaratory and injunctive relief.[214] The plaintiff, stockholder Lionel L. Brazen, argued that the termination provision "was not a valid liquidated damages clause because it failed to reflect an estimate of the actual expenses incurred in the preparation of the merger."[215] Additionally, Brazen claimed that the "$550 million payment was 'an unconscionably high termination or "lockup" fee,' employed 'to restrict and impair the exercise of the fiduciary duty of the Bell Atlantic board and coerce the shareholders to vote to approve the proposed merger.'"[216] The parties filed cross-motions for summary judgment.[217] Despite Brazen's allegations, the Delaware Chancery Court rejected his arguments and found that the termination fees were valid under the business judgment rule.[218]

On appeal, the Delaware Supreme Court reviewed the summary judgment order *de novo*.[219] The court affirmed the judgment of the chancery court on different grounds.[220] Unlike the chancery court, the Delaware Supreme Court reviewed the termination fees as a liquidated damages clause rather than applying the business judgment rule.[221] The court acknowledged that both parties had expressly agreed that they intended the termination fees to be treated as liquidated damages.[222] Likewise, the court found that this treatment was "not without precedent."[223]

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213. *Id.* at 46.
214. *Id.*
215. *Id.*
216. *Id.* at 46-47 (quoting Brazen v. Bell Atl. Corp., C.A. No. 14976, slip op. at 1, 1997 WL 153810 (Del Ch. Mar. 19, 1997)).
217. *See id.* at 47.
218. *See id.*
219. *See id.*
220. *See id.* at 50.
221. *See id.* at 48.
222. *See id.*
223. *Id.* at 48 n.11 (citing Kysor Indus. Corp. v. Margaux, Inc., 674 A.2d 889 (Del. Super. Ct. 1996) (upholding an agreement that provided for a $300,000

The court further found that the termination fees were valid as liquidated damages, applying a standard two-prong analysis for determining the validity of liquidated damages.[224] Relying upon *Lee Builders v. Wells*, a 1954 case from a Delaware Chancery Court, the court applied the following test: "Where the damages are uncertain and the amount agreed upon is reasonable, such an agreement will not be disturbed."[225]

In applying this test, the court stated that "[t]o be a valid liquidated damages provision under the first prong of the test, the damages that would result from a breach of the merger agreement must be uncertain or incapable of accurate calculation."[226] In this case, however, the court found that the plaintiff had not challenged the fees on this basis and concluded that "[g]iven the volatility and uncertainty in the telecommunications industry due to enactment of the Telecommunications Act of 1996 and the fast pace of technological change . . . advance calculation of actual damages in this case approaches near impossibility."[227]

The second prong of the liquidated damages analysis was more problematic for the court. In applying the second prong of its analysis, the court stated that two factors are relevant to determining whether the liquidated damages are reasonable.[228] "[T]he anticipated loss by either party should the merger not occur" must be considered.[229] The court described the second factor as "the difficulty of calculating that loss: the greater the difficulty, the easier it is to show that the amount fixed was reasonable."[230] To fail the second prong of the liquidated damages test, the court indicated "the amount at issue must be unconscionable or not rationally related to any measure of damages a party might conceivably sustain."[231]

The court held that the termination fee in this case was reasonable because of the factors the parties had considered:

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termination fee to be paid as liquidated damages)).

224. *See id.* at 48.

225. *Id.* (quoting Lee Builders v. Wells, 103 A.2d 918, 919 (Del. Ch. 1954)).

226. *Id.*

227. *Id.*

228. *See id.*

229. *Id.*

230. *Id.* (quoting RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (1981)).

