NO-SHOP CLAUSES

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ABSTRACT

This article examines and discusses both the permissibility of no-shop clauses under Delaware law and the treatment of impermissible no-shop clauses by Delaware courts.

The article begins by providing an introduction to the topic. After differentiating between sale of control transactions and strategic transactions, the author argues that the correct standard of review for no-shop clauses is the Revlon *standard or, where* Revlon *is not applicable, the business judgment rule. Observing that both standards require directors to act in good faith and to pursue their shareholders' interests, the author concludes that in both sale of control transactions and strategic transactions there is a far reaching accordance of prudent director conduct pertaining to the adoption of no-shop clauses. The only difference is that sale of control transactions limit directors' evaluation of a deal to its current share value whereas strategic transactions allow the consideration of long term goals. The decisive factor in both scenarios is the board's capability of showing that it was fully informed about all available material information regarding the transaction. This being suggested, the article examines the application of the requirement of a fully informed board with respect to the various forms of no-shop covenants.*

Turning to the question of how to proceed with impermissible no-shop clauses, the article approves of the Delaware courts practice of invalidating them. After discussing the arising conflict between contract and corporate law values, the article argues that the invalidation of impermissible no-shop clauses is both consistent with established legal principles and desirable from a policy point of view. In doing so, the author bases his analysis primarily on established rules of agency law and the promotion of investor confidence.

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I. INTRODUCTION

After an introduction to the topic, the permissibility of no-shop clauses in acquisition agreements between publicly held corporations in Part II and the consequences of impermissible no-shop clauses in Part III will be examined and discussed. In doing so, the author will focus upon Delaware law.

A. *What Are No-Shop Clauses?*

No-shop clauses are deal protection devices. They are common in modern day acquisition documents, yet they are often a central point of bargaining. The term no-shop clause is not used uniformly and may cover a wide range of covenants. For purposes of this article, the term no-shop clauses will be used as a blanket-term covering all various forms of no-shop covenants. A plain no-shop clause is one that restricts the target company for a limited period of time from actively soliciting third party bids, but permits it to provide information to and negotiate with an unsolicited competitive bidder. A more severe variation of this clause, the no-talk clause, does not distinguish between solicited and unsolicited bids. The no-talk clause prohibits negotiations with third parties altogether. In addition, both plain no-shop and no-talk clauses may contain fiduciary out covenants releasing the target corporation from its contractual obligations when they cannot be reconciled with its board of directors' fiduciary duties.[1]

B. *Other Deal Protection Devices*

No-shop clauses are not the only deal protection devices. Other commonly used deal protection devices are break-up fees, lock-ups, stock options and recommendation agreements. Frequently, the parties to a transaction do not rely solely upon one deal protection device, but instead employ several simultaneously.

1. Break-Up Fees

Break-up fees are triggered if the merger is not consummated, e.g., because the target corporation's shareholders refuse to vote for it.[2] Break-

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[1]Fiduciary out clauses often stipulate that independent counsel must be involved to determine whether the clause's requirements are met.

[2]*See* Gregory V. Varallo & Srinivas M. Raju, *A Process Based Model for Analyzing Deal Protection Measures*, 55 BUS. LAW. 1609, 1612-13 & n.9 (2000).

up fees that do not exceed three to four percent of the value of the transaction are usually upheld by Delaware courts.[3]

2. Lock-Ups

A lock-up is an agreement under which the acquirer obtains an option to buy or vote target stock or to acquire important assets of the target corporation.[4] The permissibility of lock-ups is "highly fact specific"[5] and shall not be the subject of this article. As a rule of thumb, however, lock-ups may neither preclude shareholder votes nor coerce shareholders into approval of the transaction.

3. Stock Options

Stock options fall within the category of lock-ups, but deserve a short paragraph to themselves. They entitle the acquirer to buy a certain amount of shares in the target corporation at a certain price if a specified event occurs. This device has several effects. First, the acquirer benefits financially from a better third offer by participating in an increase in the target's stock price. Second, significant stock options may deter tender offers, because the initial acquirer is at any time capable of acquiring large amounts of the target's stock by exercising its stock options.[6] The third and most potent protective effect used to be that significant stock options made the pooling of interests—a favorable accounting method for business combinations—unavailable for competitive bidders. In June 2001, however, the Financial Accounting Standards Board eliminated this accounting method.[7] Therefore, stock options may have lost their significance as a deal protection device.[8]

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[3]*See id.* at 1613 & n.9. It should also be noted that Delaware courts have discerned break-up fees according to the law applied to liquidated damages provisions. *See, e.g.*, Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997) (upholding a $550 million break-up fee).

[4]Varallo & Raju, *supra* note 2, at 1617. The right to buy important assets of the target corporation is also referred to as a crown jewel option.

[5]*Id.*

[6]Tender offers are offers to buy target stock made directly to the target's shareholders.

[7]*See, e.g.*, *Statement of Financial Accounting Standards No. 141: Business Combinations*, FIN. ACCT. SERIES, No. 221-B (2001) (eliminating the prior accounting method for business combinations, which is now unavailable for competitive bidders).

[8]*See* 1 MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS §§ 5A.03[1], 5A.03[2] (2002).

4. Recommendation Agreements

Recommendation agreements commit a board of directors to recommend a transaction to their shareholders. If the deal is no longer favorable at the time of the shareholder vote, this contractual duty clashes with the fiduciary duty to candidly inform and disclose to the shareholders. Therefore, "any provision that commits the board to recommend the deal at a future time must be accompanied by a fiduciary out clause."[9] The amendment of section 251(c) of the Delaware General Corporation Law,[10] however, now explicitly authorizes the board to submit a transaction to the shareholders without the board's recommendation.[11] Hence, a clause committing the board to simply submit a transaction to the shareholders is generally permissible and does not require a fiduciary out clause.[12]

C. *Why Deal Protection?*

Mergers and most other negotiated corporate transactions inherently lead to an unique situation. Due to the requirements of shareholder approval, compliance with the Hart-Scott-Rodino Act's waiting periods, the preparation and filing of proxy statements, and the registration and listing of securities exchanged in the transaction, a gap of two to four months arises between signing and closing of the deal.[13] This leaves ample time for a competitive bidder to interfere with the transaction.[14] Often, however, either the acquirer, the target or both have a strong interest in the consummation of the deal and therefore desire to exclude unwelcome bidders.

The acquirer usually spends a substantial amount of time and money discovering potential synergy effects, identifying an appropriate target, and preparing its bid.[15] Therefore, the acquirer dreads its deal to become "a

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[9]William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 658 (2000).

[10]DEL. CODE ANN. tit. 8, § 251(c) (2003).

[11]*Id.*

[12]*See* Allen, *supra* note 9, at 658.

[13]Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 241 (1990).

[14]*Id.* If not before, a transaction must be publicly disclosed when signed. *See also* Basic v. Levinson, 485 U.S. 224 (1988) (holding that "[m]ateriality in the merger context depends on the probability that the transaction will be consummated, and its significance to the issuer of the securities").

[15]Bainbridge, *supra* note 13, at 242; Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 3-7 (1982); Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1547 (1996)

stalking horse for other offers" and to have a good business opportunity snatched away by a free riding competitor.[16] Furthermore, the acquirer may incur opportunity costs by neglecting or foregoing other possible acquisition opportunities.[17] Thus, it is understandable that acquirers commonly request or insist upon deal protection devices.[18]

Although not quite as apparent, deal protection may also serve the target. First, the target might consider a deal very valuable, but at the same time, face the threat of losing it if it does not concede to demanded deal protection devices.[19] Second, the target may trade deal protection devices for premiums to the acquisition price. Third, a locked up deal provides certainty for employees, suppliers and creditors who otherwise might turn their backs to a corporation that appears to be for sale. Also, it should be noted that, from a social perspective, the possibility of deal protection may provide an incentive for potential acquirers to do the burdensome and costly research, and that unavailability of such protection may come at the cost of fewer investments in information respecting mergers and acquisitions.[20]

(stating that the incurred costs include "the costs of investigating and estimating the value of the target company, lining up financing, complying with governmental regulations, preparing documentation, and potentially litigating"); Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups*, 21 CARDOZO L. REV. 1, 4 (1999).

[16]Allen, *supra* note 9, at 653.

[17]*See* Brazen v. Bell Atlantic Corp., 695 A.2d 43, 45 (Del. 1997) ("[T]he parties took into account the losses each would have suffered as a result of having focused attention solely on the merger to the exclusion of other significant opportunities. . . . The 'lost opportunity' cost issue loomed large."). *See also* Bainbridge, *supra* note 13, at 242 (emphasizing the substantial up front cost to the prospective acquirer in making the initial offer resulting from the risk of nonconsummation); Regan, *supra* note 15, at 4 (providing that lock-up options deter or even preclude other bidders from making a superior offer).

[18]It should be pointed out, however, that even without deal protection an acquirer is not completely unprotected. If it can demonstrate that the competitor wilfully disrespected its contract, it may seek damages for tortuous interference with contract. The most famous and notorious case in this context is *Texaco, Inc. v. Pennzoil Co.* *See* Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. App. 1987), *writ of error refused* 748 S.W.2d 631 (Tex. 1988), *cert. dismissed*, 485 U.S. 994 (1988).

[19]*See* Allen, *supra* note 9, at 654. "In the end, the final justification for a target agreeing to terms of this sort— which restrict its future functioning in some respects—is that failing to do so involves an unacceptable risk of loss of a highly desired contract." *Id.*

[20]*See id.* at 654 n.1; Easterbrook & Fischel, *supra* note 15, at 7; Celia R. Taylor, *"A Delicate Interplay": Resolving the Contract and Corporate Law Tension in Mergers*, 74 TUL. L. REV. 561, 598 (1999).

D. *Why is Deal Protection Problematic?*

While often employed in the pursuit of the corporations' and shareholders' best interest, deal protection may conflict with directors' fiduciary duties of loyalty and care. According to predominant modern day corporate law doctrine, directors owe a duty to maximize their shareholders' wealth.[21] Deal protection, however, curtails the board of directors' ability to solicit, negotiate, and favorably respond to competing bids.[22] This inherently entails the peril of foregoing more valuable offers.[23] Directors may be induced to hold onto and submit to their shareholders a less than optimal deal.[24]

Furthermore, some deal protection devices may factually coerce shareholders into approval of the protected transaction or even preclude the shareholder vote altogether.[25] Severe break-up fees, for example, can render a rejection of a transaction by the shareholders economically and financially unreasonable.[26] Also, lock-ups vesting the buying corporation

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[21]The question of what purpose a corporation serves has been long debated, remains largely unresolved, and any tentative answer is likely to be subject of change due to altering ideologies and efficiency concerns. *See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 281 (1992). Due to last decade's globalization of capital markets and their competition for capital, however, a trend from the stakeholder value or entity conception towards the shareholder value or property conception evolved. *See* Harvey J. Goldschmid, *Outline on the Duty of Care and the Business Judgment Rule*, 1994 A.L.I.'S PRINCIPLES OF CORPORATE GOVERNANCE, Part II., § 2.01.

[22]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, 2.

[23]It should be noted, however, that competing bidders can always circumvent no-shop and no-talk clauses by making a tender offer. In that sense those covenants might be less dangerous than other deal protection devices. *See* Bainbridge, *supra* note 13, at 249.

[24]This motivation may very well be based on a rational business decision, e.g., in the case of an expensive break-up fee. That does not change, however, that the "naked" transaction was not the most favorable in the first place—or at least that it is no longer.

