

## NOTE

### CORPORATE COURTSHIP GONE SOUR: APPLYING A BANKRUPTCY APPROACH TO TERMINATION FEE PROVISIONS IN MERGER AND ACQUISITION AGREEMENTS

#### I. INTRODUCTION

Upon arriving on the foreign shores of ancient Mexico in 1519 with hundreds of soldiers honeycombed with dissension and self-interest, Hernán Cortés, the infamous conquistador,<sup>1</sup> issued his first command. His first directive immediately ordered the deliberate burning of the ships that transported him and his army to the distant territory.<sup>2</sup> His men watched as their only means of retreat sank to the bottom of the Gulf of Mexico.<sup>3</sup> With no practicable means of retreat, the only direction they could go was forward.<sup>4</sup> Historians explain that the purpose of Cortés's order was to

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1. Conquistador is a term used to identify a "military leader in the Spanish conquest of the New World in the sixteenth century. Francisco Pizarro, the conqueror of Peru, and Hernán Cortés, the conqueror of Mexico, were the greatest of the conquistadors. The name is frequently used to mean any daring, ruthless adventurer." at <http://www.infoplease.lycos.com/ce6/history/A0813267.html> (last visited Oct. 5, 2002). For a comprehensive historical review of the conquistadors, see generally PAUL HORGAN, CONQUISTADORS IN NORTH AMERICAN HISTORY (1963).

2. See The Spanish Conquest of Mexico, at <http://climbing.olycon.com/mexico/History.htm> (last visited Oct. 5, 2002).

3. See *id.*

4. The analogy of corporate takeovers to military engagements and conquests seems to encompass much of the takeover vernacular. See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 258 (2d Cir. 1984) (stating that contests for corporate control have been ever more frequent phenomena on the American business scene).

Waged with the intensity of military campaigns and the weaponry of seemingly bottomless bankrolls, these battles determine the destinies of large and small corporations alike. Elaborate strategies and ingenious tactics have been developed both to facilitate takeover attempts and to defend against them. Skirmishes are fought in company boardrooms, in shareholders' meetings, and, with increasing regularity, in the courts.

*Id.*; see also *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1260 (S.D.N.Y. 1985) (likening the takeover landscape to military battles); Nicholas L. Georgakopoulos, *Corporate Defense Law for Dispersed Ownership*, 30 HOFSTRA L. REV. 11, 12-13 (2001) (comparing hostile acquisitions to the

impress upon the minds and hearts of his army that conquest is the only option when all means of retreat are severed.<sup>5</sup> The soldiers had no practical choice but to go forward and conquer the foreign empire.

The notion that there is no going back has infiltrated the world of mergers and acquisitions. Corporate lawyers acting in concert with company executives have instituted mechanisms that virtually ensure the consummation of a merger from the outset.<sup>6</sup> Yet these transactions are supposedly bound by the shareholders' legal and statutory right to vote in approval or disapproval of a transaction.<sup>7</sup> It has been argued that this infrequent shareholder voting exercise has become meaningless due to mechanisms that allegedly coerce their vote of approval.<sup>8</sup>

Mergers and acquisitions are subject to competition as these desirable transactions often attract several interested bidders that are willing to compete for a target entity.<sup>9</sup> The terms "target" and "bidder" are commonly used in the field of mergers and acquisitions. *Bidder* refers to a party making an offer to purchase or acquire control of a particular corporation, the *target*.<sup>10</sup> When considering a potential merger, the companies involved invest time, effort, and capital in order to determine such factors as corporate compatibility and economic feasibility.<sup>11</sup> Tremendous financial resources are often devoted when pursuing such a transaction.

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Roman Empire, Charlemagne, the Great Discoverers and the colonial expansion of the seagoing European powers and explaining how targeted societies could have done better if they had a defense system akin to takeover defense mechanisms); Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 IOWA J. CORP. L. 381, 384 (2002) (describing the takeover environment of the mid-1980s as an "era of open corporate warfare").

5. See *The Spanish Conquest of Mexico*, *supra* note 2. Interestingly enough, Cortés's father had sent him off to school to become a lawyer but Cortés felt that it was not interesting and subsequently failed out. See *id.*

6. See *Law Firms Report Record of M&A Activity for 1995*, MERGERS & ACQUISITIONS REPORT, Jan. 22, 1996, at 1996 WL 8300372 [hereinafter *Law Firms Report*]. There is, however, a recent exception to this premise. In the recent merger battle between Hewlett-Packard and Compaq Computer, dissident director Walter Hewlett is leading a political-like campaign against the merger. Mr. Hewlett has spent tens of millions of dollars on advertisements to reach the 900,000 shareholders that control the fate of the \$22 billion deal. See Pui-Wing Tam & Scott Thurm, *H-P Struggle Brings Smashmouth Politics to Corporate World*, WALL. ST. J., Mar. 5, 2002, at A1.

7. See MODEL BUS. CORP. ACT § 11.03 (1999); see also PETER C. KOSTANT, BUSINESS ORGANIZATIONS 253 (1996). The legal voting rights shareholders possess and the problem of shareholder coercion will be discussed in greater detail *infra* Part V.

8. See generally *Brazen v. Bell Atl. Corp.*, 695 A.2d 43 (Del. 1997) (entertaining the argument of a shareholder who claimed that the termination fee provision in the Bell Atlantic merger ultimately coerced shareholders into voting in approval of the said transaction).

9. See, e.g., *Power Struggle*, ECONOMIST, Mar. 7, 1998, at 5.

10. See BLACK'S LAW DICTIONARY 147, 1306 (5th ed. 1979).

11. See Mark F. Hebbeln, Note, *The Economic Case for Judicial Deference to Break-Up Fee Agreements in Bankruptcy*, 13 BANKR. DEV. J. 475, 475 (1997).

If a merger fails, a bidder may lose heavily in transaction costs expended investigating the merger.<sup>12</sup> Moreover, a bidder can lose the opportunity to profit from another strategic merger.<sup>13</sup> To minimize these risks, bidders and targets frequently employ protective measures in the form of a “deal protection” provision.<sup>14</sup> A deal protection provision is broadly defined as “any contractual provision the effect of which is to make a favored transaction more likely of consummation and less able to be assailed by an interloper.”<sup>15</sup> Among these protective measures, one of the most negotiated<sup>16</sup> measures is the implementation of termination fee provisions into merger and acquisition agreements.<sup>17</sup>

As will be discussed in greater detail in Part II, a termination 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.”<sup>18</sup> While termination fee provisions are central to acquisition agreements, they tend to raise complex dilemmas. If courts examine the enforcement of termination fee provisions deferentially, thereby facilitating combination transactions,<sup>19</sup> the shareholders can potentially be left with one choice,

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12. See Thomas A. Swett, Comment, *Merger Terminations After Bell Atlantic: Applying a Liquidated Damages Analysis to Termination Fee Provisions*, 70 U. COLO. L. REV. 341, 342 (1999).

13. See *id.*

14. See Gregory V. Varallo & Srinivas M. Raju, *A Fresh Look at Deal Protection Devices: Out from the Shadow of the Omnipresent Specter*, 26 DEL. J. CORP. L. 975, 976 (2001) [hereinafter *Deal Protection Devices*].

15. *Id.* at 977.

16. See Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779, 807 (1997) (explaining that termination fees are the most negotiated provisions in acquisition agreements). See also *Law Firms Report*, *supra* note 6. “[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.” *Id.*

17. See Kling, *supra* note 16, at 807. There are several other types of deal protection provisions. These include: No-Shop Provisions—provisions that thwart the ability of a target to shop around its offer to other potential acquirers; No-Talk Provisions—provisions that prohibit the target from negotiating with unsolicited bidders; Board Recommendation Covenants—covenants restricting the ability of directors of a target to alter their recommendation to shareholders with respect to the exercise of their statutory voting rights on the merger. See Frederick H. Alexander, *Reining in Good Intentions: Common Law Protections of Voting Rights*, 26 DEL. J. CORP. L. 897, 899 (2001). Another deal protection provision involves the issuance of stock options. These options afford the acquirer the right to acquire a large amount of shares of a target company at a predetermined price, contingent on several specific events occurring. Stock options are typically triggered when a termination fee provision is triggered. See Gregory V. Varallo & Srinivas M. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 BUS. LAW. 1609, 1615 (2000) [hereinafter *Process Based Model*]. While these are the most commonly used deal protection provisions, there is no definitive list of these provisions “because the term describes a class of devices that is fluid, adaptable and bounded only by the imagination of counsel.” *Deal Protection Devices*, *supra* note 14, at 976.

18. Hebbeln, *supra* note 11, at 475.

19. The term “combination transaction” will be used interchangeably with the terms “merger” and “acquisition.”

namely to approve the proposed transaction.<sup>20</sup> Shareholders not wanting the corporation in which they own stock to pay out an exorbitant termination fee may be forced to exercise their vote in favor of acquisitions that are not necessarily in their best interests or in the best interests of the corporation.<sup>21</sup>

Nevertheless, termination fees have become typical in the merger and acquisition landscape.<sup>22</sup> The economic issues surrounding these fees, including incentives created by them, the opportunity costs of potential purchasers in performing due diligence, and information costs, collectively create compelling arguments to support judicial deference in determining their validity.<sup>23</sup> These differing perspectives, economically

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20. Depending on the size of a given deal this figure can potentially yield a quantitative pro-rata loss to the shareholders. See Mark Lebovitch & Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger of Equals Transactions*, 2001 COLUM. BUS. L. REV. 1, 45-46.

21. See *id.*; see also David Henry & Frederick F. Jespersen, *Mergers: Why Most Big Deals Don't Pay Off*, BUS. WK., Oct. 14, 2002, at 60. Henry and Jespersen examined 1000 deals announced between July 1, 1995 and August 31, 2001 worth at least \$500 million and involving at least one domestic corporation. The study concluded that "61% of buyers destroyed their own shareholders' wealth . . . The average return for all buyers was 4.3% below their peers and 9.2% below the S&P 500." *Id.* The cited reason for the loss in shareholder wealth was buyers paying too much and transferring wealth to the seller's shareholders. "From the week before the deals to the week after, sellers collected a hefty 19.3% extra return on their stock market value vs. their peers." *Id.* I am grateful to Jamie Barber and Roland Estevez for bringing this study to my attention.

22. See *Law Firms Report*, *supra* note 6; see also John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 315 (2000) (noting that termination fees have been deployed in almost 70% of deals in 1998). Additionally, termination fees have spread to foreign markets. In Australia, one journalist described the fees as "a sinister new practice creeping into Australian takeovers . . . [and further labeled the provisions a] penalty agreement." *Penalty Agreements Wrongfully Punish Shareholders*, AUSTL. FIN. REV., Dec. 2, 2000, at 14. Australian merger regulators have attempted to cap the amount of termination fee provisions at 1% citing shareholder concerns as the reason for the cap. See Brett Clegg, *Takeover Panel Earns Its Stripes*, FIN. REV., Feb. 27, 2002, available at <http://afr.com/specialreports/report1/2002/02/27/FFXYDG2Q1YC.html> (last visited Oct. 6, 2002). Termination fee provisions have also been a topic of debate in the reformation of the London City Code on Takeovers and Mergers. In a recent proposal, the Takeover Panel, the quasi-legislative body that enforces takeover law and antitrust issues in the United Kingdom, adopted a rule that would limit termination or break fees to one percent of the transaction offer price. See FRESHFIELDS, *CHANGES TO THE CITY CODE ON TAKEOVERS AND MERGERS*, available at <http://www.freshfields.com/practice/corporate/publications/pdfs/changes.pdf> (July 2000) (last visited Oct. 6, 2002); see also *Will Break Fees Become the Norm?*, available at <http://docs.tob-europa.com/jims/ukbreak.doc> (last visited Oct. 6, 2002). In a recent Canadian merger between Clarica Life Insurance and SunLife Financial Services, several major Clarica shareholders have vowed to oppose the union because of the \$195 million (C\$310 million) excessive termination fee. This termination fee is the largest in Canadian history (but most fees involving Canadian companies generally range from 2% to 7% of a target's enterprise value). See Laura King, *Canadian Insurers Face Shareholder Fight*, DAILY DEAL, Mar. 4, 2002.

23. See Hebbeln, *supra* note 11, at 476.

inducing bidders and constraining shareholder choice, must somehow be reconciled when termination fee provisions are under the judicial microscope. The question of what standard should be applied when courts examine termination fee provisions is still uncertain.<sup>24</sup>

This Note examines the Delaware judiciary's treatment of termination fee provisions.<sup>25</sup> The focus will center on the struggle between the economic desire for judicial deference and the problems associated with the potential absence of meaningful shareholder choice. Part II describes the general risks and costs associated with combination transactions and termination fee provisions. Part III discusses the Delaware judiciary's doctrinal framework and the different legal standards of review applied in evaluating these provisions. Part IV introduces the liquidated damages approach to termination fee provisions that was established in the seminal case *Brazen v. Bell Atlantic Corp.*<sup>26</sup> Part V discusses the shareholder's legal right to vote, the potential coercive effect of termination fees, and the problems associated with the absence of meaningful shareholder choice. Part VI comparatively assesses termination fees in combination transactions to similar provisions in bankruptcy asset-purchase agreements. The various standards of review applied by bankruptcy courts are examined. Lastly, this Note suggests that the best interest of the estate test, adopted by bankruptcy courts, that inquires into the substance of the termination fee provisions, be adopted and implemented analogously, by the Delaware judiciary.