231. *Id.*

(a) the lost opportunity costs associated with a contract to deal exclusively with each other;
(b) the expenses incurred during the course of negotiating the transaction;
(c) the likelihood of a higher bid emerging for the acquisition of either party; and
(d) the size of termination fees in other merger transactions.[232]

Additionally, the court observed that since it was not conducting its review under the business judgment rule, it was "appropriate to apply a reasonableness test."[233] Under the more general reasonableness test, the court also held the $550 million termination fee to be reasonable because it represented two percent of Bell Atlantic's market capitalization of $28 billion and was within the percentage range accepted by other Delaware courts.[234]

V. TERMINATION FEE PROVISIONS AFTER *BELL ATLANTIC*

A. Merger Agreement Drafting Considerations

The favorable result for the parties to the merger agreement in *Bell Atlantic* was due to the carefully drafted termination fee provision. This provision explicitly focused on the factors the parties cited for applying a liquidated damages analysis. As indicated by *Bell Atlantic*, termination fees may be used to compensate a party to a merger that has failed because of outside interference.[235] To protect the investment of substantial research, expense, and time associated with a merger proposal, drafters must structure a termination fee provision that courts will enforce.[236]

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232. *Id.* at 48-49.
233. *Id.* at 49.
234. *See id.*
235. *See* Mirvis et al., *supra* note 57, at 453.
236. *See generally, supra* Part I.C-D. The counsel of a corporation engaged in acquiring a target company must be able to provide a board of directors with both a review of its options and a process to follow that ensures the board has fulfilled its duties to the shareholders. *See* Frankle, *supra* note 12, at 825. Once the board decides to pursue a merger, counsel must draft a merger agreement that specifies the terms of the proposed merger. *See* Kling et al., *supra* note 60, at 782 ("The acquisition agreement will also contain (critically important) provisions setting forth the purchase price to be paid, provisions describing the stock, assets and/or liabilities being acquired and miscellaneous provisions including those related to termination rights and their consequences."). Because the merger process is prolonged and

Counsel should be aware, however, that termination fee provisions will not be reviewed in a vacuum. Courts reviewing merger agreements often will review the entire agreement and the procedural context that drove the proposed merger.[237] Even though the termination fee provision may be the only part of a proposed merger that is challenged, the scope of the inquiry may be larger than the text of the merger agreement alone. For example, after examining *Revlon*'s use of lock-up, no-shop, and cancellation fee provisions in its merger agreement, the *Revlon* court invalidated these provisions because they "limited alternative bidders' chances" for competing.[238] The court considered these provisions as "part of the overall plan to thwart" the competitor's efforts.[239] Likewise, in *Paramount Communications Inc. v. QVC*,[240] the court reviewed and enjoined a no-shop provision, a stock option agreement, and a termination fee provision that were designed to impede QVC's competing bid.[241] In short, even if individual provisions are reasonable under the *Revlon* duties, counsel should recognize that an overall merger agreement might not survive the test. To ensure that termination fee provisions are upheld as liquidated damages, drafters

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subject to competition, drafters should design agreements that provide protection and compensation to the initial bidder in the event a rival bidder interferes with or succeeds in acquiring the target. *See* Mirvis et al., *supra* note 57, at 452. Likewise, the target may require compensation if the initial bidder fails to complete the merger. *See supra* Part IV.C. In addition to establishing the terms of the merger, the agreement should discuss the rights and duties of the parties during the negotiation process. *See generally* Kling et al., *supra* note 60, at 798-99. Boards cannot bind themselves to a merger. They must have shareholder ratification. Nevertheless, in order to be taken seriously, boards wishing to negotiate a merger must have some terms limiting their actions during negotiations. *See id.* The agreement needs to allow both the bidder's and target's boards the flexibility to negotiate for their shareholders and consider alternatives to the merger. *See supra* note 183 and accompanying text. The agreement must also establish the time frame in which the agreement will be effective and discuss the consequences to each party if the merger is not completed. *See supra* Part IV.C (discussing the termination agreement between Bell Atlantic and NYNEX); *see also* Kling et al., *supra* note 60, at 807 (noting that virtually all agreements provide termination dates that are automatic or may be exercised by the parties).

237. *See supra* Part III.D-E (discussing how the *Revlon, Time, Paramount,* and *Unitrin* courts reviewed various merger agreements, considering the position of the parties and the effect of their tactics).

238. *See supra* note 151 and accompanying text.

239. *See supra* note 107 and accompanying text.

240. 637 A.2d 34 (Del. 1994).

241. *See supra* Part III.E.2.

should consider the analysis used by the court in the *Bell Atlantic* case.