[25]The requirement of shareholder approval for mergers is provided by § 251(c) of the Delaware General Corporation Law. *See* DEL. CODE ANN. tit. 8, § 251(c) (2003). For sales of "all or substantially all" of the corporation's assets it is prescribed in § 271(a) of the Delaware General Corporation Law. *See* DEL. CODE ANN. tit. 8, § 271(a) (2003). It should be pointed out, however, that shareholder approval is not generally imperative in corporate transactions. In triangular mergers, i.e., where the parent corporation drops a subsidiary and then merges the target into the subsidiary (forward triangular mergers) or the subsidiary into the target (reverse triangular mergers), shareholder votes are dispensable. "[S]hareholders who seek voting . . . rights under a de facto merger theory have lost when they have taken the matter to court." DALE A. OESTERLE, THE LAW OF MERGERS AND ACQUISITIONS 57 (1999).

[26]With such a termination fee in place, stockholders know that if they do not approve of the negotiated transaction, their company will have to pay the jilted merger partner a sum of money. If the same stockholders approve the transaction, their corporation will not pay any fee. The termination fee inherently coerces the stockholder vote because it provides a financial

with an option to buy or vote large amounts of target stock may factually preclude a shareholder vote. Because, however, no-shop clauses only hinder a corporation from soliciting and negotiating competing offers, but do not entail disadvantageous consequences to a terminated deal or otherwise affect or prevent a shareholder vote, they do not fall within this category.

Moreover, corporate transactions often lead to a conflict of interests between shareholders and directors.[27] Shareholders are primarily interested in the profitability of the transaction.[28] On the other hand, directors often fear losing their position, strive for more influence, or strive for better compensation.[29] Thus, directors might be tempted to agree to and protect a deal for their personal benefit and to the detriment of their shareholders' interests. Furthermore, there is a potential threat of directors conceding to deal protection devices in return for attractive employment contracts.[30]

In sum, deal protection devices—and no-shop clauses as such—are delicate and raise various concerns regarding to fiduciary duties. The question of their permissibility is intriguing and—because largely unresolved—worth examining and discussing.

II. THE PERMISSIBILITY OF NO-SHOP CLAUSES

The law on no-shop clauses is still evolving. Although Delaware courts have recently begun to pay increased attention to the subject and addressed it in several cases, strong and clear precedent is still lacking. Instead, the law is confusing, inconsistent at first blush, and highly fact specific. In the following sections, an attempt will be made to discover a red thread in the Delaware case law on no-shop clauses and to suggest and provide clear and predictable rules for them.

The permissibility of no-shop clauses depends largely upon the standard of review applied to them. It is worth while to remind oneself of the standards of review encountered in corporate law and their underlying rationales before digging into the complex subject of the permissibility of no-shop covenants.

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incentive to vote in favor of the negotiated transaction—the larger the termination fee, the more coercive it is. It is because of this concern for coercing the vote that the law allows for reasonable termination fees, but not excessive ones. *See* Lebovitch & Morrison, *supra* note 22, at 14.

[27]Bainbridge, *supra* note 13, at 272.

[28]*Id.* at 273.

[29]*Id.*

[30]*Id.* at 273-74.

A. *Standards of Review in Corporate Law*

In corporate law, just like in many other fields of law, courts apply various standards of review. Contingent upon the circumstances, they range from a rather deferential standard of review of directors' decisions via intermediate standards to a standard of strict scrutiny, which is difficult and burdensome to meet.[31]

1. The Business Judgment Rule

Most ordinary business decisions made by a disinterested board of directors are subject to review under the deferential business judgment rule.[32] According to the business judgment rule, directors' decisions are presumed to have been made on "an informed basis . . ., in good faith and in the honest belief that the action taken was in the best interest of the company."[33] To overcome this presumption, a plaintiff must demonstrate that the directors acted with gross negligence, e.g., because they failed to inform themselves prior to making a business decision.[34] This allocation of the burden of proof is generally "outcome determinative."[35] It essentially "shelters directors from liability for decisions that prove in hindsight to have been ill-advised or simply unlucky."[36]

The underlying rationale of the business judgment rule is to protect directors from "substantive second guessing by ill-equipped judges or juries, which would, in the long run, be injurious to investor interests."[37] Business decisions inherently entail risks and uncertainty, and it is neither from an individual investor's nor from a social perspective desirable to

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[31]This system of differing standards of review is not specific to corporate law, but criss-crosses American law. For instance, its application in the context of equal protection under constitutional law immediately comes to mind.

[32]Varallo & Raju, *supra* note 2, at 1627.

[33]Cede & Co. v. Technicolor, Inc. (*Technicolor II*), 634 A.2d 345, 360-61 (Del. 1993); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See also* LIPTON & STEINBERGER, *supra* note 8, § 5A.01[1] (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987)).

[34]Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (denying directors protection under the business judgment rule for failure to gather and consider all available and relevant information—among those an investment banker's fairness opinion—*before* approving a merger); *Aronson*, 473 A.2d at 812 (providing that directors have a duty to inform themselves under the business judgment rule and that director liability rests on the concept of gross negligence); LIPTON & STEINBERGER, *supra* note 8, § 5A.01[1][a][i].

[35]*See* 1 DENNIS L. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 19 (5th ed. 1998).

[36]WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 150 (7th ed. 2000).

[37]*In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

discourage directors from engaging in reasonably risky and uncertain ventures that have potential for great profit.[38] In other words, the business judgment rule encourages calculated risk taking and entrepreneurial activity.[39]

2. The Entire Fairness Test

The counterpart to the business judgment rule is embodied in the entire fairness test which is triggered when the majority of the directors[40] approving a transaction appears on both sides of the transaction, and thus is affected by a conflict of interests.[41] In *Weinberger v. UOP, Inc.*, Justice Moran provided that:

> [t]he concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, . . . and how the approvals of the . . . stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], 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.[42]

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[38]*See* BLOCK, *supra* note 35, at 21-22. With respect to the individual investor, this argument is especially valid on the basis of the portfolio theory according to which investors hold well diversified portfolios and thereby "reduce the risks associated with holding only a single security." *See* LAWRENCE E. MITCHELL ET AL, CORPORATE FINANCE AND GOVERNANCE 240 (2d ed. 1996). From a social perspective, the main concern is that risk averse directors might hamper economic progress.

[39]Frederick H. Alexander, *Reining in Good Intentions: Common Law Protections of Voting Rights*, 26 DEL. J. CORP. L. 897, 899, & 901 (2001); 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, 977 (2001).

[40]The entire fairness test also finds application where majority shareholders conceivably enriched themselves at the expense of minority shareholders. *See, e.g.*, Gabelli & Co. v. Liggett Group, Inc., 444 A.2d 261 (Del. Ch. 1982), *aff'd*, 479 A.2d 276 (Del.1984). The most common instance for such a transaction is a cash out merger. That is a cash merger following an acquisition of control of a target with the purpose of eliminating the minority shareholders.

[41]LIPTON & STEINBERGER, *supra* note 8, § 5A.01. The classic example of transactions exposing directors to the entire fairness test are management buyouts.

[42]Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). *See also* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1140 (Del. Ch. 1994) (*Technicolor*), *aff'd*, 663 A.2d 1156 (Del. 1995) ("Thus in assessing overall fairness (or entire fairness) . . . the court must consider the process itself that the board followed, the quality of the result achieved and the quality of the disclosure made to the shareholders to allow them to exercise such choice as the circumstances could provide.").

Procedurally the plaintiff must plausibly allege procedural or substantive unfairness of the transaction.[43] Once that is accomplished, the burden shifts, which requires the defendants to show that the transaction was entirely fair.[44]

The policy reason for the enhanced scrutiny under the entire fairness test is almost evident and does not need much explanation. Interested directors pose a moral hazard and thus endanger shareholders' interests extraordinarily. Basically, interested directors ought to abstain from voting and appoint an independent committee. If they keep pulling the threads, however, shareholders' interests are protected by the entire fairness analysis.

3. Intermediate Standards of Scrutiny

Challenged directorial conduct which was arguably influenced by an entrenchment motive is reviewed under intermediate standards of scrutiny.[45] These standards constitute threshold inquiries to directorial conduct before the business judgment rule is applied. The two prominent and recurrently contested director decisions in this context are the adoption of anti-takeover defensive measures and approval of a sale of control transaction. The former must pass the *Unocal* test[46] and the latter must be reached in compliance with the *Revlon* duties.[47]

a. *The* Unocal *Test*

Whether facing or obviating a hostile takeover, directors often adopt defensive measures.[48] Because hostile takeovers almost certainly entail the dismissal of the incumbent board of directors,[49] target directors have a strong personal incentive to frustrate actual and discourage potential insurgents. Recognizing this, the two-pronged *Unocal* test requires

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[43] *Weinberger*, 457 A.2d at 703.

[44] *Id.*

[45] William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1293 (2001).

[46] The *Unocal* test is named after the Delaware Supreme Court's decision in *Unocal Corp. v. Mesa Petroleum Co.* *See* Unocal Corp. v. Mesa Petroleum Co. 493 A.2d 946 (Del. 1985).

[47] The *Revlon* duties derive their name from the Delaware Supreme Court case *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. (*Revlon*), 506 A.2d 173 (Del. 1986).

[48] The most common being shareholder rights plans, which are also commonly referred to as poison pills.

[49] Bainbridge, *supra* note 13, at 272-73.

directors to show both that they "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" (the reasonableness test) and that the adopted defensive measures were "reasonable in relation to the threat posed" (the proportionality test), before they are accorded the protection of the business judgment rule.[50] Applying the *Unocal* test, Delaware courts consider various factors such as the offered price, the feasibility of the transaction, the financing for the offer, and directors' showing of good faith and reasonable investigation.[51] Since *Unitrin, Inc. v. American General Corp.*,[52] however, only defensive measures that either preclude or coerce a shareholder vote are considered disproportional.[53] Thus, *Unitrin* severely diluted the enhanced scrutiny proposed in *Unocal*.[54]

From a policy perspective, the reason for the substitution of the business judgment rule by the *Unocal* test is twofold. First, there is a desire to shelter shareholders from directorial conduct primarily motivated by entrenchment purposes.[55] Second, a vivid takeover market and the permanent pressure to perform enhance corporate governance and economic efficiency.

b. *The* Revlon *Duties*

Transactions involving a change of control of the corporation trigger the *Revlon* duties. Under the *Revlon* duties, once the directors have decided to sell control of a corporation, their role changes "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[56] With this crude rule being promulgated in *Revlon*, questions arose concerning the criteria of a change in control transaction or the steps that directors are obliged to undertake to

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[50]Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1377 (Del. 1995); *Unocal*, 493 A.2d at 955.

[51]*See supra* note 50.

[52]651 A.2d 1361 (Del. 1995).

[53]*Id.* at 1387-88. "If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness'". *Id. See also* LIPTON & STEINBERGER, *supra* note 8, § 5A.01[2][b] (analyzing the *Unitrin* court applying enhanced scrutiny).

[54]*Unitrin*, 651 A.2d at 1387-88.

[55]*Unocal*, 493 A.2d at 954. "Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.*

[56]*Revlon*, 506 A.2d at 182.