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24. See Chief Justice E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1, 12 (2002) (explaining that the question of whether to apply the business judgment rule or a more substantive standard to deal protection provisions, such as termination fees, is yet to be determined by the Delaware Supreme Court); see also *Deal Protection Devices*, *supra* note 14, at 976; *Process Based Model*, *supra* note 17, at 1627 (explaining that "there is still ambiguity under Delaware law as to the relevant standard that should be applied in examining deal protection measures").

25. While cases from other jurisdictions will be utilized, the main focus will be on Delaware courts as Delaware has long been recognized as the leading jurisdiction in dealing with issues of corporate law. See, e.g., DALE A. OESTERLE, *THE LAW OF MERGERS, ACQUISITIONS, AND REORGANIZATIONS* 41 (1991). "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 on the New York Stock Exchange are Delaware corporations." *Id.*

26. 695 A.2d 43 (Del. 1997).

## II. TERMINATION FEE PROVISIONS IN MERGER AND ACQUISITION AGREEMENTS

A termination or break-up fee<sup>27</sup> is a fee paid by the target to the acquiring party, the bidder, in the event that a contemplated transaction is not consummated for reasons set forth in the acquisition agreement.<sup>28</sup> The fee is intended as a form of deal protection for the potential purchaser of the business, who may invest a great deal of time and capital in the process of appraising the target entity for the purpose of formulating an accurate bid or offer.<sup>29</sup> Termination fee provisions have become “the most hotly negotiated provisions in these acquisitions,”<sup>30</sup> and are often expected when negotiating a merger.<sup>31</sup>

Termination fee provisions usually range from one to five percent of the transaction’s purchase price.<sup>32</sup> Recent trends indicate that the amounts of the fees in these provisions are increasing.<sup>33</sup> Given the size of the mergers of today, one to five percent of the purchase price is often a very large financial commitment. The following chart illustrates the top twenty pending transactions based on the size of the termination fees and the aggregate percentage of the transaction purchase price for the years 2001 and 2002:<sup>34</sup>

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27. The terms “break-up fee” and “termination fee” are one and the same and are often used interchangeably.

28. See Hebbeln, *supra* note 11, at 475.

29. See *id.*

30. Kling, *supra* note 16, at 807.

31. See generally *Law Firms Report*, *supra* note 6.

32. See SIMON M. LORNE, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 2:23 (2001). The parameters of the amount of termination fees have been formed on Delaware case law. In *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, No. 17398, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999), the validity of a 6.3 percent termination fee was considered by the Court of Chancery in the context for a request for preliminary injunctive relief. The court stated that since it concluded that plaintiff had met their burden (by demonstrating a reasonable probability of success on the merits), it would not address plaintiff’s argument that the termination fee was unduly coercive. See *id.* at \*5. The court did, however, state in dicta that a 6.3 percent termination fee “certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point.” *Id.* Part III.B *infra* will discuss the “range of reasonableness” analysis articulated by the Delaware courts in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

33. See LORNE, *supra* note 32, at § 2:23; see also Coates & Subramanian, *supra* note 22, at 334. For specific rates of termination fee incidence and the size of termination fees see Part V *infra*.

34. I am grateful to Jill C. Tydell, a mergers and acquisitions analyst at Dealogic, for providing me with the data in this chart. Note that the time range of the 2002 figures is nine-months rolling, ending October 14, 2002, and all the mentioned deals exclude buybacks. The merger of Hughes Electronics and EchoStar was listed in this chart despite its recent failure to obtain regulatory approval. The merger entailing a \$600 million termination fee contingent on regulatory approval, recently failed to obtain approval from the Federal Communication Commission (“FCC”) on grounds that the merger would cause “immediate and substantial” consumer harm. This was the first

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Target	Bidder	Deal Date	Termination Fee (\$ million)	Transaction Value (\$ million)	Aggregate Percentage of Purchase Price
Pharmacia	Pfizer	7/15/02	1,600	62,011	2.6%
TRW	Northrop Grumman	2/22/02	275	12,882	2.1%
Golden State Bancorp	Citigroup	5/21/02	235	5,880	4.0%
Hispanic Broadcasting	Univision Comm.	6/12/02	100	3,516	2.8%
Nestle SA (US ice cream business)	Dreyer's Grand Ice Cream	6/17/02	75	2,353	3.2%
Cook Group	Guidant	7/30/02	50	3,000	1.7%
Unilab	Quest Diagnostics	4/02/02	35	1,098	3.2%
FEI	Veeco Instruments	7/12/02	30	1,195	2.5%
HJ Heinz Co	Del Monte Foods	6/13/02	20	2,806	0.7%
Bay View Capital Corp	US Bancorp	7/22/02	20	429	4.7%
AT&T	Comcast	7/06/01	1,500	71,950	2.1%
Hughes Electronics	EchoStar	8/03/01	600	29,173	2.1%

time in thirty years the FCC voted to block a merger. *See* Yochi J. Dreazen & Andy Pasztor, *FCC Rejects EchoStar-Hughes Merger*, WALL ST. J., Oct. 11, 2002, at A3. As of the publication of this Note, the deal has not yet been formally withdrawn. The FCC will send its opinion on the merger to an administrative law judge for review. If the parties do not withdraw the transaction, they will have thirty days to file an amended application addressing the FCC's concerns. *See id.* Under federal merger guidelines, the government wants to be convinced that a new competitor will be able to compete in an industry within two years of a pending transaction. In its pursuit of obtaining the blessing of federal antitrust regulators, EchoStar has agreed to help turn a third company, Cablevision Systems Corp., into a viable competitor by providing it with proprietary technology, a large swath of spectrum, and other concessions. *See* Andy Pasztor & John R. Wilke, *EchoStar Tries to Save Hughes Deal*, WALL ST. J., Oct. 28, 2002, at A3. The determining factor in this respect is whether the potential competitor, Cablevision, will be able to "launch its own satellite-television business quickly enough to mollify antitrust enforcers." Andy Pasztor, *Cablevision's Satellite Plans Are Key to EchoStar-Hughes*, WALL ST. J., Oct. 29, 2002, at B13. Several Wall Street analysts, satellite officials and antitrust lawyers are skeptical about Cablevision's ability to build a satellite business fast enough to meet the federal guidelines. *See id.* The termination fee provision in this transaction will likely be challenged if the deal is ultimately withdrawn. *See* Robert Frank & Andy Pasztor, *EchoStar Could Face Huge Breakup Fees*, WALL ST. J., Oct. 11, 2002, at C11. Additionally, the acquisition of AT&T by Comcast, listed in this chart, recently passed regulatory approval and will close in the near future.

American Water Works	RWE	9/17/01	138	7,566	1.8%
Royal Caribbean Cruises	P&O Princess Cruises	11/20/01	63	8,093	0.8%
Provident Mutual Life	Nationwide Financial Services	8/08/01	55	1,560	3.5%
Midcoast Energy Resources	Enbridge	3/16/01	15	581	2.6%
WebLink Wireless	Metrocall	4/02/01	12	477	2.5%
Yonkers Financial	National Bank of Greece-Atlantic Bank of New York	11/14/01	4	61	6.5%
Golf Trust of America	Legends	2/28/01	3	113	3.0%
Occam Networks	Accelerated Networks	11/12/01	3	11	30.4%

In a typical scenario, one company places a bid on the target, and the bid is accepted.<sup>35</sup> The two entities reach a final agreement on the terms of the acquisition, but prior to the closing of the transaction, a third company offers a higher bid for the target company.<sup>36</sup> The original bidder who diligently pursues the expensive transaction sensibly seeks protective provisions such as termination fees to shield it from exposure to such situations; otherwise they risk expending a great deal of capital while receiving nothing in return.<sup>37</sup>

The payment of the termination fee is usually contingent on the happening of certain triggering events. The most common triggers in termination fee provisions include: (1) a breach of covenant, representation, or warranty in a merger agreement; (2) failure to obtain the

35. See, e.g., LORNE, *supra* note 32, § 2:23.

36. See *id.* When the third party gains control of the target and breaks up the original bidder's plan to acquire the target, this phenomenon is known as "deal-jumping."

37. Deal protection provisions potentially deter, and sometimes preclude, a competing bid. The reason for this is when a termination fee is triggered, the cost of the target for the third party is raised in accordance with the amount of the fee owed to the initial merger partner. See Charles M. Nathan, *Judgment Call: Deal Defense*, DAILY DEAL, June 22, 2001.

requisite regulatory approvals; (3) failure to consummate the merger due to a consummated transaction with a third party within a predetermined period of time after an merger agreement is signed; and (4) the failure of shareholders to vote in approval of the merger.<sup>38</sup> When a termination fee is triggered “solely in the event that shareholders were to vote against a transaction, regardless of the presence or absence of a competing proposal, or later consummation of such proposal” this is called a “naked no vote.”<sup>39</sup> Naked no vote provisions are the most difficult to reconcile as a policy matter because payment of the termination fee undoubtedly burdens and arguably coerces the shareholder vote, a legal right that is afforded to the shareholders by statute.<sup>40</sup> Alternatively, the effect such a provision would have on the shareholder vote would depend on the proportionality of the fee—if the amount is small then the effect on the shareholder vote may be innocuous.<sup>41</sup>

The cost of obtaining reliable information about a bidder or target is an important consideration for all parties to a merger.<sup>42</sup> The typical acquisition agreement will include the target’s representations concerning the structure of the corporation as well as the information the bidder uncovered while conducting due diligence.<sup>43</sup> Due diligence will often include the examination of financial statements disclosing liabilities, financial holdings and assets, long-term sales and supply contracts, pending litigation, tax compliance history, employee contracts, and employee benefit plans.<sup>44</sup> This diverse information requires expert opinions<sup>45</sup> by investment bankers, lawyers and accountants.<sup>46</sup> Consequently, termination fee provisions serve as insurance on the

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38. See *Process Based Model*, *supra* note 17, at 1612; see also *Deal Protection Devices*, *supra* note 14, at 981.

39. *Deal Protection Devices*, *supra* note 14, at 981.

40. See DEL. CODE ANN. tit. 8, § 141 (1991 & Supp. 1998) (affording shareholders the right to vote when fundamental corporate changes occur). The coercive impact termination fee provisions have on the shareholder franchise, specifically naked no vote provisions, will be discussed in greater detail *infra* Part V.

41. See Alexander, *supra* note 17, at 908.

42. See, e.g., Hebbeln, *supra* note 11, at 494.

43. See Kling, *supra* note 16, at 782.

44. See *id.*

45. Note that the appraisal of a corporation is an increasingly complex inquiry that requires the aid of a diverse pool of experts and extensive information. See e.g., Floyd Norris, *Is \$2 Billion Fair Payment for a Fiancée Left at the Altar?*, N.Y. TIMES, Nov. 5, 1999, at C1.

46. See Hebbeln, *supra* note 11, at 494. “Due diligence includes, *inter alia*, checking loan commitments, compliance with state and federal environmental laws, SEC compliance and conducting title searches.” *Id.* at 494 n.136.

bidder's initial investment, namely the expense of obtaining information and advice concerning the target.<sup>47</sup>

Since the bidder will often incur substantial up-front costs in making the initial offer, the initial bidder's risk of being rejected by a target can be costly.<sup>48</sup> Large corporations are no longer content to sit idle as competitors enter strategic mergers.<sup>49</sup> These corporations will often present an unsolicited bid to a target after a competitor announces merger prospects with that same target.<sup>50</sup> Indeed, one study of mergers involving competitive bidding reveals that the second bidder is likely to win in a "substantial majority" of merger contests.<sup>51</sup>

Termination fee provisions serve several specific functions for targets as well. For the target, the termination fee may be necessary in order to attract serious bidders.<sup>52</sup> The target's willingness to offer a termination fee as a guarantee to a would-be bidder may potentially attract the bid of a "stalking horse."<sup>53</sup> 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.<sup>54</sup> The first bidder, or stalking horse, will often attract other bidders who will then become in

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47. In the current merger landscape, large corporations have been using mergers to gain advantage within their industries. See, e.g., Constance L. Hays, *Unilever Deal for Bestfoods Signals More Acquisitions*, N.Y. TIMES, June 7, 2000, at C1 (noting that through Unilever's acquisition of Bestfoods to become the world's second largest food-maker, Unilever hopes to increase efficiency and regain dominance in the food purchasing industry). This phenomenon, combined with the rapidly increasing stock market values, has greatly increased the money invested and the price paid for acquisitions. Thus, the transaction costs associated with these transactions, as well as the competition to acquire, has partially led to a need for deal protections. See Richard G. Parker & David A. Balto, *The Merger Wave: Trends in Merger Enforcement and Litigation*, 55 BUS. LAW. 351, 356 (1999).