B. Bell Atlantic *Analysis and Ensuring the Validity of Contract Terms*

In *Bell Atlantic*, the court respected the parties' intention to have the termination fee provision viewed as a liquidated damages provision.[242] Future drafters should recognize that in *Bell Atlantic*, the drafters explicitly stated that the termination fee was to be considered liquidated damages.[243] In support of this approach, the parties stated the specific factors they considered in fixing liquidated damages at $550 million.[244] The parties' recitation of these factors clearly seemed to influence the court's acceptance of the termination fee provision.[245] Thus, to increase the likelihood that courts will respect a drafter's liquidated damages provision, these drafters should state what factors are being considered by the parties calculating the liquidated damages amount.

There are several reasons why a recitation of the factors the parties considered may positively influence a court considering the validity and enforceability of a termination fee provision cast in terms of liquidated damages. First, a discussion of the factors allows the drafter to articulate the difficulty of determining the actual damages that may be suffered if the merger fails. This satisfies the first prong of the test articulated by *Bell Atlantic*: to uphold the liquidated damages, the court must find that actual damages are uncertain or impossible to calculate exactly. It also satisfies the second prong of the test articulated by *Bell Atlantic*: whether the agreed upon amount is reasonable. As the *Bell Atlantic* court noted, the more difficult it is to calculate the loss, the easier it is to show that the agreed upon amount is reasonable. Second, drafters can use their discussion of the factors considered to prove that the actual amount is uncertain and that

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242. *See* Brazen v. Bell Atl. Corp., 695 A.2d 43, 48 (Del. 1997).

243. *See id.* at 47.

244. *See supra* text accompanying note 232.

245. *See Bell Atlantic*, 695 A.2d at 49 (noting that the liquidated damages provision was reasonable "given the undisputed record showing the size of the transaction, the analysis of the parties concerning lost opportunity costs, other expenses and the arms-length negotiations").

the termination fee amount specified as liquidated damages is reasonable.

Drafters can further demonstrate that the liquidated damages specified do not act as a penalty, which would render a liquidated damages provision unenforceable. They can do so in part by making the liquidated damages reciprocal. For, by exposing both parties to equal liability, liquidated damages are less likely to be viewed as coercive.[246]

C. *Factors Favoring the Construction of Termination Fee Provisions as a Liquidated Damages Provision*

In a complex merger negotiation, the potential effects of a failed merger are virtually impossible to calculate in advance.[247] A failed merger without a termination fee provision will likely result in expensive and prolonged litigation concerning the cost of the damages. In general, liquidated damages are a cheap and efficient means of addressing the risks of a failed merger. Rather than litigating difficult evidentiary issues concerning valuation, the parties can negotiate a liquidated damages clause reflecting the anticipated but uncertain losses they would suffer as a result of a failed merger.

A termination fee reviewed as liquidated damages may also be more likely to be enforced than one analyzed under the business judgment rule or the enhanced business judgment rule. There are several reasons why this is true. First, unlike the business judgment rule, the liquidated damages analysis does not examine the decisions of the board of directors.[248] Business judgment rule analysis presumes "that the directors are acting independently, in good faith and with due care in making a business decision."[249] In some situations, the board may not want to risk a court's adverse finding and application of the more stringent enhanced business judgment standard. Under these circumstances, the liquidated damages analysis is a favorable alternative.

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246. *See infra* text accompanying notes 251, 269-70.

247. *See All Fall Down*, *supra* note 51, at 65 (noting that the failed merger of Glaxo Wellcome and SmithKline Beecham reduced the value of the two corporations' shares by $21 billion).

248. *See Bell Atlantic*, 695 A.2d at 49.

249. *Id.*

Second, even if a board would be able to meet the requirements of the business judgment rule or the enhanced business judgment rule, the liquidated damages provision may still be preferable. For example, there are many industries that are experiencing both regulatory and market uncertainty.[250] For parties considering a merger in these industries, it may be easier for them to survive the liquidated damages analysis than the business judgment rule. If they can prove that actual damages are too difficult to calculate and that the liquidated damages amount agreed upon is reasonable, the termination fees should be held valid by courts. In essence, proving uncertainty may be easier than being subjected to review under the traditional or enhanced business judgment rules.