"maximize current share value."[57] These concerns awaited to be resolved by future cases.[58]

It took several years until the landmark decisions of *Paramount Communications, Inc. v. Time, Inc.*[59] and *Paramount Communications, Inc. v. QVC Network, Inc.*[60] shed light upon the change of control trigger. Applying the *Revlon* duties' rationale—the loss of a further opportunity to participate in a change of control premium[61]—it is understood that while a cash sale necessarily results in a change in control,[62] this conclusion cannot be frivolously drawn for a stock-for-stock merger between two publicly held corporations. Most stock-for-stock transactions simply shift control of the target from one group of public shareholders to another such group.[63] Thus, neither the pre-merger target had nor will the resulting entity have a controlling shareholder who could sell his block of shares, thereby pocketing the control premium. Casually put, nothing is gained and nothing lost. Recognizing this, both *Time* and *QVC* hold that typical stock-for-stock transactions where no one stockholder controls the post-merger voting power do not constitute a sale of control.[64] Therefore, such transactions are not subject to review upon compliance with the *Revlon* duties, but subject to review under the business judgment rule.[65] Only in

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[57]Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1055 (Del. Ch. 1997).

[58]*See id.* at 1054. "[T]his broad generalization masks more questions than it answers. In fact the meaning of *Revlon*—specifically, when its special duties were triggered, and what those duties specifically required—were questions that repeatedly troubled the bench and the bar in the turbulent wake of the *Revlon* decision." *Id.*

[59]Paramount Communications, Inc. v. Time, Inc. (*In re* Time, Inc. S'holder Litig.), 571 A.2d 1140 (Del. 1990) (*Time*).

[60]Paramount Communications, Inc. v. QVC Network, Inc. (*In re* Paramount Communications, Inc. S'holders' Litig.), 637 A.2d 34 (Del. 1994) (*QVC*).

[61]*See id.* at 43. Note also that if a corporation does not have a controlling shareholder or group of shareholders, any acquirer seeking control of the corporation must address all shareholders equally. Thus, all shareholders benefit alike from the acquirer's willingness to pay a premium in order to gain control. KLEIN & COFFEE, *supra* note 36, at 169.

[62]LIPTON & STEINBERGER, *supra* note 8, § 5A.02. Note that the target's shareholders will be cashed out in a cash sale and thus will not have a continuing interest in the resulting entity.

[63]LIPTON & STEINBERGER, *supra* note 8, § 5A.01[2][a].

[64]*QVC*, 637 A.2d at 43; *Time*, 571 A.2d at 1151.

[65]Accordingly, the *Time* court held that the Time board's decision to commence and defend a friendly and strategic transaction with Warner Communications and to reject a hostile bid offering a higher immediate price by Paramount in order to preserve the "Time Culture" and on the belief that the combination with Warner offered the better long term value, did not implicate *Revlon* duties. Instead, it reviewed the initial decision to merge with Warner under the business judgment rule. *Time*, 571 A.2d at 1142, 1151, 1154. The defense of the deal, on the other hand, was subject to the *Unocal* test which it passed on the grounds of the directors having made a *bona fide* and informed decision. *Id.* at 1142, 1154-55.

the exceptional case that renders the surviving corporation with a controlling shareholder do the *Revlon* duties kick in.[66]

The characteristics of a sale of control transaction established thus far reveal that the issue is not yet fully resolved. For example, how are transactions to be categorized where the selling corporation's shareholders receive a mixed consideration consisting of both cash and stock?[67] Also, what is the standard of review for transactions which factually, but not mathematically, constitute a sale of control?[68]

Regarding the special obligations a sale of control imposes upon directors, *Revlon* simply instructed that directors must seek "the highest price for the benefit of the stockholders."[69] Further development of this direction, however, was left to following cases.

Revlon had already indicated and *QVC* confirmed and finally resolved that, "[w]hen assessing the value of non-cash consideration," a board under *Revlon* duties may not be guided by long-term strategic concerns, but "should focus on its [the consideration's] value as of the date it will be received by the stockholders."[70] Here lies the fundamental

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[66]In *QVC*, "the resulting entity would have [had] a single stockholder with approximately 70% of the combined voting power." LIPTON & STEINBERGER, *supra* note 8, § 5A.01[2][a], at 5A-13.

[67]Lipton and Steinberger have found that:

> [t]he Delaware Chancery Court has declined to apply the *Revlon* obligations in the context of a cash tender offer for 33% of the shares of Santa Fe Pacific to be followed by a stock-for-stock merger with Burlington Northern. However, the Delaware Chancery Court indicated in dicta that *Revlon* duties may apply in the context of a merger in which over 30% of the consideration was the acquirer's stock and the remainder was cash.

LIPTON & STEINBERGER, § 5A.01[2][a], at 5A.16 (footnotes omitted) (basing their analysis on *In re* Santa Fe Pacific Corp., No. 13,587, 1995 Del. Ch. LEXIS 70 (Del. Ch. May 31, 1995), *reprinted in* 20 DEL. J. CORP. L. 1104 (1995), and on *In re* Lukens S'holder Litig., 757 A.2d 720, 732 n.25 (Del. Ch. 1999), *aff'd sub nom.* Walker v. Lukens, Inc., 757 A.2d 1278 (Del. 2000)). *See also Equity-Linked Investors*, 705 A.2d at 1055 ("How this 'change in control' trigger works in instances of mixed cash and stock and other paper, awaits future cases.").

[68]Except for an ease of application it is hard to find any doctrinal justification for a more lenient review of transactions that are economically indistinguishable from a mathematical sale of control transactions. The acknowledgement of "de facto" sale of control transactions, however, would, of course, implicate the question of where to draw the line. Because any invariable percentage is bound to be as random as the purely mathematical approach, courts would have to engage in a cumbersome investigation and evaluation of each case's facts. For reasons of feasibility and predictability, courts might therefore be well advised to hold onto the easily applicable mathematical categorization. *See generally* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 928-29 (2001).

[69]*Revlon*, 506 A.2d at 182.

[70]*QVC*, 637 A.2d at 44 n.14. *See also Equity-Linked Investors*, 705 A.2d at 1055 ("[T]he gist of the *Revlon* state . . . [is] to act reasonably to maximize current, not some future, value.").

difference between a sale of control and a non-control transaction. Whereas strategic considerations are permissible under the business judgment rule in non-control transactions,[71] they "are irrelevant" in sale of control transactions "where the future strategy and synergies essentially will be out of the seller's stockholders' control and will reside principally in one individual or affiliated stockholder group."[72]

Pertaining to "the methods by which a board can fulfill its obligation to seek the best value reasonably available to the stockholders,"[73] Delaware courts have suggested the conduct of an auction or a canvas of the market.[74] At the same time, however, the courts have made clear that "there is no single blueprint that a board must follow to fulfill its duties."[75] Thus, while usually appropriate and advisable, there is no general duty to hold an auction or otherwise "shop" the company.[76] To the contrary, decisions regarding how to sell control of a company are protected by the business judgment rule.[77] Therefore, directors have considerable leeway when

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[71]Non-control transactions are commonly referred to as strategic transactions.

[72]LIPTON & STEINBERGER, *supra* note 8, § 5A.01[2][a], at 5A-14. *See also Equity-Linked Investors*, 705 A.2d at 1055 (providing that when the shareholder's future is unsure, the board has a duty to make an informed judgment in good faith to maximize shareholder value).

[73]*QVC*, 637 A.2d at 44.

[74]*See, e.g.*, Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-87 (Del. 1989) (finding that when multiple bidders are competing for control, fairness requires the auction process, but when there is a single offer, "fairness demands a canvas of the market to determine if higher bids may be elicited").

[75]*Id.* at 1286. *See also QVC*, 637 A.2d at 44 (quoting *Barkan*, 567 A.2d at 1286).

[76]*See Barkan*, 567 A.2d at 1287. "When, however, the directors possess a body of reliable evidence with which to evaluate . . . a transaction, they may approve that transaction without conducting an active survey of the market. As the Chancellor recognized, the circumstances in which this passive approach is acceptable are limited." *Id.*

[77]*QVC*, 637 A.2d at 45. Chief Justice Veasey made the following statement in his opinion:

> Although an enhanced scrutiny test involves a review of the reasonableness of the substantive merits of a board's actions, a court should not ignore the complexity of the directors' task in a sale of control. There are many business and financial considerations implicated in investigating and selecting the best value reasonable available. The board of directors is the corporate decisionmaking body best equipped to make these judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made a **reasonable** decision, not a **perfect** decision. If a board selected one of several **reasonable** alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

Id. See also Mills Acquisition Co. v. Macmillan, Inc., 559 A2d 1261, 1279 (Del. 1989) (providing that the focus must be on the "'fairness' of the auction process in light of promoting the maximum shareholder value as mandated by this Court in *Revlon*").

choosing a strategy to attain the best value for shareholders. Under the business judgment rule, however, it is vital that the directors reach their decision on an informed basis.[78] Thus, a board conducting a sale of control must be conscious of all available methods to sell the company and each method's respective advantages and risks.

B. *Appropriate Standard of Review for No-shop Clauses*

Having revisited the available standards of review in corporate law, it is finally time to turn to the question of what framework of judicial review for no-shop covenants is most appropriate in terms of fairness, predictability and accordance with established Delaware corporate law.

1. The *Unocal/Unitrin* Standard

It has been argued that the *Unocal/Unitrin* standard of review was generally the most suitable for deal protection devices and thus no-shop clauses.[79] The fundamental proposition to this approach is that deal protection devices are inherently defensive in nature and therefore deserve to be treated like defensive measures.[80]

There is substantial judicial support for the proposition that deal protection devices are defensive.[81] The *Time* court recognized the defensive component of deal protection devices and accordingly applied the *Unocal* standard to them.[82] More recently, Delaware courts have endorsed and confirmed this view. For example, in *ACE Ltd. v. Capital Re Corp.*, Vice Chancellor Strine—addressing a no-talk provision—wrote: "When corporate boards assent to provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the policy concerns that animate the *Unocal* standard of review might be implicated."[83] Also in *McMillan v. Intercargo Corp.*, the Vice Chancellor elaborated on this opinion and provided some further doctrinal reasoning by stating:

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[78] *Barkan*, 567 A.2d at 1287; LIPTON & STEINBERGER, *supra* note 8, § 5A.02[1][c], at 5A-32.

[79] *See* Lebovitch & Morrison, *supra* note 22, at 15.

[80] *See* Lebovitch & Morrison, *supra* note 22, at 10-11; Varallo & Raju, *supra* note 2, at 1630.

[81] *See supra* note 80.

[82] *Time*, 571 A.2d at 1151. "[A]s the Chancellor stated, such devices are properly subject to a *Unocal* analysis." *Id.*

[83] ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 108 (Del. Ch. 1999).

> The word "protect" bears a close relationship to the word "from." Provisions of this obviously defensive nature (e.g., no-shops, no-talks, termination fees triggered by the consummation of an alternative transaction, and stock options with the primary purpose of destroying pooling treatment for other bidders) primarily "protect" the deal and the parties thereto *from* the possibility that a rival transaction will displace the deal.[84]

For the sake of completeness, it should be noted that the defensive character of deal protection devices is not contingent upon the emergence of a rival bidder. Even in the absence of an acute threat, deal protection is necessarily defensive. As Lebovitch and Morrison correctly point out:

> [W]hy would two companies agree to Deal Protections at all if they did not believe that the merger needed to be protected from future threats? The very existence of Deal Protection in merger agreements where a third-party hostile bidder has yet to come forward proves the defensive nature of these devices.[85]

Acknowledging that deal protection devices are inherently defensive, the logical next step is to submit them to the *Unocal/Unitrin* test.[86] Accordingly, deal protection devices must be a proportionate response to a threat to the corporation. Notwithstanding the perceived familiarity with the *Unocal/Unitrin* analysis, a closer examination of the consequences of its application to deal protection devices, especially regarding no-shop provisions, is warranted.