48. See generally Hebbeln, *supra* note 11.

49. See, e.g., Hays, *supra* note 47.

50. See John C. Coffee, Jr., *Under the 'Merger of Equals' Doctrine, Can a Target Board Always Favor a Friendly Suitor When a Second Bidder Makes a Higher, Unsolicited Offer?*, NAT'L L.J., Mar. 30, 1998, at B5.

51. See Richard S. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141, 147 (1983) (noting that second bidders prevailed in seventy-five percent of the forty-eight cases examined). Often an auction will occur when directors decide to sell the corporation to the highest bidder. In an auction, the target corporation will solicit bids and the highest bidder will obtain control of the corporation. See 3A WILLIAM MEADE FLETCHER ET. AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1041.50 (perm. ed., rev. vol. 1994).

52. See Hebbeln, *supra* note 11, at 478.

53. See James A. Fanto, *Breaking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249, 323 (2001) (defining a "stalking horse" as a potential purchaser who "invest[s] significant amounts of time and money, only to see another reap the benefits of the transaction, and to lose the opportunity of competing transactions").

54. See Hebbeln, *supra* note 11, at 478 (noting that absent some guarantee to potential purchasers that they will be reimbursed for their expenses, potential purchasers may be hesitant to conduct the expensive due diligence required to properly value the target).

effect, the “white knight.”<sup>55</sup> The stalking horse’s offer is generally considered to be the initial bid that is often then “shopped around” to attract higher offers.<sup>56</sup> Thus, the target may benefit from a termination fee provision as it arguably provides a guarantee to potential bidders that induces an initial bid. Furthermore, the initial bid can subsequently be used to attract other more lucrative bids. The target can also protect its own opportunities by requiring a termination fee that is reciprocal.<sup>57</sup> If the initial bidder becomes disinterested or pursues another course of action, it may be required to pay the target for its time and potentially reducing its opportunity to engage in a merger with another corporation.<sup>58</sup>

It is important to note however, that these economically based assertions are disputed. As will be discussed in Part VI, Professor Markell contends that termination fees are often unnecessary to induce bidders. Markell argues from an economic standpoint that a target can eliminate the need for termination fees by increasing the available information about itself. Moreover, what will induce a bidder is the incentive and prospect that the transaction will ultimately benefit the bidder in the future and not the prospect of being immediately compensated for due diligence costs.<sup>59</sup>

In sum, the bidder and the target face a considerable risk that the merger will not consummate due to, among other things, the likelihood of subsequent bidders. Accordingly, it is important for merger partners to protect their investments by minimizing the aforementioned risks.

### III. TERMINATION FEE PROVISIONS IN DELAWARE JURISPRUDENCE

Termination fee provisions are subject to judicial examination and are at times held unenforceable.<sup>60</sup> For instance, termination fees may be invalidated if they are “part of the overall plan to thwart” another bidder’s

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55. The term “white knight” has been defined “as a potential acquirer usually sought out by the target of an unfriendly takeover to rescue it from the unwanted bidder’s takeover.” ROBERT W. HAMILTON, *THE LAW OF CORPORATIONS IN A NUTSHELL* 488 (3d ed. 1991).

56. See *In re Integrated Res., Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992), *aff’d sub nom. Official Comm. of Subordinated Bondholders v. Integrated Res., Inc.*, 147 B.R. 650 (Bankr. S.D.N.Y. 1992) (quoting *In re Marrose Corp.*, Nos. 89B 12171-80 (Bankr. S.D.N.Y. 1991) (“[Termination] fees may encourage the making of what is colloquially referred to as a ‘stalking horse’ offer, which is an initial bid that is then ‘shopped around’ to attract higher offers”).

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

58. See *Process Based Model*, *supra* note 17, at 1613.

59. See Bruce A. Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 AM. BANKR. L.J. 349, 386 (1992).

60. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, (Del. 1986) (analyzing a termination fee and holding that it was enforceable because it intended to prevent acquisition of the target company).

efforts,<sup>61</sup> or they may be upheld as valid liquidated damages clauses.<sup>62</sup> This Part assesses the various standards of review Delaware courts apply in their examination of termination fee provisions.<sup>63</sup>

As termination fee provisions surface in the combination transaction landscape, courts have analyzed their validity by applying several different standards. When contemplating combination transactions, directors require flexibility to make the difficult and often complex decisions associated with such transactions.<sup>64</sup> Directors are charged with maximizing the price to be attained for the shareholders.<sup>65</sup> This requirement only manifests on certain occasions. Once it becomes evident that a corporation will be acquired, the duty of the board shifts from the preservation of the corporate entity to maximization of the price to be realized by the shareholders.<sup>66</sup> It is in the best interests of the shareholders of the target corporation to receive the highest value for their stock.<sup>67</sup> The Delaware courts have struggled to articulate a legal standard that appropriately conforms to directors' business decisions in their quest for maximization of the price obtained for the shareholders.<sup>68</sup> The traditional standard that courts apply is the business judgment rule.<sup>69</sup>

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61. *Id.* at 184.

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

63. *Compare* Brazen, 695 A.2d at 43 (holding that a liquidated damages analysis should be applied to termination fee provisions), *with* Unocal Corp. v. Mesa Petroleum, Inc., 493 A.2d 946 (Del. 1985) (adopting a reasonableness/proportionality standard to defensive measures adopted by directors in contests for corporate control).

64. *See* Revlon, 506 A.2d at 181.

65. *See id.* at 182.

66. *See id.*

67. *See id.*

68. *See supra* note 63.

69. *See* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1295 (2000). Directors traditionally use the business judgment rule as a defense in a shareholder's suit for damages arising out of an act or omission by the director in his or her managing capacity. *See* Alexander, *supra* note 17, at 899. This concept of judicial deference to directors' business decisions originated in an 1829 Louisiana Supreme Court decision, *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829). In *Millaudon*, the plaintiff sought to hold a bank director liable for the bank president's misconduct. The court used a protective standard to evaluate the director's conduct and refused to impose liability. *See id.* at 73-78, 94. After *Millaudon*, other jurisdictions invoked the rule. *See, e.g.,* Godbold v. Branch Bank, 11 Ala. 191, 199-201 (1847) (holding that the rule protects directors from personal liability for good faith mistakes unless the errors are grossly wrong as to show fraud or lack of knowledge); *Hodges v. New England Screw Co.*, 3 R.I. 9, 18 (1853) (holding that the directors were not personally liable because they acted in good faith, exercising ordinary care and prudence, and in the best interests of the corporation).

### A. *The Business Judgment Rule*

Under the business judgment analysis, if directors can demonstrate that they made a business decision on an informed basis, in good faith, and without self-interest, the courts will respect the board's decisions without holding the directors liable for unanticipated losses.<sup>70</sup> The Delaware Supreme Court has held that under the business judgment rule, director liability is predicated upon concepts of gross negligence.<sup>71</sup> Consequently, in the context of a merger, courts have examined the board of directors' conduct under a gross negligence standard when deciding whether it acted in an informed and deliberate manner in determining whether to approve a merger agreement before submitting the proposal to the shareholders.<sup>72</sup> Although this analysis has been frequently applied and accepted, it is not entirely clear how it functions in today's merger environment, and particularly in the context of termination fee provisions.<sup>73</sup>

Under such an analysis, judicial review has generally been limited to a procedural one, namely, the process by which the directors make the decision regarding the inclusion of the termination fee in an acquisition agreement.<sup>74</sup> Inherent in the business judgment analysis is "the protective thrust of the business judgment rule on limiting judicial scrutiny of the substance of the directors' decision."<sup>75</sup> The notion of the business judgment rule calls for deferential judicial examination of the substance of the directors' decision while focusing on the process the directors used in arriving at the determination.<sup>76</sup> Accordingly, this limited deferential review almost always leads to a result in which the termination fees are found valid.<sup>77</sup>

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70. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

71. See *id.*

72. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

73. See *Process Based Model*, *supra* note 17, at 1634-35 (noting that there is a tension when the deferential standard of the business judgment rule is applied to protective measures because such measures "could nullify as a practical matter the requirement that mergers be subject to shareholder approval"). Because of the inconsistency associated with the application of the business judgment rule, the authors explain that a certain answer must await further decisions by the Delaware Supreme Court. See *id.* at 1635.

74. See *Cinerama, Inc. v. Technicolor, Inc.*, No. 8358, 1991 WL 111134, at \*8 (Del. Ch. June 24, 1991) (describing the process oriented approach of the business judgment rule as the "objective review of the process by which [the board] reached the decision").

75. Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 301 (1994).

76. See *id.* at 302.

77. The business judgment rule promotes several identifiable policies. First, the rule encourages informed risk taking by directors because it shields them from personal liability for honest, good faith

### B. *The Enhanced Scrutiny of Unocal*

Academics and practitioners alike have criticized the business judgment rule as a legal standard because of its lenient stance in finding the directors of a corporation liable.<sup>78</sup> Indeed, in *Unocal Corp. v. Mesa Petroleum, Inc.*,<sup>79</sup> the Delaware Supreme Court addressed these concerns by enhancing the judicial analysis in the combination transaction context. The court's enhancement of judicial scrutiny resulted from the fact that directors face an "inherent conflict" in situations that contemplate a change of control and the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . . ."<sup>80</sup>

In *Unocal*, the court held that when directors cause a corporation to take defensive actions, the court must determine whether those directors reasonably perceived a threat to the corporation, and further, whether the defensive actions constituted a proportionate response to that threat.<sup>81</sup> If directors fail to act reasonably and proportionately, the court will apply the entire fairness standard of review, which will likely result in enjoining the directors' actions.<sup>82</sup> Alternatively, if the directors survive the enhanced scrutiny, the deferential business judgment rule will apply and the defensive actions will almost always be allowed.<sup>83</sup>

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decisions. *See, e.g., Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (explaining that investors can diversify their portfolios to minimize their risks, and, therefore, an overly careful approach by directors seeking to minimize their risk instead of maximizing gain is not in the best interests of investors). Secondly, the application of the business judgment rule discourages courts from reviewing business decisions in hindsight. *See id.* at 886 (recognizing that an entrepreneur's function is to make reasoned decisions with less than perfect knowledge). Lastly, the business judgment rule prevents courts from reviewing the substance of business decisions, a task for which they are not equipped. *See Weiss v. Temp. Inv. Fund, Inc.*, 692 F.2d 928, 941 (3d Cir. 1982).

78. *See* Gevurtz, *supra* note 75, at 288.

79. 493 A.2d 946 (Del. 1985). The Court upheld a discriminatory self-tender by the target corporation to all its shareholders, other than the bidder, at a premium which effectively gave a dividend to all shareholders, except the bidder, and thus forced the bidder to call off its offer. However, the Delaware Supreme Court upheld this tactic, which is now prohibited by SEC rule, only after finding that the offer was coercive and that the bidder had a reputation as a greenmailer. A "greenmailer" is defined as one who refers to a payment by the target to a potential aggressor to purchase at a premium over market shares that have been acquired by the aggressor. The acquirer in exchange agrees not to pursue its takeover bid. *See* HAMILTON, *supra* note 55, at 462.

80. *Unocal*, 493 A.2d at 954-55.

81. *See id.*; *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1372 n.9 (Del. 1995) (explaining that *Unocal's* enhanced standard of review is proper whenever the record reflects "that a board of directors took defensive measures in response to a perceived threat to corporate policy and effectiveness which touches upon issues of control").

82. The "entire fairness standard" is discussed more fully *infra* Part III.C.

83. *See Unocal*, 493 A.2d at 985.

The *Unocal* analysis began by establishing that directors have a “fundamental duty and obligation to protect the corporate enterprise” and that their fiduciary duty extends to protecting the corporation and its shareholders from perceived harm.<sup>84</sup> The court further noted that while directors have this duty to protect the corporation, they do not have “unbridled discretion to defeat any perceived threat by any Draconian means available.”<sup>85</sup> The court feared that directors, while claiming to take defensive action against threats to the corporation, might simultaneously be warding off unsolicited bidders based on self-interest.<sup>86</sup> The self-interest concern is that an unsolicited bidder may not want to perpetuate the target’s directors in office; therefore, the target’s directors seek to entrench themselves in their position as directors.<sup>87</sup> Thus, the court articulated the reasonableness/proportionality test in hopes of minimizing the possibility of director entrenchment self-interest.<sup>88</sup>

In connection with the reasonableness/proportionality framework, the Delaware Supreme Court has established a two-part analysis.<sup>89</sup> The first part looks to determine whether a particular defensive measure is “draconian.”<sup>90</sup> A measure is deemed to be “draconian” if it is either preclusive or coercive.<sup>91</sup> Second, once the defensive measure is not deemed to be “draconian,” the focus is shifted on whether the defensive measure falls within a “range of reasonableness,” with proper recognition of the board’s need for “latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats.”<sup>92</sup> Once the board of directors fulfills its burden, the burden of persuasion shifts to the plaintiffs to rebut the presumptions of the business judgment rule discussed earlier.<sup>93</sup>

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84. *Id.* at 954.

85. *Id.* at 955.