Additionally, liquidated damages are less likely to be viewed as an unfair violation of *Revlon* duties because a reciprocal liquidated damages clause protects both the bidder and target.[251] This would justify a target board's adoption of a plan as protecting shareholders' interests and maximizing the value to be gained from consolidation. Unlike other provisions which may be employed, a reciprocal liquidated damages provision arguably provides both the bidder and target mutual benefits by reducing uncertainty and providing compensation for lost opportunity.[252] However, drafters must consider that liquidated damages may not always be the optimal choice for protecting the merger agreement. Before incorporating a liquidated damages provision, parties should consider whether this approach serves their needs.

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250. An example of uncertainty driving mergers can be found in the European financial service mergers that have resulted from the anticipated adoption of the Euro as a common currency. As a result,

> the stampede for safety has already begun. Last year $107 billion-worth of financial mergers were announced in Europe . . . . Take the 50 biggest names in European finance, drop them into a hat and extract two at random, and the odds are that there will be a rumour swirling around the financial markets that they plan to wed.

Europe's Lovesick Bankers, ECONOMIST, Jan. 10-16, 1998, at 61.

251. *See infra* notes 269-70 and accompanying text.

252. Other provisions such as a no-shop, window-shop, stock or asset options, put options, and topping fees are used to protect only the initial bidder. Arguably, these provisions benefit the initial bidder at the expense of the target or subsequent bidders. *See supra* Part I.G.

D. Potential Drawbacks of a Termination Fee Provision Drafted as Liquidated Damages

Despite the many advantages of drafting a termination fee provision as a liquidated damages clause, there are several reasons a party might wish instead to have its termination fee provision reviewed under the business judgment analysis rather than the liquidated damages analysis. Notably, some parties may face additional uncertainty because of possible complications with enforcement of liquidated damages, limitations on other forms of relief, and differential exposure to risk relative to the other party.[253]

The most obvious source of uncertainty is that *Bell Atlantic* is the first major decision of this kind to uphold a termination fee provision as a valid liquidated damages clause.[254] To date, the *Bell Atlantic* court is one of only two courts that has considered the termination fee provision under the liquidated damages analysis.[255] As with any legal issue, matters that are firmly ingrained in the legal tradition provide more certainty than issues which have only recently been considered. Consequently, with only one significant Delaware Supreme Court decision for guidance, parties may be exposed to greater uncertainty under a liquidated damages analysis than the business judgment analysis.[256]

Additionally, it should be noted that the *Bell Atlantic* decision was a limited test of termination fees as liquidated damages. The plaintiff was a shareholder who sued *Bell Atlantic* because he believed the termination fee provision "tended improperly to coerce stockholders into voting for the merger."[257] The decision did not discuss the possible defenses that a party to the merger

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253. A small company may not have the financial resources that a large company has to pay a sizable termination fee. A large company may be able to assume greater risk without damaging its overall health while a smaller, less capitalized company might not feel comfortable taking a risk of such magnitude.

254. *See* Dennis J. Block & Stephen A. Radin, *Termination Provisions After Bell Atlantic*, INSIGHTS, Aug. 1997, at 4-5.

255. *See id.* (noting that only a Delaware Superior Court held a termination fee to be a valid liquidated damages provision).

256. *See id.* at 5 (noting that the Minnesota Court of Appeals in *St. Jude Medical Inc. v. Medtronic, Inc.*, 536 N.W.2d 24 (Minn. Ct. App. 1995), refused to consider a termination fee as a liquidated damages provision, although it upheld the fee as reasonable).

257. Brazen v. Bell Atl. Corp., 695 A.2d 43, 45 (Del. 1997).

agreement might make to avoid paying the liquidated damages. It is uncertain exactly how a court would view a liquidated damages provision that was contested by one of the parties. Accordingly, resolving the question of enforceability in this context may involve an entirely different set of considerations than those discussed in *Bell Atlantic*.