The application of the *Unocal* test to break-up fees, lock-ups and stock options, is not more problematic than its application to classic defensive measures, much like a poison pill plan. For instance, a break-up fee must be proportional to the posed or anticipated threat to the corporation. Therefore, its permissible size depends upon the circumstances and the posed danger. Following *Unitrin*, a break-up fee will be upheld by Delaware courts unless it is draconian because it coerces or precludes the shareholder vote.[87] This determination is ultimately left to

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[84]McMillan v. Intercargo Corp., 768 A.2d 492, 506 n.62 (Del. Ch. 2000).

[85]Lebovitch & Morrison, *supra* note 22, at 28-29.

[86]*See* McMillan, 768 A.2d at 506 n.62; *ACE Ltd.*, 747 A.2d at 108 (stating somewhat cautiously that "the *Unocal* standard of review might be implicated"); *Time*, 571 A.2d at 1151.

[87]*See supra* Part II.A.3.a.; *Unitrin*, 651 A.2d at 1387-88.

the evaluation of the courts.[88]

With respect to no-shop clauses the sheer *Unocal* analysis works similarly. The provision must meet the proportionality requirement, and the degree of their permissibility varies with the facts of the case and the perceived threat. Generally, less restrictive no-shop provisions are more likely to be considered proportional and to withstand the *Unocal* test than ones that severely limit the board's ability to adjust its conduct to an altered environment. If one ranked no-shop clauses by their permissibility under *Unocal*, provisions with fiduciary out clauses would come first, which require a conceivable mild threat. The second would be plain no-shop clauses,[89] which require a moderate threat. No-talk provisions would come last, being solely permissible as ultimate responses to a severe threat to the corporation.

As soon as *Unitrin*'s proportionality test comes into play, however, the proposition to submit no-talk clauses to the *Unocal/Unitrin* analysis reveals its Achilles heel and becomes flawed. Under *Unitrin*, defensive measures are solely disproportionate if they are draconian because they coerce or preclude the shareholder vote.[90] No-shop clauses of any kind do not have this effect. No-shop clauses limit the board's ability to actively solicit or favorably respond to competitive bids, but they neither influence nor prevent a shareholder vote. The shareholders remain free to accept or reject the proposed deal. Therefore, no-shop clauses are inherently never preclusive or coercive. Following *Unitrin*'s proportionality definition, courts must uphold no-shop and no-talk clauses under any circumstances. This result, however, is neither consistent with Delaware case law on no-shop provisions[91] nor is it intended or supported by the proponents of the

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[88]*See supra* Part I.B.1. Delaware courts empirically have upheld break-up fees not exceeding three to four percent of the value of the transaction.

[89]Note that plain no-shop clauses have barely any defensive effect. Most of all, if the initial offer was a public one, a plain no-shop covenant will not deter any hostile bidder from coming forward.

[90]*See supra* Part II.A.3.a.; *Unitrin*, 651 A.2d at 1387-88.

[91]A number of Delaware decisions, both in the sale of control and non-sale of control context, either invalidated or expressed their scepticism as to the permissibility and validity of no-shop provisions. *See, e.g.*, *QVC*, 637 A.2d 34, 51 (Del. 1994) (holding that "[t]he no-shop provision could not validly define or limit the fiduciary duties of the . . . directors"); ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 114 (Del. Ch. 1999) (stating that "the Delaware law . . . has given primacy to the interests of stockholders . . . without improper compulsion from executory contracts entered into by boards"); Phelps Dodge Corp. v. Cyprus Amax Minerals Co., No. 17,398, 1999 Del. Ch. LEXIS 202, at 83 (Del. Ch. Sept. 27, 1999) ("No-talk provisions . . . are troubling . . . because they prevent a board from meeting its duty [of care] to make an informed judgment . . . ."). More importantly, Delaware courts self-evidently discern and discuss the permissibility of no-shop clauses on a regular basis. This is a vain occupation if no-shop clauses were permissible per se.

Unocal approach.

Proponents of the *Unocal* approach and other authors toying with or evaluating it concur insofar as they acknowledge the deficiency of an application of the *Unocal* analysis that renders even the most severe no-shop clause permissible under any circumstances. Being caught in the dilemma of *Unitrin*'s proportionality test which inevitably produces this erroneous result, they twist and turn *Unitrin*'s criteria of preclusion and coercion until they attain the desired results. Consequentially, undue no-shop provisions are labeled preclusive.[92] The underlying train of thought to this analysis is provided by Lebovitch and Morrison, who claim that

> a preclusive Deal Protection may tend to prevent stockholders from considering a particular transaction. For example, when a board adopts a no-talk provision, it prevents itself from communicating with other potential bidders for the company. In doing so, the board makes it less likely that alternative bidders will come forward, thereby reducing the possibility that the stockholders will have alternative deals on which to vote. Depending upon the facts of the case, that Deal Protection may be struck as overly preclusive.[93]

While proving sensitive to unsustainable and inadequate judicial outcomes, the fundamental presumption of this analysis is flawed. A deal protection device is not simply preclusive because it reduces the likelihood that stockholders will have alternative deals to vote on.[94] *Unitrin*'s preclusion

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[92]*See ACE Ltd.*, 747 A.2d at 108. Vice Chancellor Strine held that if a no-shop clause:

> is read as precluding board consideration of alternative offers—no matter how much more favorable—in this non change of control context, the Capital Re board's approval of the Merger Agreement is as formidable a barrier to another offer as a non-redeemable poison pill. Absent an escape clause, the Merger Agreement guarantees the success of the merger vote and precludes any other alternative, no matter how much more lucrative to the Capital Re shareholders and no matter whether the Capital Re board itself prefers the other alternative. As a practical matter, it might therefore be possible to construct a *plausible* argument that a no-escape merger agreement that locks up the necessary votes constitutes an unreasonable preclusive and coercive defensive obstacle within the meaning of *Unocal*.

Id. See also Lebovitch & Morrison, *supra* note 22, at 45 (stating that preclusive and coercive deal protections tend to prevent shareholders from considering them to vote for a particular transaction); Varallo & Raju, *supra* note 2, at 1633 ("A perfect example of such a 'draconian' deal protection measure is a no-talk provision with no fiduciary out. Such a provision would likely be found to be preclusive under *Unocal/Unitrin*.").

[93]Lebovitch & Morrison, *supra* note 22, at 45.

[94]*Id.*

criteria addresses the shareholder's right to reject the protected deal and to alternatively accept a hostile offer. It is incorrectly invoked, however, in relation to votes on any other potential friendly deal that might be whirling through the corporate landscape. Such a broad construction of *Unitrin*'s preclusion criteria is not only unwarranted by *Unitrin*, but also inconsistent with established principles of Delaware corporate law.

In *Unitrin*, the Delaware Court of Chancery held that a stock buyback increasing *Unitrin*'s board's stock ownership from twenty-three percent to twenty-eight percent was a preclusive response to a hostile takeover because it chilled a proxy contest. The underlying consideration to this decision was that a board voting twenty-eight percent of the outstanding shares factually controls any shareholder vote, poses an insurmountable obstacle for any hostile takeover, and deprives the other shareholders of their ownership rights to effectively determine their corporation's future. This scenario and rationale, however, differ considerably from the "preclusion" falsely attributed to no-shop clauses. No-shop provisions do not preclude hostile takeovers or curtail shareholders' ownership rights. To the contrary, shareholders remain in control. No-shop clauses neither impair shareholders to effectively vote on the protected transaction nor do they impair shareholders to vote with their feet by tendering their shares to any emerging hostile bidder at any time. Therefore, no-shop clauses are not preclusive under *Unitrin*. Sensing this, even the proponents of the *Unocal* approach admit that "[a] broad definition of preclusive and coercive makes the *Unocal* analysis look like it did prior to . . . *Unitrin*."[95] Thus, *Unocal*'s proponents confess that they are ignoring or at least unduly modifying *Unitrin*'s holding. As desirable as such a step might be, it is for the courts to decide.[96]

Furthermore, the suggested broad interpretation of *Unitrin*'s preclusion criteria cannot be reconciled with established principles of Delaware corporate law. If one labeled a reduced possibility that stockholders will have alternative deals on which to vote preclusive, the compelling flip-side of that conclusion would be that directors must solicit, pursue and submit to a shareholder vote any conceivable and available deal. Failure to do so would necessarily deprive the shareholders of an opportunity to vote on a transaction and therefore fall within the category of preclusion. This, however, would not only be contradictory to the board of directors' role as "decision-making body,"[97] but also inconsistent with the

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[95] *Id.* at 46-47.

[96] For a critical analysis and a modified application of *Unitrin*, see Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000).

[97] *QVC*, 637 A.2d at 45.

well established law that directors are authorized to just say no to a proposed strategic transaction.[98]

In conclusion, it should be noted that the *Unocal/Unitrin* standard applies to no-shop clauses because they are—just like any other deal protection device—defensive. Because no-shop clauses, as opposed to other deal protection devices, however, are neither coercive nor preclusive, they always satisfy the *Unocal/Unitrin* test.[99] Consequently, the *Unocal/Unitrin* analysis does not submit no-shop clauses to an enhanced scrutiny, but merely acts as an intermediary that automatically defers the matter to review under the business judgment rule. Simple put, the *Unocal/Unitrin* analysis cannot get a grip on no-shop clauses and, therefore, is an inappropriate standard of review for them. If, however, the Delaware courts should ever abandon *Unitrin*'s proportionality test and return to the undiluted *Unocal* analysis, this evaluation might well lose currency.

This analysis and evaluation of the *Unocal/Unitrin* approach is equally true for the recently suggested "Franchise approach."[100] The "Franchise approach" recognizes that "[d]raconian deal protection measures may have the effect of eliminating or drastically reducing the stockholders' free choice."[101] Concerned about this, the "Franchise approach" examines whether "deal protection measures are preclusive" and whether the stockholders retain their "right to vote yes or no [on a transaction] without being, in essence, compelled or coerced."[102] Thus, notwithstanding Alexander's emphasized and vehement distinction of his vote coercion standard from the *Unocal/Unitrin* approach,[103] the "Franchise approach" works exactly like the *Unocal/Unitrin* test and is therefore—with respect to no-shop clauses—subject to the same criticism.[104]

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[98]*Time*, 571 A.2d at 1152. *See also* LIPTON & STEINBERGER, *supra* note 8, § 5A.01[7].

[99]In this respect no-shop clauses are different from other deal protection devices, such as break-up fees.

[100]*See* Strine, *supra* note 68, at 941-42; Varallo & Raju, *supra* note 2, at 981-82. *See also* Alexander, *supra* note 39, at 907 (describing his approach as a non-fiduciary "vote coercion standard" of review).

[101]Alexander, *supra* note 39, at 902.

[102]Strine, *supra* note 68, at 942. *See also* Varallo & Raju, *supra* note 2, at 981.

[103]Alexander, *supra* note 39, at 906-07.