86. *See id.*

87. *See id.* For a lucid discussion of the self-interest concern, see Allen et al., *supra* note 69, at 1290, explaining that “corporation law has always been concerned with corporate control and, in particular, with whether directors have acted to advance their personal self-interest by entrenching themselves in office.” *Id.* at 1290 & n.7 (citing *Speiser v. Baker*, 525 A.2d 1001, 1009 (Del. Ch. 1987), where the court explained the roots of this concern: “Almost from the earliest stirrings of a distinctive body of law dealing with corporations, courts have been alert to the dangers posed by structures that permit directors of a corporation, by reason of their office, to control votes appurtenant to shares of the company’s stock owned by the corporation itself . . .”).

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

89. *See generally* *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

90. *See id.* at 1387.

91. *See id.* at 1387-88.

92. *Id.* at 1388.

93. *See id.* at 1390.

Under this enhanced scrutiny framework, 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.”<sup>94</sup> It is still unclear whether such enhanced scrutiny is triggered in the context of termination fee provisions that are protective and not necessarily *defensive* measures.

Mark Lebovitch and Peter Morrison recently argued that the Delaware Court of Chancery cases indicate that deal protections, such as termination fees, should be subject to enhanced scrutiny.<sup>95</sup> They argue that deal protections should be subject to the same enhanced scrutiny as defensive measures as it promotes an appropriate balance of power between the directors and shareholders, preventing a coercive shareholder vote.<sup>96</sup> Lebovitch and Morrison conclude that even outside of an actual threat by a competing bidder, deal protection provisions are inherently defensive in nature and should be evaluated under *Unocal* enhanced scrutiny as opposed to deferential business judgment review.<sup>97</sup>

In a recent article, Professor Mark Lowenstein contends that Delaware jurisprudence under *Unocal* reveals that “the Delaware Supreme Court has been reluctant to interfere with board decisions” and further, “[i]n no case has the Supreme Court held that a defensive maneuver was

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94. 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, 109 (1996). Under a poison pill plan,

companies typically declare a dividend on its common stock that consists of rights to purchase common stock or a new series of preferred stock at a price equal to the estimated long-term value of the common stock. The exercised price is roughly three to five times stock's current value.

CFO.com, *Latest Tech Trend: Poison Pills*, at <http://www.cfo.com/article/1,5309,3210,00.html> (May 17, 2001) (last visited Aug. 21, 2002). The plan also works by becoming

exercisable once a third party acquires or offers to acquire a stake typically beyond 15 percent of the company's stock. It dilutes the new stake of the interloper because rights holders who exercise their rights generally pay the exercise price but get two shares for each right. The potential acquirer does not hold such rights.

*Id.* Martin Lipton, a takeover specialist at the New York law firm of Wachtell Lipton Rosen & Katz, created the poison pill. See Craig Schneider, *Prominent Takeover Lawyer Martin Lipton Warns of Hostile Takeover Activity*, available at <http://cfo.com/Article?article=%202254> (Mar. 14, 2001) (last visited Aug. 21, 2002). For a recent comprehensive study on the poison pill and its illustrious history, see generally Velasco, *supra* note 4.

95. See Lebovitch & Morrison, *supra* note 20, at 6.

96. See *id.* at 15-16.

97. See *id.* at 46.

disproportionate to the threat posed.”<sup>98</sup> On similar grounds, Professors Thompson and Smith argue that the actual cases decided under the *Unocal* standard, “reflect a much more passive judicial role that seems to distrust shareholder decision-making and to prefer that of directors.”<sup>99</sup>

This Note endeavors to conclude that greater scrutiny is required particularly when termination fee provisions are under judicial examination. The inadequacies of the “enhanced” *Unocal* standard has led to mounting judicial discontent as well as considerable academic commentary highlighting its deficiencies.<sup>100</sup> As will be discussed, the standard that should be adopted must broadly consider the totality of the circumstances and not merely involve perceived threats to corporate policy as the *Unocal* decision contemplates.

### C. The Entire Fairness Standard

Where the business judgment rule is the governing standard, the rule “prevents substantive review of the merits of a business decision”<sup>101</sup> and requires that courts “decline to evaluate the merits or wisdom of the transaction.”<sup>102</sup> By contrast, if a self-dealing board<sup>103</sup> has made a decision, the protection of the business judgment rule is removed.<sup>104</sup> The board,

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98. Mark J. Loewenstein, *Unocal Revisited: No Tiger in the Tank*, 27 J. CORP. L. 1, 2-3 (2001). Additionally, in *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25, 40 (Del. Ch. 1998), the Delaware Chancery Court held that the enhanced *Unocal* standard is not onerous in practice since the standard of judicial review is one of reasonableness and not perfection.

99. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 TEX. L. REV. 261, 262 (2001).

100. See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293, 324 (Del. Ch. 2000) (noting that “this case unavoidably brings to the fore certain tensions in our corporation law”); *In re Gaylord Container Corp. S’holders Litig.*, 753 A.2d 462, 475 (Del. Ch. 2000) (“*Unocal’s* purpose and application have been cloaked in a larger, rather ill-fitting doctrinal garment.”). For academic criticism of the *Unocal* standard, see Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 516 (1997) (criticizing the *Unocal* analysis as “reduc[ing] the scope of judicial monitoring of the board’s fiduciary responsibilities”); see also Loewenstein, *supra* note 98, at 2-3; Thompson & Smith, *supra* note 99, at 262 (arguing that the *Unocal* standard does not resolve shareholder-director disputes satisfactorily).

101. *In re J.P. Stevens & Co. S’holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988).

102. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

103. A self-dealing transaction or decision is when the directors, that owe a fiduciary duty to the corporation, transact when they have “a personal interest that might conflict with the interest of the party to whom she owes a fiduciary duty.” JAMES E. CLAPP, WEBSTER’S DICTIONARY OF THE LAW 391 (2000).

104. See *Cinerama, Inc. v. Technicolor, Inc.* 663 A.2d 1156, 1162 (Del. 1995) (holding that if a self-dealing fiduciary cannot demonstrate that the transaction was at an entirely fair price, the fiduciary will be liable and there is no business judgment defense).

under the entire fairness standard, must then prove that the merger transaction was a product of both “fair dealing”<sup>105</sup> and “fair price.”<sup>106</sup>

Fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”<sup>107</sup> Fair price “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.”<sup>108</sup>

It is important to note, however, that the protection of the business judgment rule is almost always invoked.<sup>109</sup> Proper invocation of the standard of review is extremely important because the realm of possible liability in entire fairness cases, as opposed to business judgment rule cases, is considerable.<sup>110</sup>

#### IV. BRAZEN V. BELL ATLANTIC: A LIQUIDATED DAMAGES ANALYSIS

In 1995 Bell Atlantic Corporation and NYNEX Corporation entered into merger negotiations.<sup>111</sup> In order to protect their investments of time, capital, and opportunity costs, the parties drafted an agreement that provided for reciprocal termination fees.<sup>112</sup> The provision was designed to protect both parties in the event the merger would not consummate.<sup>113</sup> If either party failed to obtain shareholder approval or terminated the

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105. *Id.* (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)).

106. *Id.*

107. *Id.*

108. *Id.*

109. *See* *Gevurtz*, *supra* note 75, at 288. *But see* *Francis v. United Jersey Bank*, 392 A.2d 1233 (N.J. Super. Ct. Law Div. 1978), *aff’d*, 432 A.2d 814 (N.J. App. 1981) (finding the defendant, an estate of a deceased director, liable as the corporation went bankrupt as a result of egregious financial fraud perpetrated by its officers); *see also* *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (holding the directors of a publicly held corporation liable for breaching their duty of care in approving a sale for cash without considering the possibility of other proposals at higher prices). Note that the key to the holding was that because the directors failed to inform themselves or seek expert advice, they could not claim protection of the business judgment rule for an uninformed judgment.

110. *See* *Cinerama*, 663 A.2d at 1162.

111. *See* *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 45 (Del. 1997). The merger discussions took place on the heels of the passage of the Telecommunications Act of 1996—the enactment of which, the parties concluded, had transformed the competitive landscape. The parties, therefore, viewed their opportunities to merge with other telecommunications companies as limited because of the many mergers that were being proposed by competitors, thus, limiting future business combinations. *See id.* at 47. “The Telecommunications Act of 1996 . . . allowed the regional Bell operating companies . . . to enter new areas of business . . .” *Brazen v. Bell Atl. Corp.*, No. 14976, 1997 Del. Ch. LEXIS 44, \*10.

112. *See* *Brazen*, 695 A.2d at 45.

113. *See id.*

agreement, that party would be required to pay the other party \$200 million.<sup>114</sup> Additionally, if either party consummated a competing transaction within eighteen months of the agreement, that party would be required to pay an additional \$350 million to the unfulfilled partner.<sup>115</sup> The parties included a statement in the merger agreement explaining that the termination fees “are an integral part of the transactions contemplated by this [a]greement and constitute liquidated damages and not a penalty.”<sup>116</sup>

In response to the Bell Atlantic Merger with NYNEX, plaintiff-Shareholder, Lionel Brazen, filed a class action against Bell Atlantic and its directors for declaratory and injunctive relief.<sup>117</sup> Brazen argued that the termination fee provision was not a valid liquidated damages clause because “it failed to reflect an estimate of [the] actual expenses incurred in preparation for the merger.”<sup>118</sup> Additionally, he argued that the \$550 million fee was an “unconscionably high” termination 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.”<sup>119</sup> Both parties filed cross-motions for summary judgment.<sup>120</sup> The Delaware Court of Chancery rejected Brazen’s arguments and upheld the termination fee provision under the deferential business judgment rule.<sup>121</sup>

On appeal, the Delaware Supreme Court affirmed the judgment of the lower court on different grounds.<sup>122</sup> Unlike the Chancery Court, the Delaware Supreme Court reviewed the termination fee provision as a liquidated damages clause rather than applying the business judgment rule.<sup>123</sup> The court reasoned that the parties themselves expressly intended that the termination fee be treated as liquidated damages.<sup>124</sup> Relying on *Kysor Industrial Corp. v. Margaux, Inc.*,<sup>125</sup> the court applied a liquidated damages analysis.<sup>126</sup>

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114. *See id.*

115. *See id.*

116. *Id.* at 46 (emphasis omitted).

117. *See id.*

118. *Id.*

119. *Id.* at 46-47 (footnote omitted) (quoting Brazen v. Bell Atl. Corp., No. 14976, slip op. at 1 (Del. Ch. Mar. 19, 1997)). Brazen argued that regardless of what the shareholders believed about the merits of the transaction, they all realized that by voting against the merger they would be imposing an exorbitant \$550 million fee on their company. *See id.* at 49.

120. *See id.* at 47.

121. *See id.*

122. *See id.* at 50.

123. *See id.* at 48.

124. *See id.*

125. 674 A.2d 889 (Del. Super. Ct. 1996) (upholding a termination fee provision to be paid as liquidated damages).

126. *See Brazen*, 695 A.2d at 48.

To be valid, a liquidated damages<sup>127</sup> clause must survive a two-pronged test.<sup>128</sup> First, the damages resulting from the breach must be “uncertain or incapable of accurate calculation.”<sup>129</sup> Second, the estimated damages must be a reasonable forecast of the actual damages and not “a penalty intended to punish the stockholders . . . for not approving the merger.”<sup>130</sup>

The court held that the termination fee provision was valid under the standard liquidated damages analysis.<sup>131</sup> The court noted, that “[w]here the damages are uncertain and the amount agreed upon is reasonable, such an agreement will not be disturbed.”<sup>132</sup> In analyzing the first prong of the test, that the damages must be uncertain, the court held that calculating damages in this specific instance was a “near impossibility.”<sup>133</sup> The court reasoned that the telecommunication industry was experiencing volatile and uncertain times, due to the ratification of the Telecommunications Act of 1996.<sup>134</sup> As a result of the changes in competitiveness of the telecommunications arena,<sup>135</sup> damages resulting from a breach of the merger agreement would be difficult to calculate.<sup>136</sup>

In analyzing the second prong, whether the fees were reasonable, the court was influenced by two factors: first, each party’s anticipated loss should the merger not occur, and second, the difficulty of calculating the loss.<sup>137</sup> The court noted that in order to fail the second prong of the test, the amount “must be unconscionable or not rationally related to any measure of damages a party might conceivably sustain.”<sup>138</sup> Ultimately, the court validated the \$550 million termination fee that amounted to two-percent of

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127. Liquidated damages are damages for a breach of contract for a predetermined amount stated in the contract, “where the parties agreed at the time of contracting on a reasonable figure or formula for determination of the compensation to be paid in the event of a breach.” CLAPP *supra* note 103, at 123.

128. See *Brazen*, 695 A.2d at 48.

129. *Id.* The greater the difficulty of calculation, the greater the likelihood the liquidated damages provision will be found reasonable.

130. *Id.* Note that this two-prong analysis is seemingly paradoxical. On the one hand courts insist that the damages be uncertain, while alternatively, the stipulated damages must be a reasonable forecast of what the damages would be.

131. See *id.* at 49.

132. *Id.* at 48 (footnote omitted) (quoting *Lee Builders v. Wells*, 103 A.2d 918, 919 (Del. Ch. 1954)).