In addition to the concerns discussed above, parties may not want to use a reciprocal liquidated damages clause because it may not provide sufficient protection, or it may expose a party to unacceptable levels of liability. Depending upon the size and health of the companies involved in a merger, one party may be exposed to greater risk if the merger fails. For example, a small target company may not be adequately protected by a reciprocal termination fee provision while the larger acquiring corporation may have other acquisition opportunities that allow it to be fully protected by a smaller damage provision. The smaller company may also require greater protection because its opportunity to pursue other deals is impacted more severely by the delay as compared to the effects upon the larger, more stable company.

Similarly, if the smaller party is responsible for the termination, it may not be able to pay the liquidated damages to the larger company. It may have limited operating capital and be unable to satisfy the terms of a liquidated damages provision without severely damaging its financial health and future competitive position.

This result is a distinct possibility if the termination fee is imposed when shareholders fail to ratify the merger regardless of the success of a competing offer.[258] In this situation, the target would not only be forced to pay its rejected suitor, it would also become less attractive to other suitors.

E. Eight Considerations for the Corporate Counsel

For the corporate counsel advising either an acquirer or a target company, the *Bell Atlantic* decision is worth studying carefully. *Bell Atlantic* demonstrates the court's willingness to

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258. *See* Frankle, *supra* note 12, at 834 (noting that "[a] negotiated break up fee should be tied to consummation (or at least recommendation) of an alternative transaction. . . . [O]therwise the fee could be viewed as having an undue chilling effect on other transactions, since [the company] could lose both deals and owe the 'break up' fee").

uphold termination fee provisions using a liquidated damages analysis. This decision is a watershed in the development of merger and acquisition law because it provides drafters choices in structuring termination fees to meet the varying needs of bidder and target corporations.[259]

The *Bell Atlantic* decision provides at least eight lessons for corporate counsel drafting merger or acquisition agreements that employ termination fee provisions. First, drafters should carefully analyze the needs of their clients to ensure that a merger agreement provides an enforceable means of allocating risk and protecting their clients from unwanted interference by third party suitors.

Termination fee provisions are one possible device that counsel can employ to limit the risk of an unsuccessful merger, or to compensate a party who suffers a loss as a result of a failed merger attempt.

Second, counsel should advise their clients that parties have a choice in how to draft a termination fee provision. If drafters do not specifically provide that the termination fee will be analyzed as a liquidated damages provision by default, the courts will review it using either the business judgment rule or an enhanced business judgment review.[260]

Third, if counsel wishes to have the termination fee provision upheld as liquidated damages, she should be familiar with the two-prong liquidated damages test adopted by the *Bell Atlantic* court. The first prong of the test requires a showing that "the damages that would result from a breach of the merger agreement must be uncertain or incapable of accurate calculation."[261] The second prong asks whether the amount specified as liquidated damages is "a reasonable forecast of actual damages."[262] The *Bell Atlantic* court, in applying this prong of the test, considered two factors in determining the reasonableness of the amount. First, "the anticipated loss by either party should the merger not occur," and second, "the difficulty of calculating that

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259. *See 1997's Most Significant Deals Selected by Our Board of Editors*, M&A LAW., Feb. 1998, at 32, 34 (noting that the *Bell Atlantic* court upheld the termination fee agreement as a valid liquidated damages provision).

260. *See Bell Atlantic*, 695 A.2d at 45 (discussing the analysis traditionally applied by the court when the agreement does not specify liquidated damages).

261. *Id.* at 48.

262. *Id.*

loss: the greater the difficulty, the easier it is to show that the amount fixed was reasonable."[263]

Fourth, drafters should include a discussion of the factors considered by the parties in negotiating the amount of the liquidated damages. This discussion provides the court with evidence that the damages meet both the uncertainty and reasonableness requirements of the two-prong test.[264] The *Bell Atlantic* court carefully considered the factors which were discussed by the parties in determining the amount of the liquidated damages.[265] Drafters who document discussions of these factors have an opportunity to articulate the uncertainty of actual damages and the reasonableness of the liquidated damages.