[104]Note that both Vice Chancellor Strine and Alexander avail themselves of *Unocal/Unitrin* language, such as "draconian," "preclusive," or "coercive." *See* Alexander, *supra* note 39, at 902; Strine, *supra* note 68, at 942.

2. The *Revlon* Standard

If a transaction involves a change of control of the target corporation, its directors must seek to maximize current shareholder value.[105] Grappling with this task, directors may perceive a necessity to concede to deal protection measures to fully comply with this obligation. The certainty provided by effective deal protection creates value that—if smartly negotiated—will be reflected in the acquisition price.[106] At the same time, however, deal protection in the Revlon zone raises the issues of improper employment and abuse discussed above.[107] In fact, the impediments deal protection constitutes for competitive and potentially higher bids are especially troublesome in the change of control context. An analysis of the application of the *Revlon* standard by Delaware courts to deal protection measures in general and no-shop clauses specifically reveals a trend from a rather stringent and confining treatment of deal protection devices in sale of control transactions toward a more benign and lenient approach to them.[108]

In *Revlon*, the court invalidated a lock-up option, a termination fee, and a "no-shop provision"[109] on the grounds that they were an undue attempt to foreclose further bidding and "part of the overall plan to thwart Pantry Pride's [the competing bidder's] efforts."[110] The court further stated that "[t]he no-shop provision, like the lock-up option, while not *per se* illegal, is impermissible . . . when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder."[111] In essence, the *Revlon* court declared deal protection in change of control transactions categorically impermissible.

Only three years later, Delaware courts started to take a more differentiated point of view on the matter. In *Barkan v. Amsted Industries,*

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[105]*See supra* Part II.A.3.b.

[106]*See* Alexander, *supra* note 39, at 904. "[T]he risk of being topped creates uncertainty, which detracts from value. Thus, a buyer who could buy two identical assets for the same price will prefer the transaction involving fewer contingencies." *Id.*

[107]*See id.*

[108]Unlike in the *Unocal/Unitrin* context, under the *Revlon* standard no-shop clauses do not deserve a distinct analysis from other deal protection devices, but can serve as a representative for any other deal protection measure.

[109]*Revlon*, 506 A.2d at 175. The "no-shop provision" stipulated "a promise by Revlon to deal exclusively with Forstmann [the buyer]." *Id.* Because the competing bidder, Pantry Pride, had already emerged and bid, the term "deal" must be construed to stand for "contract," if the clause is supposed to make any sense.

[110]*Id.* at 184.

[111]*Id.*

Inc.,[112] the Delaware Supreme Court approved of a no-shop restriction because the directors had valid reasons for believing that no rival bidder would be able to surpass the price offered and therefore they had good reason to believe that no alternative deal could give shareholders a better price.[113] In other words, the *Barkan* court held that the directors could conclude in good faith that they had approved the best possible deal for shareholders.[114] The facts giving rise to this holding were that an investment bank had opined that the transaction price was "'high in the range of fairness'"[115] that the target had been "in play" for ten months without one bidder having emerged to make an offer for control for it,[116] and that the transaction allowed the buyer "to receive significant tax advantages that could be reflected in the price offered to shareholders."[117] The *Barkan* court, however, was anxious to emphasize that it did not condone the imposition of no-shop restrictions in all instances. For example, it continued by explaining that "[w]here a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids" and that the crucial criteria was "that the board had sufficient knowledge of the relevant markets to form the basis for its belief that it acted in the best interests of the shareholders."[118]

Following *Barkan*'s analysis, the *QVC* court struck down a stock option agreement and a no-talk provision with a fiduciary out clause,[119] reasoning that the Paramount directors did not act on an informed basis, but were paralyzed by their uninformed belief that the QVC offer was illusory and that under those circumstances the stock option agreement and the no-

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[112]567 A.2d 1279 (Del. 1989).

[113]*Id.* at 1287-88.

[114]*Id.*

[115]*Id.* at 1283.

[116]*Barkan*, 567 A.2d at 1287.

[117]*Id.*

[118]*Id.* at 1288.

[119]*QVC*, 637 A.2d at 36-37. Chief Justice Veasey stated that:

> under the No-Shop Provision, the Paramount Board agreed that Paramount would not solicit, encourage, discuss, negotiate, or endorse any competing transaction unless: (a) a third party "makes an unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing"; and (b) the Paramount Board determines that discussions or negotiations with the third party are necessary for the Paramount Board to comply with its fiduciary duties.

Id. Under the definitions provided in *supra* Part I.A., the "no-shop provision" falls within the category of no-talk clauses with fiduciary outs.

talk clause "were impeding the realization of the best value reasonably available to the Paramount stockholders."[120]

In *Rand v. Western Airlines, Inc.*,[121] the court upheld a lock-up agreement and a no-talk clause without a fiduciary out which "stated that Western and its representatives could not 'initiate contact with, solicit, encourage, or participate in any way in discussions or negotiations with, or provide any information or assistance to, any third party . . . concerning any acquisition of [Western].'"[122] The court explained that "[b]ecause such provisions [the no-talk provision and the lock-up agreement] tend to foreclose further bidding, they must be carefully scrutinized" and that their "validity . . . turns on whether they assist the board in their 'obligation to seek the best value reasonably available' to the stockholders."[123] Regarding the facts presented in *Rand v. Western Airlines*, the court found that the lock-up and the no-talk provision had furthered the board's attempt to obtain the highest price for shareholders.[124] In its effort to sell the company, Western had contacted nine different airlines of which only Delta Airlines had shown any interest in discussing a possible acquisition. Thus, Western had "fully canvassed" the market.[125] Furthermore, Western had exchanged the lock-up agreement and the no-talk provision for a much less open ended, and therefore much more binding, material adverse change provision than the one Delta had initially insisted upon. So in a sense, a deal was exchanged for a deal. Most importantly, however, Western had shown that its board had satisfied its "duty to act on a fully informed basis."[126]

In other decisions addressing the employment of no-shop clauses in change of control transactions, Delaware courts have taken an even more benign view. For instance, in *In re Vitalink Communications Corp. Shareholders Litigation*,[127] the court upheld a plain no-shop clause which

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[120]*QVC*, 637 A.2d at 50. *QVC* is ambiguous, however, as it quotes both *Barkan*'s and *Revlon*'s clearly incompatible holdings on deal protection in change of control transactions. *See id.* at 49 n.20.

[121]No. 8632, 1994 Del. Ch. LEXIS 26 (Del. Ch. Feb. 25,, 1994), *reprinted in* 19 DEL. J. CORP. L. 1292 (1994), *aff'd*, 659 A.2d 228 (Del. 1995).

[122]*Id.* at *7, *reprinted in* 19 DEL. J. CORP. L. at 1298. The court referred to the clause as a no-shop provision. For purposes of this article, however, the provision is a no-talk clause without a fiduciary out. *See supra* Part I.A.

[123]*Rand*, 1994 Del. Ch. LEXIS 26, at *18, *reprinted in* 19 DEL. J. CORP. L. at 1303 (citing *QVC*, 637 A.2d at 47).

[124]*Id.*

[125]*Id.*

[126]*Id.* at *11, *reprinted in* 19 DEL. J. CORP. L. at 1300.

[127]No. 12,085, 1991 Del. Ch. LEXIS 195 (Del. Ch. Nov. 8, 1991), *reprinted in* 17 DEL. J. CORP. L. 1311 (1992).

was subject to a fiduciary out clause by stating that "these provisions do not, in themselves, prevent a company from canvassing the market" and that "the Lockup option and the No-shop clause were, at best, minimal impediments to an implicit market test."[128] In both *Matador Capital Management Corp. v. BRC Holdings, Inc.*[129] and *Golden Cycle, LLC v. Allan*,[130] the court discerned no-talk clauses with fiduciary out covenants and found that "[s]uch provisions do not preclude 'post-agreement market checks.'"[131] In *McMillan v. Intercargo Corp.*,[132] Vice Chancellor Strine described a plain no-shop clause as "rather standard" and continued by explaining that "[t]he presence of this type of provision in a merger agreement is hardly indicative of a *Revlon* . . . breach."[133] Recently, Vice Chancellor Strine held in *In re Pennaco Energy, Inc. Shareholders Litigation*,[134] that a company may concede to a break-up fee and a plain no-shop clause, notwithstanding that it had solely negotiated with one buyer.[135]

Although the foregoing cases, at first blush, do not reveal a clear and entirely consistent approach by Delaware courts to no-shop clauses in change of control transactions, they allow the inference of a few general principles that have evolved. First of all, even in change of control transactions, both plain no-shop and no-talk clauses are not impermissible per se.[136] As *Rand v. Western Airlines* clearly holds, however, the employment of no-shop and no-talk clauses must enhance the promotion of shareholder wealth in the sale process.[137] Whether the concession of no-shop clauses furthers the cause of eliciting the highest price for the stockholders is a question that must be resolved by the target's directors whose decision in that respect, under traditional *Revlon* doctrine, is subject

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[128] *Id.* at *19, *32, *reprinted in* 17 DEL. J. CORP. L. at 1326, 1332.

[129] 729 A.2d 280 (Del. Ch. 1998).

[130] No. 16,301, 1998 Del. Ch. LEXIS 237 (Del. Ch. Dec. 10, 1998), *reprinted in* 24 DEL. J. CORP. L. 688 (1999).

[131] *Matador Capital*, 729 A.2d at 291. *See also Golden Cycle*, 1998 Del. Ch. LEXIS 237, at *32, *reprinted in* 24 DEL. J. CORP. L. at 716 (citing Matador Capital Management Corp. v. BRC Holdings, Inc. 729 A.2d 280 (Del. Ch. 1998)).

[132] 768 A.2d 492 (Del. Ch. 2000).

[133] *Id.* at 506.

[134] 787 A.2d 691 (Del. Ch. 2001).

[135] *Id.* at 693, 705-06.

[136] *See* LIPTON & STEINBERGER, *supra* note 8, § 5A.03[3]; Bainbridge, *supra* note 13, at 301-02; Varallo & Raju, *supra* note 2, at 16-17. *But see* Kimberly J. Burgess, *Note: Gaining Perspective: Directors' Duties in the Context of "No-Shop" and "No-Talk" Provisions in Merger Agreements*, 2001 COLUM. BUS. L. REV. 431, 469-71 (2001) (finding no-talk clauses categorically impermissible).

[137] *Rand*, 1994 Del. Ch. LEXIS 26, at *11, *reprinted in* 19 DEL. J. CORP. L. at 1300.

to the business judgment rule.[138] Thus, courts rightfully focus upon the board's level of information. *Barkan*, *QVC*, and *Rand v. Western Airlines* especially reflect a direct correlation between a board's ability to show that it acted bona fide and on a fully informed basis and the court' reluctance to invalidate single covenants of often complexly negotiated acquisition agreements.[139]

Regarding the various forms of no-shop clauses, *Rand v. Western Airlines* clarifies that no-talk clauses without fiduciary outs, while principally permissible, are only warranted under extraordinary circumstances, such as the one and only deal in sight being at stake or a trade of the provision for equally incisive concessions from the other party to the transaction.[140] Furthermore, as *QVC* held specifically in the no-talk clause context, a board must actively canvass the market and thoroughly evaluate other existing or potential offers prior to agreeing to a no-talk clause. It is worth noting that the stringent requirements established for the employment of no-talk clauses by *Rand v. Western Airlines* and *QVC* are in line with the gist of recent decisions by Delaware courts pertaining to and questioning the permissibility of no-talk provisions in strategic transactions.[141] Although the courts in those cases evaluated the clauses in the more lenient non-change of control context, they grasped the opportunity to express their concern about the insertion of no-talk clauses in transaction agreements. This, of course, *a majore ad minus* will have to be considered when assessing the permissibility of no-talk clauses in the *Revlon* zone.