133. *Id.*

134. See *id.*

135. See *id.* at 45.

136. See *id.* at 48.

137. See *id.*

138. *Id.* (footnotes omitted).

Bell Atlantic's market capitalization.<sup>139</sup> The court noted that the termination fee fell within the range of other termination fee provisions previously upheld by Delaware courts.<sup>140</sup>

The court proceeded to summarily dismiss the shareholder coercion argument, observing that coercion did not arise because shareholders knew that their rejection of the merger would trigger the payment of the fee.<sup>141</sup> Relying on *Williams v. Geier*,<sup>142</sup> the court noted that shareholder coercion occurs only when the alleged coercive action is designed to obtain shareholder approval of a transaction that is not based on the merits of the transaction.<sup>143</sup>

The Delaware Supreme Court's opinion is flawed in several respects. The court failed to adequately address the Chancery Court's reasoning for refusing to apply a liquidated damages analysis to termination fees in merger agreements. To this effect Vice-Chancellor Chandler opined "[t]hat the Merger Agreement refers (once) to the termination fees as 'liquidated damages' does not change the fact that the event which triggers payment of the fees is not a breach but a termination. Liquidated damages, by definition, are damages paid in the event of a breach."<sup>144</sup> The triggering of a termination fee provision is not necessarily a result of a breach of the merger agreement, rather a contemplated protection that mitigates the effects of nonconsummation of a given transaction.

Another inconsistency in the Supreme Court's opinion is in the court's discussion of coercion. The court defined coercion as "actions which have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction."<sup>145</sup> Immediately thereafter, the court stated that termination fee provisions were "an integral part of the merits of the transaction."<sup>146</sup> Under

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139. *See id.* at 49.

140. *See id.* at 49 & n.17 (citing *Kysor Indus. Corp. v. Margaux, Inc.*, 674 A.2d 889, 897 (Del. Super. Ct. 1996); *Lewis v. Leaseway Transp. Corp.*, No. 8720, slip. op. at 6 (Del. Ch. May 16, 1990); *Roberts v. Gen. Instrument Corp.*, No. 11639, slip. op. at 21 (Del. Ch. Aug. 13, 1990); *Braunschweiger v. Amer. Home Shield Corp.*, No. 10755, slip. op. at 19-20 (Del. Ch. Oct. 26, 1989)).

141. *See id.* at 50. A discussion of shareholder coercion will follow *infra* Part V.

142. 671 A.2d 1368 (Del. 1996).

143. *See Brazen*, 695 A.2d at 50 (stating that the reciprocal termination fee provisions that were drafted to protect both corporations in the event the merger was not consummated, were an integral part of the transaction). Further, the court noted that although the termination fee provision may have influenced the shareholder vote, there was "no structurally or situationally coercive factors' that made an otherwise valid fee provision impermissibly coercive in this setting." *Id.* (footnote omitted).

144. *Brazen v. Bell Atl. Corp.* No. 14976, 1997 Del. Ch. LEXIS 44, at \*8 (Del. Ch. Mar. 19, 1997), *aff'd on other grounds*, 695 A.2d 43 (Del. 1997) (footnote omitted).

145. *Brazen*, 695 A.2d at 50 (quoting *Williams*, 671 A.2d at 1382-83).

146. *Id.*

this “circular” definition it is unlikely that a termination fee provision will ever fail such a coercion test.<sup>147</sup>

Furthermore, the Supreme Court’s reasoning for applying a liquidated damages analysis centered on the fact that the parties intended to have the terminated fee treated as such.<sup>148</sup> Conditioning the judicial analysis of termination fee provisions on the characterization of the fee in a particular merger agreement hopelessly neglects to take into account the underlying policies that Delaware courts are responsible for administering—namely, informed and responsible directorial action and protecting the value and voting rights of shareholders. Allowing the parties to a merger agreement to dictate the standard of judicial review hardly achieves these policy objectives.<sup>149</sup>

#### A. *Brazen as a Possible Prelude to Enhanced Scrutiny*

Prior to *Brazen*, other non-Delaware courts had implemented different approaches in analyzing termination fee provisions. For instance, in *CRTF Corp. v. Federated Department Stores, Inc.*,<sup>150</sup> rather than applying the traditional business judgment analysis, the New York court held that termination fees are valid only if they enhance rather than stop the process of bidding.<sup>151</sup> Other courts rejected this analysis in favor of one that is similar to *Unocal*, holding that such fees are valid when they are reasonable in relation to the bidder’s efforts and to the size of the transaction.<sup>152</sup> Thus, it is evident that the courts have established the groundwork for some form of enhanced scrutiny in the examination of termination fees, as the deference afforded by the business judgment rule is seemingly inadequate.

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147. See Coates & Subramanian, *supra* note 22, at 333. Professors Coates and Subramanian also point out that the court’s discussion of shareholder coercion suggests that termination fee provisions will unlikely be invalidated as interfering with shareholder voting rights under a *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), analysis which held that directors cannot act with the primary motivation of impairing shareholder voting without a compelling justification. See *id.* at 332. The Professors argue that the *Brazen* court’s definition of coercion “eviscerated this test” from the context of termination fee provisions. *Id.*

148. See *Brazen*, 695 A.2d at 48.

149. In the same respect, the Delaware Supreme Court fails to mandate a liquidated damages analysis for all termination fee provisions considered by the court. See generally *id.*

150. 683 F. Supp. 422 (S.D.N.Y. 1988).

151. See *id.* at 440.

152. See *Cottle v. Storer Comm., Inc.*, 849 F.2d 570, 578-79 (11th Cir. 1988) (upholding a termination fee provision representing a little over one percent of the total acquisition price); see also *Beebe v. Pac. Realty Trust*, 578 F. Supp. 1128, 1150 (D. Or. 1984) (adopting a reasonableness test in upholding a termination fee payable if the shareholder failed to ratify the transaction).

With regard to the application of the liquidated damages analysis rather than the deferential business judgment rule, the *Brazen* court emphasized that, “[t]his is not strictly a business judgment rule case.”<sup>153</sup> Furthermore, the court explained that “it [was] appropriate to apply a reasonableness test, which in some respects is analogous to some of the heightened scrutiny processes employed by [Delaware] courts in certain other contexts.”<sup>154</sup> Thus, the *Brazen* opinion seems to open the proverbial door for termination fee provisions to be examined by applying a standard that incorporates some kind of enhanced scrutiny as this Note advocates. The court, however, did not define precisely what standard should govern the examination of termination fee provisions.

## V. THE SHAREHOLDER’S RIGHT TO VOTE AND SHAREHOLDER COERCION

### A. *The Shareholder’s Legal and Statutory Right to Vote*

Delaware courts declare shareholder voting as the fundamental value of corporate governance.<sup>155</sup> In the corporate structure provided by all state corporation statutes, directors manage the business and affairs of the corporation.<sup>156</sup> Essentially, directors have unfettered power to act on behalf of the corporate entity with relatively few limitations.<sup>157</sup> In contrast, shareholders participate only infrequently in a limited set of corporate decisions.<sup>158</sup> As a court decision from early in the twentieth century explains, “[shareholders] are not . . . given general power of initiative in corporate affairs. Any action by them relating to the details of the corporate business is necessarily in the form of assent, request, or recommendation.”<sup>159</sup>

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153. *Brazen*, 695 A.2d at 49.

154. *Id.*

155. *See, e.g.*, *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

156. *See, e.g.*, MODEL BUS. CORP. ACT § 8.01 (1999); DEL. CODE ANN. tit. 8, § 141 (2001).

157. *See* DEL. CODE ANN. tit. 8, § 141 (2001).

158. *See id.*

By statute, common shareholders have the right to vote (at annual or specially called meetings) for the election of directors and on certain “fundamental matters.” Under most state statutes, the “fundamental” matters that require a common shareholder vote include: (1) mergers involving the corporation (except, under some statutes, when the corporation acquires a much smaller firm), (2) any amendment to the certificate of incorporation, (3) the sale of substantially all the corporation’s assets, and (4) liquidation.

WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 119 (6th ed. 1996).

159. *Continental Secs. Co. v. Belmont*, 99 N.E. 138, 141 (N.Y. 1912).

While the authority of shareholders is extremely limited in the scheme of corporate governance, shareholders are afforded an exercise of voting power when management entertains fundamental corporate changes.<sup>160</sup> Delaware courts have consistently made statements that strongly present the need to protect the shareholder franchise in this regard. In *Blasius Industries, Inc. v. Atlas Corp.*,<sup>161</sup> the court noted that the shareholder vote is the “ideological underpinning upon which the legitimacy of directorial power rests.”<sup>162</sup> Moreover, the voting exercise of shareholders was said to have “transcending significance.”<sup>163</sup>

In *Blasius*, directors attempted to purposely intrude on the shareholders’ right to elect a new board. The Delaware Court of Chancery created a standard of review for application in this special context.<sup>164</sup> The standard of review that *Blasius* established stated that, when directors act with the primary purpose of encumbering the shareholders’ exercise of their voting power, the directors bear an arduous burden of demonstrating a “compelling justification” for their action.<sup>165</sup> While this “compelling justification” standard has been criticized for its lack of utility,<sup>166</sup> the *Blasius* decision “reaffirmed the traditional view that director actions

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160. See Fanto, *supra* note 53, at 308. Note that a corporation conducting an acquisition can avoid the requirement of shareholder approval by conducting the transaction through a special acquisition subsidiary established for this purpose, the “triangular merger.” However, most mergers do require the approval of the shareholders of the acquiring company. See *id.* Interestingly enough, in a recent European Union directive on takeovers, European corporate law experts from seven European countries recommended measures that would place the decision of using defensive and protective tactics in the hands of the shareholders. See *EU Panel Recommends Measures to Foster Cross-Border Mergers*, WALL ST. J., Jan. 11, 2002, at A7. Corporate boards would have to receive shareholder approval before instituting these mechanisms. See *id.* If the expert recommendations are adopted many of the European Union countries would have to make changes to their takeover laws. See *id.*

161. 564 A.2d 651 (Del. Ch. 1988).

162. *Id.* at 659.

163. *Id.* at 662.

164. See generally *id.*

165. *Id.* at 661.

166. See Allen et al. *supra* note 69, at 1312-13 (criticizing the practicality—but not the underlying principle of protecting the shareholder franchise—of the *Blasius* standard of review). The Chancellors further stated,

[T]he *Blasius* doctrine evolved into a flexible standard that functionally looks very much like the *Unocal/Unitrin* standard, but with a strong emphasis on the importance of the franchise. The post-*Blasius* experience has shown that presentations to the court were not made clearer, nor were helpful analytical solutions suggested, by the addition of a *Blasius* argument to a brief that already included a *Unocal* argument. The reason is that after *Unitrin*, it is difficult to unearth or even imagine a case that would be decided differently if the analysis were conducted under the *Blasius* rather than the *Unocal* standard. Because the purpose underlying the *Blasius* standard is furthered equally well by another, more easily applied, standard, *Blasius* should be eliminated as a “stand alone” review doctrine.

*Id.* at 1312.

primarily motivated to effect a disenfranchisement have a dim chance of being sustained.”<sup>167</sup>

Further, in *Stroud v. Grace*,<sup>168</sup> the court unequivocally stated that “where boards of directors deliberately employ[] various legal strategies either to frustrate or completely disenfranchise a shareholder vote . . . [t]here can be no dispute that such conduct violates Delaware law.”<sup>169</sup> While the Delaware courts have certainly placed shareholder voting rights on the highest pedestal, as their eloquent verbiage suggests, they have not articulated a standard of review that demonstrates the “transcending significance” of the shareholder vote, particularly in the termination fee context where the problem of shareholder coercion persists.<sup>170</sup>

A Delaware decision described the inadequacy of current judicial standards best by stating, “[t]hat there are underlying policy issues is inevitable, given the tension between the directors’ acknowledged authority to manage the affairs of the corporation, and the shareholders’ independent right and authority to choose the corporation’s ultimate destiny.”<sup>171</sup> Posing the question is a step in the right direction, but it is also not answering it. The court proceeded to note, “[h]opefully, future cases will provide the occasion to develop that jurisprudence.”<sup>172</sup> The best interest test this Note advocates in Part VI allows a court to examine a termination fee provision without isolating the relevant factual surroundings. Such a standard allows for judicial discretion in assessing the issues arising out of the inclusion of termination fee provisions. This standard is more conducive for providing the shareholder franchise with the protection it so fittingly deserves.

### B. *The Problem of Shareholder Coercion*

Claims based on shareholder coercion have arisen in various different contexts. These claims arise in corporate restructuring or recapitalization, shareholder voting with respect to transactions involving controlling shareholders, shareholder voting with respect to transactions

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167. *Id.* at 1311-12 (footnote omitted).

168. 606 A.2d 75 (Del. 1992).

169. *Id.* at 91.

170. A specific discussion of shareholder coercion issues arising out of termination fee provisions will be discussed *infra* Part V.B.

171. *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 52 n.105 (Del. Ch. 1988), *aff’d*, 721 A.2d 1281 (Del. Sup. Ct. 1988).