Fifth, drafters should note that the *Bell Atlantic* court seemed to look to factors outside of the agreement in addressing the validity of merger termination fees.[266] The court noted that the liquidated damages of $550 million amounted to "2% of Bell Atlantic's market capitalization of $28 billion."[267] It is generally accepted that courts will not invalidate termination fees provisions that fall in the range of one to two percent of the transaction size.[268]

Sixth, drafters should consider making the liquidated damages provision reciprocal to reduce the likelihood that courts will interpret the damages as a penalty and enjoin their enforcement.[269] If the parties have negotiated an agreement that exposes both parties to equal liability, it is more difficult to allege that it is a penalty because coercion or improper motives were involved.[270]

Seventh, drafters should indicate whether the liquidated damages are an exclusive remedy or whether parties can recover additional damages to compensate for ascertainable losses which become known after a merger fails. Liquidated damage provisions may be drafted to cover only particular types of losses

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263. *Id.*
264. *See id.* at 48-49.
265. *See id.*
266. *See id.* at 49.
267. *Id.*
268. *See* Kling et al., *supra* note 60, at 808.
269. *See* Jennifer Farley, *Better Make Those Brazen Break-up Fees Reciprocal*, MERGERS AND RESTRUCTURING, Aug. 18, 1997, at 5.
270. *See id.*

which cannot be accurately determined. This may mean that parties would be allowed to claim additional damages that were capable of being calculated in addition to the liquidated damages that were stipulated in the merger agreement. Therefore, parties should indicate whether the liquidated damages are an exclusive remedy, or whether other losses can be claimed if they are not covered by the termination fee.

Finally, counsel should examine the cumulative effect of the various merger agreement provisions. The combined effect of no-shop provisions, window-shop provisions, topping fees, reimbursement provisions, stock options, put options, and termination fees may lead a court to find that a board violated its *Revlon* duties to maintain a level playing field and maximize shareholder value.[271]

CONCLUSION

Termination fee provisions have become an integral part of merger agreements. Both targets and bidders recognize that these provisions are necessary for successful negotiations in today's merger and acquisition environment. For the target board, the termination fee provision is a mechanism that establishes a set cost for declining an initial bidder's offer and allows the board flexibility in fulfilling its fiduciary duties by declining to recommend shareholder approval, entertaining other potential bids, or forming its own acquisition strategies.

For initial bidders, the termination fee is insurance to protect research and bidding expenses, a mechanism to screen potential targets, and a means of deterring competitors from seizing their chosen merger partner.

The *Bell Atlantic* decision is a significant development in merger and acquisition law because, for the first time, a court demonstrated its willingness to respect the judgment of directors when they expressly indicate their intent to employ termination fees as liquidated damages. Parties now have a choice in how to draft a termination fee provision to serve their particular needs. For some parties, the traditional business judgment rule will remain a suitable form of analysis for reviewing their termination fee provisions. However, for many other parties engaged in

271. *See supra* Part III.D-E.

highly complex mergers in industries with regulatory or market uncertainty, the liquidated damages test may be more useful.

The business judgment rule is applied primarily as "a process inquiry." Some parties may wish to avoid this inquiry into their decision-making process. For those parties, the liquidated damages analysis may preserve the validity of the termination fee provision when the enhanced business judgment rule would not. In contrast to the business judgment rule, the liquidated damages analysis focuses on the uncertainty of determining losses and the reasonableness of the negotiated fee. This two-prong test regarding the validity of liquidated damages may be easier for parties to draft, and more likely to be enforced. This would result in more efficient transactions, and a competitive advantage for parties who incorporate liquidated damages in their merger agreements.

The *Bell Atlantic* decision seems to suggest that the termination fees should be reciprocal. This constraint may make the liquidated damages approach undesirable for some parties who may require greater protection than their proposed merger partner.

Since the *Bell Atlantic* decision offers directors a choice of how to draft termination fee provisions, parties should carefully consider their own needs and circumstances, and choose the option which provides them with the right fit. *Bell Atlantic* should be viewed as a positive development in merger and acquisition law because it offers sophisticated parties the ability to tailor their agreements in order to remain competitive and maximize their potential gains. Many parties should strongly consider drafting their termination fee provisions as liquidated damages in order to bypass the enhanced business judgment rule and avoid the application of *Revlon* duties.