When discerning plain no-shop clauses, Delaware courts are far more generous. Notwithstanding the emphasis on the need for a fully informed board, plain no-shop clauses are usually upheld.[142] This is equally true for no-talk clauses with fiduciary outs[143] and, consequently, even more so for plain no-shop clauses with fiduciary outs. The underlying rationale for this policy is likely to be found in the board's retained ability to favorably respond to superior competing third party bids. The mere sacrifice of the right to actively solicit rival bids is apparently not considered grave. Thus,

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[138]*See Revlon*, Inc. 506 A.2d at 180, 184-85.

[139]The disruption of single covenants from complex transaction agreements, of course, implicates the risk of unbalancing the entire agreement.

[140]*See Rand*, 1994 Del. Ch. LEXIS 26, at *11, *reprinted in* 19 DEL. J. CORP. L. at 1300.

[141]*See* cases cited *supra* note 91.

[142]*See In re* Pennaco Energy, Inc. S'holder Litig., 787 A.2d 691, 693, 705-06 (Del. Ch. 2001); McMillan v. Intercargo Corp., 768 A.2d 492, 506. Ch. 2000).

[143]*See* Matador Capital Mgmt. Corp. v. BRC Holdings, Inc. 729 A.2d 280, 291 (Del. Ch. 1998); Golden Cycle, LLC v. Allan, No. 16,301, 1998 Del. Ch. LEXIS 237, at *51 (Del. Ch. Dec. 10, 1998), *reprinted in* 24 DEL. J. CORP. L. 688, 716 (1999).

the director's sole discretion is commonly deferred to without any further inquiry by the courts. As long as the protected deal is made public, and rival bidders have equal opportunities to enter and succeed in a bidding contest, this deferential review of plain no-shop clauses and no-talk clauses with fiduciary outs seems warranted and sensible.

It should be added that courts ascertaining no-shop clauses are confined in their analysis to information that was available to the directors at the time of the signing of the deal. Thus, in opposition to a few voices in the literature,[144] facts and information that are not available at that time, but arise between signing and closing, are not taken into consideration by the courts.[145] To do otherwise would implicate a judgment of business decisions with the benefit of hindsight. That concept would not only be unfair, but also contrary to corporate law doctrine.[146]

3. The Business Judgment Rule

The correct and remaining standard of review for no-shop clauses in strategic transactions is the business judgment rule, which can be described as the "default standard of review." As opposed to the *Revlon* duties, the business judgment rule does not require the board to maximize current share value, but permits the pursuit of long-term goals that promise to be beneficial to stockholder wealth in the future.[147]

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[144]*See e.g.*, R. Franklin Balotti & A. Gilchrist Sparks, III, *Deal Protection and the Merger Recommendation*, 96 NW. U. L. REV. 467, 486 (2002) (providing that "[a] restrictive no-shop clause becomes highly problematic and must be evaluated in light of post contracting events"); *see also* Burgess, *supra* note 136, at 463-64.

> [I]n the fiduciary duty of care context, a board of directors could argue that after an extensive pre-merger canvas of the market for alternative merger partners it is reasonable to tie its hands with a tight no-talk provision because it informed itself fully before committing to the provision. . . . [H]owever, the duty [of continued information] exists irrespective of prior efforts and cannot be contracted away no matter how "reasonable".

Id.

[145]*See* J Travis Laster, *Exposing a False Dichotomy: The Implications of the No-Talk Cases for the* Time/Revlon *Double Standard*, 3:2 DEL. L. REV. 179, 212-13, 217 (2000); Lebovitch & Morrison, *supra* note 22, at 5 (providing that "[a] provision that is a reasonable restriction on the board at the time it is adopted should not be struck at a later date simply because of changed circumstances or an unexpected bid"). *See also* Varallo & Raju, *supra* note 2, at 1636-38 (contending that "there is no logical basis for having an analysis of whether a board breached its fiduciary duties turn on subsequent events outside of the board's control").

[146]*See* the underlying rationale to the business judgment rule, *supra* Part II.A.1.

[147]*See supra* Part II.A.3.b. The milestone case in this context remains *Time*. With respect to deal protection devices, however, *Time*'s holding is only partially valid and appropriate under current law. As discussed above, the *Time* court acknowledged that deal protection measures are inherently defensive and accordingly subdued them to an *Unocal* analysis. *See supra* Part II.B.1.

Four recent decisions by the Delaware Court of Chancery pertaining to no-talk clauses in the strategic transaction context have attracted a lot of attention. It is warranted to discuss and evaluate them once more because they allow some inferences of what considerations motivate Delaware courts when discerning no-talk and plain no-shop clauses, and what the decisive facts are.

In *Phelps Dodge*,[148] the Phelps Dodge Corporation sought a preliminary injunction of a 6.3% termination fee and a no-talk clause without fiduciary outs inserted into a merger agreement between Cyprus Amex Minerals Co. and Asarco, Inc.[149] Finding that Phelps Dodge had not shown that irreparable harm would result if an injunction was not granted,[150] Chancellor Chandler denied the application for injunctive relief.[151] At the same time, however, he found that Phelps Dodge had established a "probability of success on the merits," and seized the opportunity to express his strong doubts as to the permissibility of both the termination fee and the no-shop clause.[152] With respect to the termination fee, Chancellor Chandler stated in dicta that he would not "take up plaintiffs' challenge to the termination fee as being unduly coercive [under *Unocal*], although I [Chancellor Chandler] think 6.3 percent certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point."[153] Concerning the adoption of the no-talk clause, Chancellor Chandler, in clearly business judgment rule language, expressed that Phelps Dodge's board may have breached its "duty of care; that is, the duty to take care to be informed of all material information reasonably available."[154] He elaborated on this view by stating that "[n]o-talk provisions . . .are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with

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In doing so the court did not and—not being bound by *Unitrin*'s coercion and preclusion criteria—was not required to distinguish between the "no-shop clause" and other deal protection devices. *Unitrin* currently being binding law, however, memos that *Time*'s uniform approach to all deal protection measures no longer works under contemporary judicial standards. *See supra* Part II.B.1.

[148]No. 17,398, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999).

[149]*Id.* at *4-*5.

[150]*Id.* at *5. The Phelps Dodge Corporation had desired to acquire either or both Cypress Amex Minerals and Arco. Vice Chancellor Chandler held that "Phelps' contention that it would walk away after a merger is consummated between Cyprus and Asarco is a self inflicted harm." *Id.*

[151]*Id.*

[152]*Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *4-*5.

[153]*Id.* at *5.

[154]*Id.* at *4-*5.

respect to even considering whether to negotiate with a third party."[155] Chancellor Chandler noted that Phelps Dodge board's adoption was "the legal equivalent of willful blindness."[156]

Two aspects about *Phelps Dodge* are particularly interesting and noteworthy. First, Chancellor Chandler appears to endorse and apply the differentiated review of deal protection devices suggested in this article. Commenting on the termination fee, he indicated that where applicable, *Unocal/Unitrin*'s coercion and preclusion criteria will be employed.[157] Reviewing the no-talk clause, however, the Chancellor quite self-evidently applied the business judgment rule.[158] Second, the Chancellor centers his evaluation of the no-talk clause on the business judgment rule's requirement of a fully informed board.[159]

In *ACE Ltd. v. Capital Re Corp.*, ACE Ltd. sought to temporarily enjoin Capital Re Corporation from terminating its deal with ACE Ltd. and alternatively merging with XL Capital Ltd.[160] It contended that Capital Re had been prohibited from negotiating with XL Capital by a no-talk clause that contained a fiduciary out requiring "the written advice of its [Capital Re's] outside legal counsel, that participating in such negotiations or discussions or furnishing such information is required in order to prevent the Board of Directors of the Company from breaching its fiduciary duties to its stockholders."[161] Before commencing negotiations with XL Capital, which topped ACE's offer by twenty-five percent, the Capital Re board had solely been advised in writing by counsel that "entering into discussions with XL Capital was 'consistent with [the board's] fiduciary duties.'"[162] Thus, ACE Ltd. asserted that the fiduciary out's conditions were not met and that Capital Re had breached its merger contract with ACE Ltd.[163] Vice Chancellor Strine, however, construed the fiduciary out differently and held that "[a]lthough perhaps not so clear as to preclude another interpretation, § 6.3 of the Agreement [the fiduciary out provision] is on its face better read as leaving the ultimate 'good faith' judgment about whether the board's fiduciary duties required it to enter discussions with XL Capital to the board itself" and that "[h]ere, the Capital Re board had good

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[155] *Id.* at *4.

[156] *Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *4.

[157] *Id.* at *5.

[158] *Id.* at *4-*5.

[159] *Id.*

[160] 747 A.2d 95 (Del. Ch. 1999).

[161] *Id.* at 98.

[162] *Id.* at 99.

[163] *Id.* at 100-01.

economic reason to believe that consummation of the merger in the face of the XL Capital offer was adverse to the interests of the Capital Re stockholders."[164] Therefore, Capital Re had not breached its merger agreement with ACE Ltd. To read the fiduciary out literally would involve "an abdication by the board of its duty to determine what its fiduciary obligations require at precisely that time in the life of the company when the board's own judgment is most important."[165] The Vice Chancellor concluded that such a reading of the fiduciary out would likely render the no-talk provision invalid.[166] The Vice Chancellor cynically added that "such a provision seems innocuous" anyway.[167] Vice Chancellor Strine then asked, "I mean, can't the board find someone willing to give the opinion?"[168]

Making some general comments concerning the permissibility of no-shop clauses, the Vice Chancellor stated that "one would think that there would be limited circumstances in which a board could prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction."[169] He acknowledged, however, that even a provision like the one in question might be permissible if the initially negotiated merger was not locked up by voting agreements—like in ACE Ltd.—but instead the shareholders remained free to accept and reject the merger and thus to choose between that merger, a subsequent merger, or no merger at all.[170] The Vice Chancellor pointed out that another "legitimate circumstance may be where a board has actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end."[171]

The broader question of what judicial review standard best accommodates no-talk clauses was only touched on by Vice Chancellor

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[164] *ACE Ltd.*, 747 A.2d at 103.

[165] *Id.* at 106 (quoting Vice Chancellor Strine).

[166] *Id.* at 109. Thus, in a sense, the Vice Chancellor's construction of the fiduciary out was the more favorable one to ACE Ltd. "Therefore, it is important that I [Vice Chancellor Strine] consider that ACE's interpretation of the contract and the facts may be the best one and determine whether the TRO should issue in that light. Looked at even in that way, however, ACE is not in any better position to obtain a TRO . . . ." *Id.* at 104.

[167] *Id.* at 106.

[168] *ACE Ltd.*, 747 A.2d at 106.

[169] *Id.* at 107.

[170] *Id.* at 110-11 n.55.

[171] *Id.* at 107 n.36.