172. *Id.*

not involving interested parties, and board responses to takeover attempts.<sup>173</sup>

The shareholder coercion issues involving termination fee provisions are whether such fees “inequitably” or “wrongfully” coerce the shareholders to vote in favor of the transaction.<sup>174</sup> Generally, the party bringing the suit will argue that the termination fee is so large as to coerce shareholder approval of the transaction merely to avoid the exorbitant fee that would be incurred by the company in the event the transaction was not approved.<sup>175</sup> Thus, the merits of the transaction are never truly considered by the voting shareholders and the approving vote is coerced by fear of a punitive fee, making the vote ineffective and the transaction voidable.<sup>176</sup>

The defendant will counter by contending that the inclusion of the termination fee provision was a crucial part of the deal and there was no intention to use the fee to foster shareholder approval.<sup>177</sup> The defendant corporation will likely defend the validity of the termination fee provision by raising the business judgment rule defense. That is to say, the decision to include the termination fee provision is a byproduct of an informed directorial decision, thereby invoking the protection of the business judgment rule. Additionally, the defendant will demonstrate that the inclusion of the fee was a strategic decision proceeded by a cost-benefit analysis that benefited the corporation, in that it induced and offered incentive to potential bidders.<sup>178</sup>

The shareholder coercion concern will increase as the incidence and amount of termination fees increase. An empirical study conducted by Professors John Coates and Guhan Subramanian illustrated the incidence and magnitude of termination fee provisions.<sup>179</sup> Figure 1 illustrates the increasing popularity of termination fees over a twelve-year period of

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173. See Dennis J. Block & Jonathan M. Hoff, *The Doctrine of Inequitable Coercion Under Delaware Law*, N.Y.L.J., Apr. 22, 1999, at 5.

174. See, e.g., *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49-50 (Del. 1997).

175. See generally *id.* (arguing that the termination fee provision in question coerces shareholder approval of the transaction because of the risk of incurring the fee).

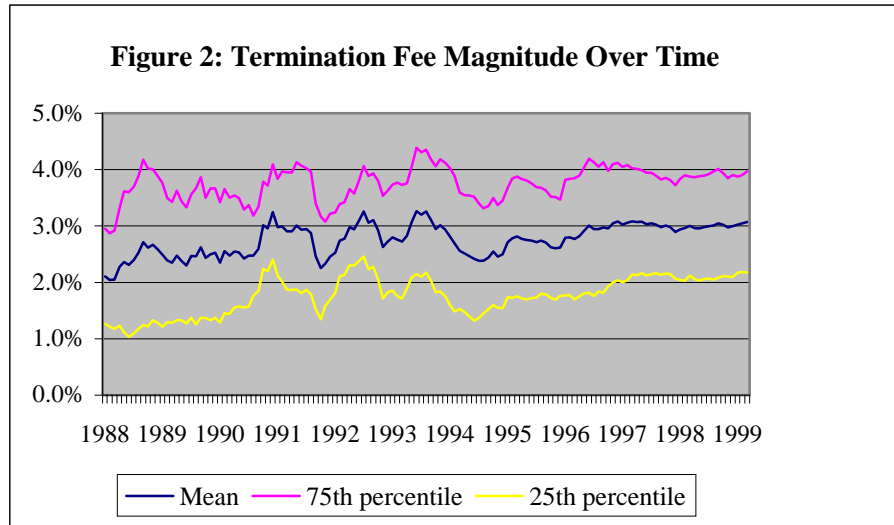
176. Indeed this concern is a genuine one. For instance, in a letter from Walter Hewlett to Hewlett-Packard shareholders, Mr. Hewlett writes, “HP will NOT owe Compaq a \$675 million break-up fee if HP stockholders just vote down the transaction.” *Walter Hewlett Sends Letter to Hewlett-Packard Shareholders*, PR NEWSWIRE, Feb. 14, 2002. This statement was also placed in a myriad of advertisements in the *Wall Street Journal* as part of Mr. Hewlett’s campaign against the merger. See *Attention: All Hewlett-Packard Stockholders*, WALL. ST. J., Feb. 19, 2002, at C11. This demonstrates the practical importance termination fee provisions play in shareholder voting considerations.

177. See *Brazen*, 695 A.2d at 49.

178. See, e.g., *id.* at 47.

179. See Coates & Subramanian, *supra* note 22, at 11.

merger and acquisition activity, demonstrating that by 1998, termination fee provisions were deployed in almost seventy percent of combination transactions.<sup>180</sup>



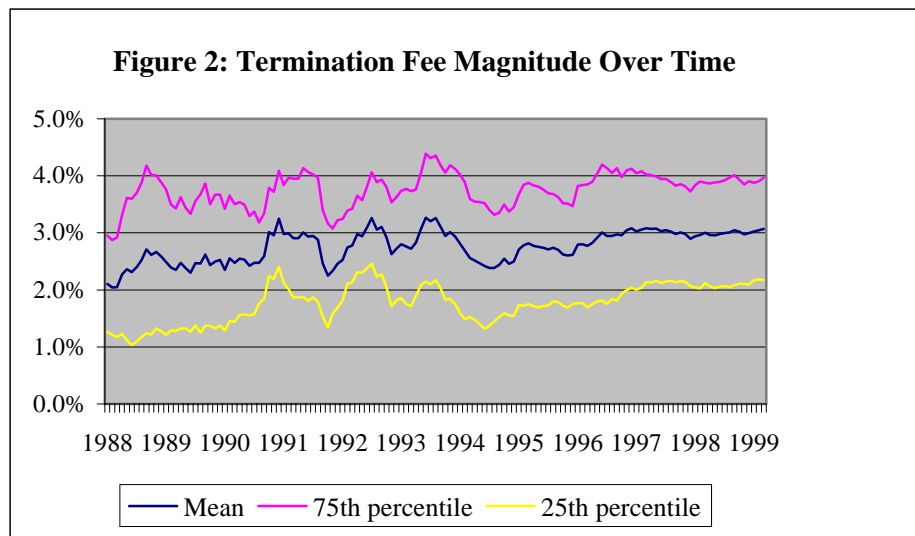
Furthermore, Figure 2 below illustrates the magnitude of termination fee provisions over twelve years, as well as the seventy-fifth and twenty-fifth percentile levels. Figure 2 demonstrates the upward trend of termination fee provisions since 1995. Indeed, Professors Coates and Subramanian postulate that absent judicial intervention, the size of termination fees will increase in the future.<sup>181</sup> Such a finding is “consistent with the perceptions of practitioners who report a slight increase in the size of [termination] fees over the past few years.”<sup>182</sup> Ultimately, the Professors contend that if the upward trend continues, termination fees will become more coercive to shareholders.<sup>183</sup>

180. See *id.* Figures 1 and 2 were recreated in substantial form from the empirical data graciously provided by Professors Coates and Subramanian. I am grateful to Gary Moore for his technical assistance in preparing these charts for publication.

181. See *id.* at 12.

182. See *id.* (citing specific practitioner interviews indicating the increasing magnitude of termination fees).

183. See *id.* at 12 (explaining that the incidence and magnitude of termination fee provisions increased after the *Brazen* case that dismissed the shareholder claim in the termination fee context).



There is no clear legal definition for the term “coercion.” The term is used in a variety of different legal contexts. In *Williams v. Geier*,<sup>184</sup> the Delaware Supreme Court developed an analysis to determine whether there had been impermissible shareholder coercion in a given situation. The court stated that, “[a]n otherwise valid stockholder vote may be nullified by a showing that the structure or circumstances of the vote were impermissibly coercive.”<sup>185</sup> The court further explained that “wrongful coercion” can exist when the stockholders are caused “to vote in favor of the proposed transaction for some reason other than the merits of that transaction.”<sup>186</sup> The *Geier* case expressly states that the determination of coercion depends on the specific factual context of each case and should be reviewed on a case-by-case basis.<sup>187</sup> The court in *Geier*, however, failed to provide a test or standard in determining what constitutes shareholder coercion.

Perhaps the shareholder coercion claim is strongest when the termination fee in question is of the naked no vote breed. As mentioned, this type of termination fee provision contemplates a scenario where there has been a negative shareholder vote by the target’s shareholders without

184. 671 A.2d 1368 (Del. 1996).

185. *Id.* at 1382.

186. *Id.* at 1382-83.

187. *See id.* at 1383.

any competing bid affecting their voting decision.<sup>188</sup> The viability of a substantial naked no vote provision has been doubtful in light of a recent Chancery Court opinion, and rightfully so.

In *McMillan v. Intercargo Corp.*,<sup>189</sup> plaintiff shareholders sued their former directors for breaching their fiduciary duties in connection with an acquisition that had been consummated.<sup>190</sup> The plaintiffs argued that the directors breached their fiduciary duties of care and loyalty as a result of their failure to ensure the highest value reasonably attainable through the acquisition.<sup>191</sup> The complaint further alleged that the merger agreement contained a preclusive and coercive fee of \$3.1 million plus expenses.<sup>192</sup> The termination fee constituted approximately 3.5 percent of the \$88 million value of the transaction.<sup>193</sup> The complaint also asserted that there were two other bidders that were interested in negotiating a merger, if they had the opportunity to do so.<sup>194</sup>

In examining the termination fee provision, Vice Chancellor Strine explained that although “the termination fee was at the high end of what our courts have approved, it was still within the range that is generally considered reasonable.”<sup>195</sup> The Vice Chancellor placed emphasis on the fact that the termination fee was conditioned upon the occurrence of two contingent events—a negative shareholder vote and the target benefiting from a more favorable transaction within ninety days or another acquisition proposal within the year.<sup>196</sup> The Vice Chancellor continued to explain how the termination fee provision “ensured that the Intercargo stockholders would not cast their vote in fear that a no vote alone would trigger the fee; the fee would be payable only if the stockholders were to get a better deal.”<sup>197</sup> From Vice Chancellor Strine’s justification of the termination fee in question, his concern with the naked no vote provision

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188. See *supra* notes 39-41 and accompanying text.

189. 768 A.2d 492 (Del. Ch. 2000). The shareholders attempted to block consummation of the merger but the Chancery Court rejected their request for a preliminary injunction. Chancellor Strine described the failure to obtain the injunction rather artfully as he explained: “the metaphorical merger eggs have been scrambled.” *Id.* at 500.

190. See *id.* at 495.

191. See *id.*

192. See *id.* at 498.

193. See *id.*

194. See *id.* 498-99.

195. *Id.* at 505.

196. See *id.*

197. See *id.*

is alluded to. As a result of this intimation, practitioners have been wary of sizable naked no vote provisions.<sup>198</sup>

Vice Chancellor Strine's concern with the naked no vote situation is certainly warranted. As mentioned previously, the typical purpose of negotiating a termination fee provision is to compensate the first bidder when it serves as a stalking horse for the target to obtain a more favorable transaction.<sup>199</sup> Thus, it is inherently inconsistent with this purpose, to condition a termination fee solely on a negative shareholder vote. Moreover, the Delaware statutory scheme expressly authorizes a shareholder vote when corporations enter into combination transactions.<sup>200</sup> Coercing or intruding on the shareholders' legal and statutory right to vote by employing a naked no vote provision is certainly problematic as a public policy matter. Under the substantive standard of review this Note advocates, it would be difficult, if not impossible, to uphold a naked no vote termination fee provision. Such an outcome would be consistent with the primacy of the shareholders' right to make a free and meaningful choice.

If courts apply the best interest standard discussed, courts will be able to scrutinize the substance of termination fee provisions and come to an informed conclusion regarding what fees impermissibly coerce fundamental shareholder voting and what fees do not. Such a standard is consistent with the Delaware judiciary's high regard for the shareholder franchise. This application would narrow the chasm between the rhetoric of Delaware courts and their actual decisions.

## VI. TERMINATION FEE PROVISIONS IN BANKRUPTCY ASSET SALES

While termination fee provisions originated in the context of corporate mergers and acquisitions, such fees are included in bankruptcy asset purchase agreements.<sup>201</sup> A corporation in bankruptcy may wish to

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198. See Richard E. Climan et al., *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 267-68 (2002).

199. See *supra* notes 52-58 and accompanying text.

200. See *supra* Part V.A.

201. The first case to address the validity of these provisions in bankruptcy was *In re 995 Fifth Avenue Associates*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989) (upholding the payment of a \$500,000 termination fee). It is important to note that termination fees are not addressed in the Federal Bankruptcy Code. There have been various bankruptcy code sections proposed by scholars. Most notable is the proposal of Paul Lackey convincingly advocating the adoption of an *ex ante* approach to determining the propriety of termination fees. See Paul B. Lackey, Note, *An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 COLUM. L. REV. 720, 743 (1993).

sell its assets in order to pay off its debts.<sup>202</sup> The debtor may attempt to sell the assets by public auction.<sup>203</sup> If such an auction does not yield the best price available, the debtor may attempt to sell its assets by private sale.<sup>204</sup> In both transactions, the debtor will tentatively agree with a buyer as to a particular sale.<sup>205</sup> Both private and public sales require approval from a bankruptcy court.<sup>206</sup> In a Chapter 11 case, the debtor strives to gain court confirmation of a plan of reorganization<sup>207</sup> that will give the debtor a fresh start, and relieve the debtor from most debts he or she incurred prior to the bankruptcy.<sup>208</sup>

A bankruptcy court will confirm the sale only if it is convinced that the price to be paid is the best price under the circumstances.<sup>209</sup> The delay in awaiting court approval, coupled with the possibility that the sale will not be approved, may lead potential purchasers to insist that the debtor pay termination fees if the court instead approves a competing bid.<sup>210</sup>

Termination fee provisions in bankruptcy asset-purchase agreements function virtually in the same manner as they do in merger and acquisition agreements. Potential purchasers are reluctant to incur the costs to engage in the due diligence necessary to determine the worth of the debtor's business and prepare the first bid.<sup>211</sup> The same looming possibility of other purchasers relying on that work and making a higher bid, discussed previously, exists in the bankruptcy context.<sup>212</sup> Consequently, debtors

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202. See 11 U.S.C. § 363(b)(1) (1994) (providing that the trustee, after notice and a hearing, may sell, use, or lease property of the estate, other than in the ordinary course of business).

203. The Bankruptcy Rules permit sale by public auction. See FED. R. BANKR. P. § 6004(f)(1) (2002).

204. The Bankruptcy Rules also permit private sales of estate assets. See *id.*

205. See 11 U.S.C. § 363(b)(1) (1994).

206. See *id.*

207. The reorganization of a corporation commonly occurs when a corporation is approaching the point of bankruptcy or insolvency. The purpose of Chapter 11 reorganization is to "assist financially stressed business enterprises by providing them with breathing space in which to return to a viable state." *In re C-TC 9th Ave. P'ship*, 113 F.3d 1304, 1309 (2d Cir. 1997).

208. See Robert J. Rosenberg & A. Brent Truitt, *Investors See Both Risk and Opportunity*, N.Y.L.J., Sept. 13, 1999, at 13. There is an exception to the rule that a Chapter 11 debtor receives a discharge of debts. Section 1141(d)(3) of the Bankruptcy Code provides that if a corporate debtor sells all or substantially all of its assets and will not carry on any business after the chapter eleven case is concluded, then the debtor does not get a discharge. See 11 U.S.C. § 1141 (1993).

209. See *In re Chung King, Inc.*, 753 F.2d 547, 549 (7th Cir. 1985) (stating the general goal of bankruptcy sales is to obtain the best price); *In re Fin. News Network, Inc.*, 126 B.R. 152, 153 (S.D.N.Y. 1991) (holding that failure to consider a superior bid did not meet the court's "paramount obligation" of determining the highest and best bid).

210. See Lackey, *supra* note 201, at 722.

211. See *In re Hupp Indus., Inc.*, 140 B.R. 191, 193-94 (Bankr. N.D. Ohio 1992) (discussing the various functions of termination fees).

212. See *id.*

provide termination fees as an economic incentive to bolster the bidding process.<sup>213</sup> While termination fees compensate the buyer for the risk of being outbid, they may concomitantly deter others from making bids.<sup>214</sup>

#### A. *Bankruptcy Court Standards of Review*

Bankruptcy courts have applied various standards in determining the permissibility of termination fees. In applying these standards, the courts are especially concerned with “prevent[ing] potential acquirors from obtaining undue advantages to the detriment of the bankrupt company’s creditors and shareholders.”<sup>215</sup> Moreover, as mentioned earlier, the paramount consideration of bankruptcy courts is to obtain the highest and best price for what is being sold.<sup>216</sup>

When confronted with termination fee requests, some bankruptcy courts<sup>217</sup> have applied a modified business judgment rule.<sup>218</sup> The termination fee will be approved if the agreement to provide the fee represents the proper exercise of the debtor’s judgment. Indeed, the first bankruptcy court confronted with the question of what standard of review to apply opted to review the fee “by analogy” to termination fee provisions in the corporate merger and acquisition context.<sup>219</sup> The modified version of the business judgment rule is best explained in the seminal *Integrated Resources* case.<sup>220</sup>

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213. Courts recognize that termination fees may enhance the bidding process by encouraging the initial bid. Termination fees may “be legitimately necessary to convince a ‘white knight’ to enter the bidding by providing some form of compensation for the risks it is undertaking.” *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 624 (S.D.N.Y. 1987) (citing *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182-84 (Del. 1986)). On the other hand, termination fees may discourage others from making bids by increasing the cost of the acquisition. *See id.*

214. Termination fees “are designed to protect the transaction for the acquirer, to make it more expensive for any third party to enter the bidding after an agreement has been announced, and to ensure the initial putative acquirer that it will be appropriately compensated if such should occur.” LORNE, *supra* note 32, § 2:23.

215. John J. Jerome & Robert D. Drain, *Bankruptcy Court is Newest Arena for M & A Action*, N.Y.L.J., June 3, 1991, at 8.

216. *See supra* note 209 and accompanying text.

217. Most courts in the Second Circuit, which encompasses the Southern District of New York where most “mega-cases” are filed, apply this modified business judgment rule. *See* S. ELIZABETH GIBSON, A GUIDE TO THE JUDICIAL MANAGEMENT OF BANKRUPTCY MEGA-CASES (Fed. Jud. Ctr. ed. 1992) (defining “mega-cases” as a bankruptcy involving a debtor of at least \$100 million).

218. *See In re 995 Fifth Ave. Assocs.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989). In *995 Fifth Ave.*, the court considered whether the proposed termination fee prohibited or had a chilling effect on bidding and whether the amount of the proposed fee was reasonable in relation to the size of the sale, the work, and the expense involved in negotiating the agreements to determine if the fee met the modified business judgment rule. *See id.*

219. *See id.* at 28.

220. 147 B.R. 650 (Bankr. S.D.N.Y. 1992).

In *Integrated Resources*, Banker's Trust made a proposal to fund a reorganization plan for the debtor, Integrated, which included a termination fee provision.<sup>221</sup> The court began its analysis by stating that the primary responsibility of the debtor seeking to sell its assets is the maximization of the value of the assets.<sup>222</sup> Furthermore, the court imposed the burden of proving that the purchase price was the highest and best offer on the debtor.<sup>223</sup> The court concluded that the modified business judgment rule was the appropriate standard of review in the evaluation of termination fees.<sup>224</sup>

In applying the modified business judgment rule, the court established a three-part test for bankruptcy courts to apply in their examination of termination fees: "(1) is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation; (2) does the fee hamper, rather than encourage, bidding; (3) is the amount of the fee unreasonable relative to the proposed purchase price?"<sup>225</sup> The court concluded that the termination fee was economically appropriate because it attracted a potentially successful bid, it established a bidding standard for subsequent bidders, and it served to attract additional bidders.<sup>226</sup>

In the corporate merger and acquisition context, a court's analysis would generally begin by focusing on whether the decision to accept a termination fee provision was a "sweetheart deal"<sup>227</sup> and whether any fraud was present.<sup>228</sup> Under the business judgment rule, absence of bad faith or gross negligence in the decision to accept such a provision would be presumptively valid.<sup>229</sup> The analysis would then cease.<sup>230</sup> In the bankruptcy context, the Second Circuit has modified the deferential business judgment standard and required that the fee be reasonable and encourage rather than deter bidding.<sup>231</sup>

The bankruptcy decision in *Integrated Resources* failed to explain precisely why the court decided to modify the business judgment standard.

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221. *See id.* at 653.

222. *See id.* at 659.

223. *See id.*

224. *See id.* at 656.

225. *Id.* at 657.

226. *See id.* at 662.

227. A sweetheart deal is defined as "[a] collusive agreement" usually tainted with self-dealing. BLACK'S LAW DICTIONARY 1462 (7th ed. 1999).

228. *See supra* Part III.A.

229. *See id.*

230. As discussed in Part III *supra*, a court may apply *Unocal's* enhanced scrutiny or *Brazen's* liquidated damages approach.

231. *See Hebbeln, supra* note 11, at 485.

Perhaps the reason for this modification is that bankruptcy courts have acknowledged that the decision to include termination fees requires more scrutiny, since there are several parties involved in these transactions, each pursuing their own interests. While the modified business judgment rule seems to provide an “extra layer of protection” for creditors, debtors and shareholders alike,<sup>232</sup> the standard is premised on the deferential conceptualizations of the business judgment rule. The foundation for this standard of review is inconsistent with the overarching policy consideration of protecting the shareholder franchise. A superlative standard of review would better take into account the statutory role of the shareholders in the combination transaction context. The best interest standard discussed later in this Note, if adopted analogously, does precisely that.

*B. In re Hupp Industries<sup>233</sup> and the Best Interest Standard*

While the modified business judgment rule is the standard of review in the Second Circuit, many bankruptcy courts have rejected the *Integrated Resources* test.<sup>234</sup> Rather than being concerned with the debtor’s business judgment, these courts apply a more stringent standard that focuses on whether the termination fees make economic sense and whether the fees benefit the bankruptcy estate.<sup>235</sup> The underlying rationale

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232. *Id.*

233. 140 B.R. 191 (Bankr. N.D. Ohio 1992).

234. *See In re S.N.A. Nut Co.*, 186 B.R. 98, 102-03 (Bankr. N.D. Ill. 1995) (rejecting the business judgment rule as the correct standard to apply to termination fees); *In re Tiara Motorcoach Corp.*, 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) (rejecting the *Integrated Resources* modified business judgment rule); *In re Hupp Indus.*, 140 B.R. at 194 (establishing a seven-factor test to apply to termination fee provisions though not explicitly rejecting the business judgment rule).

235. *See In re Hupp Indus.*, 140 B.R. at 194, 196. Another standard of review applied by bankruptcy courts that is not mentioned in the above discussion of bankruptcy court standards of review is the “administrative expense” standard. *See In re O’Brien Envtl. Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999). In *O’Brien*, the Third Circuit established standards for determining the appropriateness of termination fee provisions in the bankruptcy context. *See id.* at 535-38. The *O’Brien* court held that even though bidding incentives, such as termination fees are generally measured against a business judgment standard in nonbankruptcy transactions, the administrative expense provisions of § 503(b) of the Bankruptcy Code govern in the bankruptcy context. *See id.* at 535. Accordingly, in order for a termination fee to be approved, the fee must provide some benefit to the debtor’s estate. *See id.* at 533. The *O’Brien* Court identified at least two circumstances in which termination fees may provide benefit for the estate. First, a benefit may be found if “assurance of a [termination] fee promoted more competitive bidding, such as by inducing a bid that otherwise would not have been made and without which bidding would have been limited.” *Id.* at 537. Second, where the availability of termination fees induces a bidder to research the value of the debtor and submit a bid that serves as a minimum floor bid, on which other bidders will rely to formulate their own bid, “the bidder may have provided a benefit to the estate by increasing the likelihood that the price at which the debtor is sold will reflect its true worth.” *Id.* As will be discussed *infra*, the argument that termination fees induce a bidder to

for adopting this standard is that the paramount purpose of the bankruptcy sale is to maximize the value of the estate and, therefore, the payment of a termination fee may unnecessarily decrease the value.<sup>236</sup>

The seminal case applying the best interest of the estate test was *In re Hupp Industries, Inc.*<sup>237</sup> The termination fee at issue in *Hupp* was unusual as the agreement provided for \$100,000 to be paid to the bidder whether or not the bidder was successful in its purchase of the debtor.<sup>238</sup> The court held that, although termination fees are “presumptively appropriate” in the merger and acquisition context, courts in the bankruptcy context “must be necessarily wary of any potential detrimental effect that an allowance of such a fee would visit upon the debtor’s estate.”<sup>239</sup> In assessing the propriety of the termination fee, the *Hupp* court introduced a seven-factor best interest test:

- 1) Whether the fee requested correlates with a maximization of value to the debtor’s estate;
- 2) Whether the underlying negotiated agreement is an arms-length transaction between the debtor’s estate and the negotiating acquirer;
- 3) Whether the principal secured creditors and the official creditors committee are supportive of the concession;
- 4) Whether the subject [termination] fee constitutes a fair and reasonable percentage of the proposed purchase price;
- 5) Whether the dollar amount of the [termination] fee is so substantial that it provides a “chilling effect” on other potential bidders;
- 6) The existence of available safeguards beneficial to the debtor’s estate; [and]
- 7) Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the [termination] fee.<sup>240</sup>

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research the value of an entity is refutable on the basis that debtors (or targets) can eliminate the need for termination fees by increasing the available information about itself. *See* Markell, *supra* note 59, at 386.

236. *See In re Hupp Indus.*, 140 B.R. at 194.

237. *See id.*

238. *See id.* at 195.

239. *Id.* at 194.