Strine incidentally.[172] Not committing himself to one standard of review, Vice Chancellor Strine seemed to reach for the *Unocal/Unitrin* approach.[173]

In *In re IXC Communications, Inc. Shareholders Litigation*,[174] shareholders of IXC Communications challenged a no-talk clause with a fiduciary out inserted into a merger agreement between IXC Communications and Cincinnati Bell, Inc.[175] Almost six months before signing the deal with Cincinnati Bell, IXC Communications had publicly announced that it had retained Morgan Stanley Dean Witter to consider possible merger or sale options.[176] During that period of time, IXC Communications had numerous contacts with parties of varying degrees of interest.[177]

Building their case on the holding in *Phelps Dodge*, the plaintiffs asserted that IXC Communications' board of directors had breached its duty of care by agreeing to the no-talk clause.[178] Vice Chancellor Steele,[179] however, was not persuaded and rejected the plaintiffs' motion to preliminarily enjoin the pending shareholder vote on the proposed merger.[180] Applying the business judgment rule,[181] he stated that the plaintiffs had failed to "demonstrate that [the] IXC board inadequately informed itself about . . . potential suitors over the search for a strategic partner"[182] and that no-talk clauses "are common in merger agreements and do not imply some automatic breach of fiduciary duty."[183] He then continued by stating that "the assertion that the board 'willfully blinded' itself by approving the . . . 'no-talk' provision [was] unpersuasive . . . considering how late in the process this provision came" and that he was

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[172]The Vice Chancellor stated that "[i]n this necessarily hurried posture, it is impossible to examine in depth the appropriate doctrinal prism through which to evaluate the 'no-talk' provision in the Merger Agreement." *ACE Ltd.*, 747 A.2d at 108 (quoting Vice Chancellor Strine).

[173]*See id.* "When corporate boards assent to provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the policy concerns that animate the *Unocal* standard of review might be implicated." *Id.*

[174]Nos. 17,324 & 17,334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999).

[175]*Id.* at *2.

[176]*Id.* at *4, *7.

[177]*Id.* at *4-*5.

[178]*IXC Communications, Inc. S'holders Litig.*, 1999 Del. Ch. LEXIS 210, at *8.

[179]Vice Chancellor Steele is now a Justice of the Supreme Court of Delaware.

[180]*Id.* at *33-*34.

[181]*Id.* at *11-*13.

[182]*Id.* at *13.

[183]*IXC Communications, Inc. S'holders Litig.*, 1999 Del. Ch. LEXIS 210, at *17.

"comfortable concluding that the IXC board met its duty of care by informing itself over . . . nearly six months."[184]

In *State of Wisconsin Investment Board v. Bartlett* (*S.W.I.B.*),[185] Vice Chancellor Steele reiterated his view on no-talk clauses previously expressed in IXC Communications. In *S.W.I.B.*, the plaintiffs, shareholders of Medco Reseach, Inc., sought a preliminary enjoinment of a merger between Medco Research and King Pharmaceuticals, Inc.[186] Similar to the plaintiffs in *IXC Communications*, they alleged that the Medco Research board had acted with gross negligence and therefore violated its duty of care by agreeing to a "no-talk/no-shop provision."[187] Reviewing the case under the business judgment rule,[188] Vice Chancellor Steele found that "[t]he plaintiff's allegations do not demonstrate that the Medco board failed to inform itself of all material facts concerning the proposed merger with King."[189] Instead, the Vice Chancellor found that the board, with the help of an experienced investment bank, had "aggressively sought [other] suitors" and made an "effort to 'shop' the company" and to "canvass the market to seek a more economically viable business combination," before engaging in the merger with King Pharmaceuticals.[190] Therefore, the Vice Chancellor concluded "that the evidence equally supports the view that Medco's board proceeded with the King merger because its efforts had failed to find a viable combination with other suitors" and because "[t]he proposed merger with King . . . appeared to be a viable and preferable option to going it alone."[191] Hence, the Medco board had not breached its fiduciary duties. Regarding the no-talk clause the Vice Chancellor stated that, "in the absence of [a] breach of fiduciary duty . . . these provisions are reviewable as business judgments and are, thus, granted deference."[192]

The foregoing decisions have been attributed to be inconsistent in their approach to and evaluation of no-talk clauses. Indeed, at first glance, Vice Chancellor Steele in *IXC Communications* and *S.W.I.B.* appears to advocate a much more lenient and deferential review of no-talk clauses than Vice Chancellor Chandler in *Phelps Dodge* or Vice Chancellor Strine in

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[184] *Id.* at *16-*17.

[185] No. 17,727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000), *reprinted in* 26 DEL. J. CORP. L. 469 (2001).

[186] *Id.* at *1-*2, *reprinted in* 26 DEL. J. CORP. L. at 474.

[187] *Id.* at *6-*10, *reprinted in* 26 DEL. J. CORP. L. at 475-78.

[188] *Id.* at *10-*12, *reprinted in* 26 DEL. J. CORP. L. at 479-80.

[189] *S.W.I.B.*, 2000 Del. Ch. LEXIS 42, at *15, *reprinted in* 26 DEL. J. CORP. L. at 481.

[190] *Id.* at *16 , *reprinted in* 26 DEL. J. CORP. L. at 481.

[191] *Id.* at *17, *reprinted in* 26 DEL. J. CORP. L. at 482.

[192] *Id.* at *30, *reprinted in* 26 DEL. J. CORP. L. at 487.

ACE Ltd. A closer look at the decisions, however, reveals a far-reaching accordance of the opinions expressed therein.[193]

Notwithstanding the arguable insecurity and discrepancy pertaining to the correct and appropriate standard of review for no-shop clauses, all three judges in these decisions highlight the prerequisite of a fully informed board. Vice Chancellor Chandler expressed his concerns as to the boards "duty to make an informed judgment with respect to even considering whether to negotiate with a third party."[194] Vice Chancellor Strine conceded that no-talk clauses might be permissible "where a board has actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end."[195] Vice Chancellor Steele emphasized a board's fiduciary duty to "inform itself of all material facts concerning the proposed merger"[196] prior to agreeing to a no-talk clause. Thus, in all of the situations described above, the decisive factor was the board's level of information, a criteria that is typically associated with the business judgment rule.

C. *Summary and Conclusion*

The correct standard of judicial review for deal protection devices is contingent upon the nature of the transaction. If the transaction involves a change of control of the corporation, it will be reviewed under the *Revlon* standard and courts will scrutinize whether the board of directors conducted the sale of the company in compliance with its duties to maximize current shareholder value. On the other hand, if the transaction is a strategic one, deal protection devices are generally subject to the *Unocal/Unitrin* standard of review.[197] Because *Unitrin*'s coercion and preclusion criteria, however, are inherently insignificant when applied to no-shop clauses, those are better reviewed under the business judgment rule.

The, at first blush, stringent dichotomy between sale of control and strategic transactions becomes blurred when analyzed more closely and translated into praxis. The doctrinal explanation for this is twofold. On the one hand, even under the *Revlon* standard, directors are granted the shelter of the business judgment rule with respect to their choice of a strategy deemed to produce the best price for the company. On the other hand, the

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[193]Varallo & Raju, *supra* note 2, at 1627.

[194]*Phelps Dodge*, 1999 Del. Ch. LEXIS 202, at *4.

[195]*ACE Ltd.*, 747 A.2d at 107 n.36.

[196]*S.W.I.B.*, 2000 Del. Ch. LEXIS 42, at *15, *reprinted in* 26 DEL. J. CORP. L. at 481.

[197]*See supra* Part II.B.1.

business judgment rule does not relieve directors from seeking the transaction offering the best value to shareholders, but solely exempts them from limiting their evaluation of a deal to its current value to shareholders and, instead, permits them to pursue long-term and strategic goals that might not pay off immediately. The practical consequences of this blurred division are that directors in both sale of control and strategic transactions must act bona fide and fully inform themselves of all material facts pertaining to the merger. Thus, notwithstanding the exposure to different standards of review, prudent directorial conduct in both types of transactions will correspond.[198] This result might seem surprising, but is not shocking at all considering that the dividing line between sale of control and non-sale of control transactions in many respects can only be drawn somewhat randomly.

As to the permissibility of the various forms of no-shop clauses, three general observations can be made. First, the court's inclination and willingness to invalidate a no-shop clause increases with the provision's severity. Second, courts are reluctant to disturb carefully contemplated business decisions made on an informed basis. Thus, directors can compensate for a severe no-shop clause by demonstrating that they acted bona fide and took the requisite steps to thoroughly inform themselves prior to agreeing to the clause. Third, fiduciary outs may mitigate a provision's severity to a degree that does not attract the courts' heightened attention.

More specifically, the following rules seem to have evolved. No-talk provisions without fiduciary outs evoke the courts' suspicion and are merely permissible when indispensable to the board in its efforts to secure the best transaction for the shareholders. They require an exceptionally well informed board, and thus are generally only available after an active and extensive market check. Scenarios conceivably warranting no-talk clauses without fiduciary outs include their exchange for concessions to equally incisive provisions from the other party or an extraordinary high acquisition price that the board has a good and traceable reason to believe will not be topped. Plain no-shop provisions are reviewed much more leniently and deferentially. Although abstractly subject to the same principles as no-talk clauses, plain no-shop provisions require a far less compelling cause and factual showing. Courts apparently have accepted their common usage as a bargaining tool and will not have them cause the disruption of complex acquisition contracts. Finally, sincere and generous fiduciary outs

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[198] *See* Varallo & Raju, *supra* note 2, at 1636 ("Hence, it could be argued (and we do argue) that the most important and, we suggest, potentially outcome-determinative factor in these cases was *not* the standard of review used by the court, but instead the process followed by the board *before* the deal protections at issue had been approved.").

constitute a safe harbor for both no-talk and plain no-shop clauses. Besides partially defeating the purpose of no-shop clauses, however, fiduciary outs might become subject to a broad interpretation.

III. CONSEQUENCES OF IMPERMISSIBLE NO-SHOP CLAUSES

A. *The Conflict*

Courts encounter and are invoked to ascertain no-shop clauses in two scenarios. In the first scenario, the target corporation, after signing the deal with the acquirer, but before closing the deal, ignores its contractual commitments and, notwithstanding a plain no-shop or a no-talk clause, attempts to solicit better bids or negotiates with an insurgent. In the second scenario, the rival transaction between the target and the insurgent is already consummated. Contingent upon how advanced the rival negotiations and transaction are, the acquirer will either seek a preliminary enjoinment of the target's defaulting conduct, rival the transaction, or seek damages for breach of contract. Under very special circumstances, even a motion for specific performance is conceivable.[199]

Finding that a target board breached its fiduciary duties by unreasonably agreeing to a no-shop clause and, therefore, that the provision was impermissibly adopted with respect to corporate law doctrine, courts face the dilemma of how to proceed. On the one hand, there is the desire to protect the target shareholders' interests. This suggests a tendency by the courts to simply invalidate the undue no-shop covenant. On the other hand, the fundamental contract law principle of *pacta sunt servanda* cannot easily be discarded. Currently, Delaware courts resolve this tension between corporate and contract law values in favor of corporate law demands. Impermissible no-shop clauses are declared "invalid and unenforceable" and courts consequently do not grant dismissed and frustrated acquirers injunctive relief and do not award them damages.[200] This undifferentiated preference of corporate law values over contract law values is not compulsory or self-evident. To the contrary, it has been subject to considerable criticism in the corporate law literature. Furthermore, courts both inside and outside Delaware have begun to recognize the tension between corporate and contract law principles arising from impermissible deal protection devices. Recent decisions give rise to the inference that a more balanced law on the subject is evolving.