240. *Id.*

Ultimately, the court rejected the termination fee because it was unrelated to any costs incurred by the potential purchaser and because the fee was to be paid regardless of whether the bidder acquired the debtor.<sup>241</sup>

Similarly, in *In re America West Airlines, Inc.*,<sup>242</sup> the court expressly rejected the business judgment rule as a standard of reviewing termination fee provisions.<sup>243</sup> The court stated that the proper analysis must “include a determination that all aspects of the transaction are in the best interests of all concerned.”<sup>244</sup> In applying the best interest of the estate standard, the court reasoned that the debtor had been extensively marketed and, thus, the termination fee “[would] not induce further bidding or bidding generally.”<sup>245</sup>

The court, in *In re Tiara Motorcoach Corp.*,<sup>246</sup> also applied the best interest of the estate standard. The court invalidated the termination fee on the grounds that there was no evidence suggesting that the party requesting the fee had conducted any due diligence that other entities relied on or benefited from.<sup>247</sup> Further, the court held that the termination fee did not “serve and protect the interests of the estate, creditors and equity holders,” and that the termination fee “arrangement would chill bidding.”<sup>248</sup>

Of special interest is the reasoning of the *Tiara* court in expressly adopting the more stringent standard. The court reasoned that a bankruptcy sale is not in the ordinary course of business, and thus “the business judgment of the debtor should not be solely relied upon.”<sup>249</sup> An analogy can be drawn from this rationale to the corporate merger and acquisition context. While directors in care of a corporation enjoy the protection of the business judgment rule, the scope of this deference should be limited when directors are confronted with fundamental corporate changes, particularly in deciding whether to accept termination fee provisions that may significantly affect the shareholder franchise.

Delaware Chancery courts that assess termination fee provisions in acquisition agreements should adopt a test that is similar to the best interest of the estate test. Ideally, such a test would take into consideration the totality of the circumstances as the best interest test indeed endeavors

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241. *See id.* at 195.

242. 166 B.R. 908 (Bankr. D. Ariz. 1994).

243. *See id.* at 912.

244. *Id.*

245. *Id.* at 913.

246. 212 B.R. 133 (Bankr. N.D. Ind. 1997).

247. *See id.* at 138 n.7.

248. *Id.* at 137-38.

249. *Id.* at 137.

to accomplish. The following Part will establish how the best interest test will operate in the combination transaction context.

*C. The Best Interests of the Shareholders: Substantive Review of Termination Fee Provisions*

As mentioned previously, once it becomes evident that a corporation will be acquired, the duty of the board shifts from the preservation of the corporate entity to maximization of the price to be obtained for the shareholders.<sup>250</sup> This notion of maximizing the shareholder value by obtaining the best price mirrors the bedrock bankruptcy goal of maximizing the debtor's estate. Bankruptcy courts have recognized an inconsistency with this principle when applying the deferential business judgment rule standard.<sup>251</sup> They sought to protect the value of the debtor's estate by adopting a more rigorous standard.<sup>252</sup> Similarly, the Delaware courts should protect the notions of maximizing shareholder value and safeguarding the shareholder franchise by enacting a similar standard.

The core concern of the Delaware courts should center on whether the termination fee provision is in the best interests of the shareholders, and the series of factors established by the *Hupp* court does precisely that. The factors articulated by the *Hupp* court attempt to look beyond the mere decision-making process, and into the actual substance of the termination fee and how it functions in the business environment. An analysis into the substance of directorial action is not without precedent.<sup>253</sup> In a recent decision involving the disputed merger of Wachovia and First Union, the North Carolina Business Court applied an analysis that substantively reviewed the directors' actions that involved adopting defensive and deal protection provisions including a termination fee.<sup>254</sup>

After finding that the board of directors met its fiduciary duty of care in adopting certain provisions into a merger agreement, the court considered whether those provisions interfered with the shareholders' vote on the merger.<sup>255</sup> In justifying its entry into the realm of substantive review, the court stated "[t]he business judgment rule . . . lets some legal

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250. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

251. See generally *In re Hupp Indus., Inc.*, 140 B.R. 191 (Bankr. N.D. Ohio 1992).

252. See generally *id.*

253. See generally *First Union Corp. v. SunTrust Banks, Inc.*, No. 01-CVS-10075, 01 CVS 4486, 01 CVS 8036, 2001 NCBC 09 (Super. Ct. N.C. Amended Aug. 10, 2001); see also Allen et al., *supra* note 69 at 1299-1301; Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 926-31 (2001).

254. See generally *First Union Corp.*, 2001 NCBC 09.

255. See, e.g., *id.* ¶ 161.

rights go unredressed for the sake of the efficiency of the system. When the legal rights are statutory shareholder rights, 'sacred space,' the review process should not permit these legal rights to go unredressed."<sup>256</sup> In support of the court's review, recent commentary suggests that "to the extent that deal protection measures do affect the integrity of stockholder votes, there must be judicial review to insure that the integrity of the stockholder voting process is maintained."<sup>257</sup>

The termination fee provision in *First Union* prevented Wachovia, a party to the merger agreement, from terminating the agreement, thereby extending the life of the agreement for five months beyond the shareholder vote against the transaction.<sup>258</sup> The purpose of this provision was to delay any further action after an adverse shareholder vote.<sup>259</sup> The court explained the problematic and coercive nature of the termination fee and how it would create looming uncertainties for Wachovia shareholders.<sup>260</sup>

The termination fee provision left the shareholders with either the option of voting in approval of the merger, or disapproving the merger and "run[ning] the risk that something will happen in the ensuing five months that will be disadvantageous in light of the directors' inability to respond to any offers."<sup>261</sup> Moreover, the court explained that contractually limiting the ability of the directors to act created uncertainty for the shareholders and this directorial action made it more likely that the shareholders were to "vote for the bird in the hand."<sup>262</sup> Ultimately, the provision resulted in the inability of other suitors to get a proposal before the board, and the shareholders were required to vote knowing that this transaction was the only opportunity they will have to sell for five months. The court plainly concluded, "[t]hat is coercive."<sup>263</sup>

The *First Union* court was undoubtedly influenced by recent scholarship of former and current Delaware Chancellors.<sup>264</sup> In a recent article Vice-Chancellor Strine argues that judicial emphasis should be placed on the uncoerced shareholder choice as such an approach more adequately balances the competing pressures of directors and shareholders in the merger setting. The Vice-Chancellor stated:

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256. *Id.* ¶ 153 (footnote omitted).

257. Alexander, *supra* note 17, at 903 (footnote omitted).

258. *See First Union Corp.*, 2001 NCBC, ¶ 155.

259. *See id.* ¶ 159.

260. *See id.* ¶ 161.

261. *Id.*

262. *Id.*

263. *Id.* ¶ 162.

264. *See id.* ¶ 67; *see generally* Allen et al., *supra* note 69; Strine, *supra* note 253.

[the] judicial emphasis on stockholder choice makes sense. It gives boards the first bite at the apple and contractual tools to use to accomplish their preferred strategy. It enables the merger partners to receive contractual protections that limit their injuries if transactions do not go through. But it also ensures integrity by limiting the boards' ability to intrude on the stockholders' co-equal right to approve mergers.<sup>265</sup>

The *First Union* court expressly adopted the Vice-Chancellor's policy considerations in formulating its analysis.<sup>266</sup>

In another article exploring standard of review uncertainties in Delaware, former Chancellor Allen with Vice-Chancellors Strine and Jacobs endorsed a substantive review of certain board actions and emphasized the necessity to broaden judicial review for the purpose of better protecting uncoerced shareholder votes.<sup>267</sup> The Chancellors contemplated what is necessary for a standard of review to achieve the lofty goal of "functionality."<sup>268</sup> A functional standard of review must do three things:

(i) provide judges with a practical and logical framework to determine whether corporate directors have fulfilled their duties in a particular context and the appropriate remedies if they have not;

(ii) avoid needless complexity that creates opportunities for inefficient processing of cases that have little likelihood of ultimate success; and

(iii) be aligned with the public policies that animate the corporate law by providing incentives for directors to act in a manner most likely to advance corporate and stockholder interests, and by deferring to outcomes reached through effective intra-corporate dispute resolution mechanisms.<sup>269</sup>

While the *First Union* standard embraced many of these considerations, it does have its shortcomings.<sup>270</sup> The analysis in *First Union* did not adequately assess the negotiations of the Wachovia and

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265. Strine, *supra* note 253, at 942.

266. *See id.* *First Union Corp.*, 2001 NCBC, ¶ 68.

267. *See generally* Allen et al., *supra* note 69; Strine, *supra* note 253.

268. *See* Allen et al., *supra* note 69, at 1297.

269. *Id.* (footnote omitted).

270. *See, e.g.*, Paul A. Kuebler, *Recent Development: First Union v. SunTrust and the Delaware Experience: An Analysis of Deal Protection Measures*, 80 N.C. L. REV. 2109, 2120 (criticizing the *First Union* opinion as "[oversimplifying] the realities surrounding deal protection provisions and fail[ing] to establish a tri-leveled system of review, with increasing levels of scrutiny applied as the potential for director conflict of interest increases").

First Union boards in determining whether to uphold the termination fee. While this Note has argued that the Delaware courts should look to the substance of a termination fee provision, it is also necessary to examine the board's decision-making process, an important component that is contemplated by the *Hupp* court's analysis. The totality of the circumstances analysis the *Hupp* court established, if comparably applied in the merger context, addresses the longstanding Delaware policies of advancing the shareholder interest and concomitantly provides incentives for responsible directorial action.

The seven-factor analysis of the *Hupp* court can be adopted analogously as follows:

- (1) Whether the termination fee correlates with the maximization of value to the shareholders;
- (2) Whether the underlying negotiated agreement is an arms-length transaction between the merger partners;
- (3) Whether the directors followed a reasonable decision-making process;
- (4) Whether the termination fee constitutes a fair and reasonable percentage of the proposed purchase price;
- (5) Whether the dollar amount of the termination fee is so substantial that it deters or chills other potential bidders;
- (6) Whether other provisions exist in the merger agreement that are detrimental to the shareholders; and
- (7) Whether there is a substantial adverse impact to the shareholder's legal and statutory right to vote.

Practitioners may criticize the application of such a standard as being incoherent and lacking bright-line guidelines. The response to this common criticism was captured in a recent statement of Chief Justice Veasey of the Delaware Supreme Court. The Chief Justice explained that "it is impracticable to devise a bright-line regulatory scheme that could: 1) adequately cover the vast corporate landscape, 2) prevent circumvention by unscrupulous actors, and 3) keep pace with changes in corporate governance, takeover strategies and defenses, and financial devices."<sup>271</sup> Additionally, in discussing takeover jurisprudence dealing with deal protections, Veasey continued, "[a]t the heart of any jurisprudence in this area should be a concern for the best interests of stockholders."<sup>272</sup> The best interest of the shareholders standard this Note advocates is flexible enough to accommodate the Chief Justice's

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271. Veasey, *supra* note 24, at 2.

272. *Id.* at 9.

significant concerns and provides courts with a practical framework of inquiries to be applied.

This analysis is consistent with the fundamental premise of corporate law—the notion that “the legitimacy of [the] director[’s] action derives from the vote of the shareholders.”<sup>273</sup> It comports to those policies that “animate” corporate law, informed board decisions and protection of shareholder rights. Merely applying the business judgment rule or one of its subsequent derivations will not achieve this responsible and desired outcome.

## VII. CONCLUSION

Initially, bankruptcy courts applied the business judgment rule to termination fee provisions by drawing from the long-standing jurisprudence of the Delaware Court of Chancery. Thereafter, the bankruptcy courts rejected the deferential standard as being inadequate and adopted the more appropriate best interest framework. The time has come for the Delaware courts to reach a similar conclusion. The Delaware Chancellors have recognized a need for substantive review of certain board action and the *First Union* court attempted to apply such an analysis. In doing so, the *First Union* court correctly opined, “refocusing on the relationship between shareholder rights and directors . . . would be [] helpful.”<sup>274</sup>

The tension between deference to directorial action and the scope of judicial review has been dubbed “[t]he defining tension in corporate governance.”<sup>275</sup> This tension is especially provoked when termination fee provisions and other deal protections are adopted into merger agreements. The business judgment rule, enhanced *Unocal* review, and *Brazen’s* liquidated damages analysis are inadequate responses to this tension because they each fail to address the two pillars on which the corporate law is erected—the sanctities of shareholder value and franchise, and the discretion afforded to directors to act in an informed and responsible manner. If adopted analogously to examine termination fees in the combination transaction context, the *Hupp* analysis will address this tension by focusing judicial review on these policies that Delaware courts have long held in the highest regard.

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273. Loewenstein, *supra* note 98, at 25.

274. *First Union Corp. v. SunTrust Banks, Inc.*, No. 01-CVS-10075, 01 CVS 4486, 01 CVS 8036, 2001 NCBC 09 (Super. Ct. N.C. Amended Aug. 10, 2001).

275. See E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 403 (1997).

This Note has demonstrated that it is inconsistent to apply judicial standards of review that fail to take into account shareholder value and franchise, particularly to board actions accepting termination fee provisions that could render the statutory right of shareholders a practical nullity. Indeed, the economic benefits of termination fees may be genuine, however, such a determination would depend on each individual factual scenario. Simply presuming the validity of a termination fee and divorcing the fee from its factual context is an inadequate way of assessing the important policy considerations that courts of equity are charged with administering. Applying a best interest of the shareholders standard takes into account the totality of the circumstances and more adequately addresses the increasing tension between shareholders and directors in the merger and acquisition context.

*Ely R. Levy\**

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