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[199] *See, e.g.*, IBP, Inc. v. Tyson Foods, Inc. (*In re* IBP, Inc. S'holders Litig.), 789 A.2d 14 (Del. Ch. 2001) (holding that the acquired corporation was entitled to specific performance).

[200] *See QVC*, 637 A.2d at 51.

The next three sections will illustrate the evolution of Delaware law on the matter. This will be followed by a presentation of two contradictory decisions on the conflict from jurisdictions other than Delaware. Finally, the question of whether corporate law values should prevail over contract law values will be discussed.

B. *The Evolution of Delaware Law on the Matter*

Corporate law concerns have not always swayed the conflict between corporate and contract law values so vehemently. Delaware courts first addressed the tension between corporate and contract law principles arising from impermissible deal protection devices in *Smith v. Van Gorkom*.[201] In *Smith*, the target board had signed a merger and recommendation agreement without having informed itself of all material facts.[202] Being sued for breach of fiduciary duties, the board contended that, notwithstanding the recommendation agreement, it had remained free to either continue to recommend the merger, to recommend that the shareholders vote against it, or to simply leave the decision to the shareholders, and thus, to comply with its fiduciary duties.[203] Essentially, the board asserted that the recommendation agreement had not imposed any contractual constraints upon it. The court rejected the target board's contention, holding that the recommendation agreement vested the acquirer with valid contractual rights although the target board had acted with gross negligence and thus breached its fiduciary duties when approving of it.[204] Non-compliance with the recommendation agreement "clearly involved a substantial risk—that the Board would be faced with [a lawsuit] by Pritzker [the acquirer] for breach of contract."[205] Thus, the court gave deference to contract law values.

The prevalence of contract over corporate law values, however, was of short duration. In *Revlon*, the Delaware Supreme Court affirmed the Delaware Court of Chancery's preliminary injunction enjoining a lock-up, a "no-shop clause," and a termination fee without directly addressing possible contractual rights of the acquirer.[206] The court simply stated that

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[201] 488 A.2d 858 (Del. 1985).

[202] *Id.* at 864.

[203] *Id.* at 887-88.

[204] *Id.* at 888-89. Justice Horsey stated that "[c]learly, the Board was not 'free' to withdraw from its agreement . . . by simply relying on its self-induced failure to have reached an informed business judgment at the time of its original agreement." *Id.* at 888

[205] *Smith*, 488 A.2d at 888.

[206] *See Revlon*, 506 A.2d at 176.

the deal protection devices had a "destructive effect on the [ongoing bidding process]," were "impermissible," and "part of the overall plan to thwart Pantry Pride's [the rival bidder's] efforts," and "that the need for both bidders to compete in the marketplace outweighed any injury to Forstmann [the acquirer]."[207] Thus, the Delaware Supreme Court clearly set corporate values above contract values.

In *QVC*, this resolution of the tension between corporate and contract law principles was confirmed.[208] The *QVC* court held impermissible deal protection devices "invalid and unenforceable."[209] Regarding the "no-shop provision," the court held that it

> could not validly define or limit the fiduciary duties of the Paramount directors. To the extent that a contract, or a provision thereof, purports to require a board to act . . . in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. Despite the arguments of Paramount and Viacom to the contrary, the Paramount directors could not contract away their fiduciary obligations. Since the No-Shop [clause] was invalid, Viacom never had any vested contract rights in the provision.[210]

Kysor Industrial Corp. v. Margoaux, Inc.[211] and *Brazen v. Bell Atlantic Corp.*,[212] both decisions pertaining to break-up fees, are viewed to indicate that Delaware courts are increasingly aware of the conflict between corporate and contract law, and are inclined to strengthen the acquirer's position by acknowledging his contractual rights.[213] At least the *Kysor* court addressed the conflict and recognized the acquirers' contractual interests.[214] It even stated in dicta that even if the target board had breached its fiduciary duties, "it does not impact on Kysor's [the acquirer's] action at law for damages due to an alleged breach of contract."[215] On the other hand, both the *Kysor* and the *Brazen* court—applying a liquidated damages

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[207] *Id.* at 183-85.

[208] Paramount Communications, Inc. v. QVC Network, Inc. (*In re* Paramount Communications, Inc. S'holders Litig.), 637 A.2d 34 (Del. 1994).

[209] *Id.* at 51.

[210] *Id.* (citation omitted)

[211] 674 A.2d 889 (Del. Super. Ct. 1996).

[212] 695 A.2d 43 (Del. 1997).

[213] *See* Regan, *supra* note 15, at 20-22; Taylor, *supra* note 20, at 618-21.

[214] *See Kysor Indus. Corp.*, 674 A.2d at 897.

[215] *Id.*

analysis—found that the break-up fees were reasonable.[216] Thus, their adoption did not constitute a breach of fiduciary duties by the target board. Ultimately, the courts, therefore, did not have to decide upon the break-up fees' validity. Interestingly, however, the *Brazen* court appears to take it for granted that break-up fees that do not meet the standards for liquidated damages clauses are invalid.[217] Therefore, Brazen's strengthening of the acquirer's position and of contract law values seems questionable.

Finally, in *ACE Ltd.*, Vice Chancellor Strine, notwithstanding the promotion and application of a profound analysis that attempts to fairly balance corporate and contract law values,[218] indicates that Delaware courts—at least as a rule of thumb—will continue to invalidate impermissible deal protection devices.[219]

In sum, it can be concluded that Delaware courts, although more sensitive to the conflict and perhaps inclined to strengthen contract law values in the future, currently tend to invalidate impermissible deal protection devices.

C. *Jurisdiction Other than Delaware*

In *Jewel Cos. v. Pay Less Drug Stores Northwest, Inc.*,[220] the United States Court of Appeals for the Ninth Circuit reversed the district court's holding that a board approved merger agreement did not have any legal effect prior to shareholder approval. The pertinent facts are that Jewel Companies, Inc. and Pay Less Drug Stores signed a merger agreement that included mutual best efforts clauses.[221] When Pay Less Drug Stores Northwest, Inc. made a better offer for Pay Less Drug Stores, however, the Pay Less Drug Stores board of directors abandoned the strategic merger with Jewel and approved and recommended to its shareholders a merger with Pay Less Drug Stores Northwest, Inc.[222] In return, Jewel, Inc. sued Pay Less Drug Stores Northwest, Inc. for tortuous interference with a contract.[223] Discerning the best efforts clause, the Ninth Circuit held that

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[216] *Brazen*, 696 A.2d at 47; *Kysor Indus. Corp.*, 674 A.2d at 897.

[217] *Brazen*, 695 A.2d at 48.

[218] *ACE Ltd.*, 747 A.2d at 104-06.

[219] *Id.* at 107-08. Vice Chancellor Strine provided that "[t]he logic of *QVC* itself casts doubt on the validity of such a contract." *Id.* at 108. Note also that the Vice Chancellor throughout the decision quotes heavily from and explicitly follows *QVC*.

[220] 741 F.2d 1555 (9th Cir. 1984) (applying California law).

[221] *Id.* at 1557-58.

[222] *Id.* at 1558.

[223] *Id.*

it was within the board's authority to enter into such an agreement,[224] and that it constituted a valid and binding contract.[225] Therefore, *Jewel* is frequently listed as an example where the court gave deference to contract over corporate law values.[226] It must be noted, however, that the *Jewel* court neither found that the target board breached its fiduciary duties when it approved of the best efforts clause nor explicitly addressed the question of whether the best efforts clause would be valid and binding if the target board had breached its fiduciary duties by agreeing to it.[227] The refusal to "decide the question whether upon the unsolicited receipt of a more favorable offer after signing a merger agreement the board still must recommend to its shareholders that they approve the initial proposal"[228] demonstrates that the court did not decide whether contract law values should outweigh corporate values.[229] Thus, *Jewel*'s holding is overrated as to its significance regarding the solution of the discussed conflict between corporate and contract law values.

In *ConAgra, Inc. v. Cargill, Inc.*,[230] the Supreme Court of Nebraska faced a case similar to *Jewel*. ConAgra, Inc. and MBPLX Corporation had decided to merge, and the MBPLX board had agreed to a best efforts clause.[231] When Cargill, Inc. made an offer for MBPLX that was deemed superior to the merger with ConAgra, however, the MBPLX board cancelled the stockholder vote on the ConAgra merger and instead recommended that their shareholders accept Cargill's offer.[232] In response, ConAgra filed a suit against MBPLX Corporation and Cargill, Inc. for

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[224]*Jewel Cos.*, 741 F.2d at 1562-64.

[225]*Id.* at 1564. The Ninth Circuit held that "the district court erred in ruling that a merger agreement between boards of directors is of no legal effect prior to shareholder approval." *Id.*

[226]*See* Regan, *supra* note 15, at 25; Taylor, *supra* note 20, at 581-84.

[227]The Ninth Circuit did, however, state that:

> [w]e do, of course, recognize that a board may not lawfully divest itself of its fiduciary obligations in a contract. However, to permit a board of directors to decide that a proposed merger transaction is in the best interest of its shareholders at a given point in time, and to agree to refrain from entering into competing contracts until the shareholders consider the proposal, does not conflict in any way with the boards fiduciary obligation.

Jewel, 741 F.2d at 1563 (citations omitted).

[228]*Id.* at 1564 n.13.

[229]*See, e.g.*, Regan, *supra* note 15, at 27 (finding that the court's decision implicitly states that corporate fiduciary precepts could possibly override contract precepts in particular instances).

[230]382 N.W.2d 576, 577 (Neb. 1986) (applying Delaware law).

[231]*Id.* at 582.

[232]*Id.* at 586.

breach of contract and tortuous interference with a contract.[233] When the case reached the Supreme Court of Nebraska, the court ruled:

> When the MBPXL board resolved to cancel the shareholders' meeting at which the ConAgra merger proposal was to have been submitted and instead recommended shareholder acceptance of the cash-out Cargill offer, that was not a breach of the ConAgra merger agreement. Once the directors of MBPXL learned of the competing Cargill offer, the "best efforts" clause in the ConAgra proposal could not relieve the MBPXL directors of their duties to act in the shareholders' best interests. They had an obligation at that point to investigate the competing offer, and if, in the exercise of their independent good faith judgment, they found that the Cargill offer was a better offer for the MBPXL shareholders, they were bound to recommend the better offer.[234]

The Supreme Court of Nebraska further held that "there was a continuing fiduciary duty owed by each board of directors to its respective shareholders which could not be contracted away. . . [and that] [t]o hold otherwise would be to place innocent shareholders of a company at the mercy of corporate directors whom the shareholders rely upon for candor and fair dealing."[235] Thus, the court squarely prioritized corporate law values over contract law values. It is noteworthy, however, that the dissenting opinion strongly criticized the majority's ignorance on the principles of contract law.[236]

D. *Should Corporate Law Values Prevail over Contract Law Values?*

The question of whether corporate law values should prevail over contract law values is just as much a matter of policy as of legal doctrine. It implicates questions concerning the "freedom of contract" and its boundaries, and whether the target's shareholders or the acquirer's shareholders are more adequately burdened with the costs of impermissible deal protection provisions. For the release of the target company from its contractual obligations and the protection of its shareholders' interests comes at the price of causing costs to the acquirer and, therefore, its

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[233] *Id.* at 578.

[234] *ConAgra*, 382 N.W.2d at 588.

[235] *Id.* at 587.

[236] *Id.* at 589.

shareholders. Regardless of whether the court denies an application for injunctive relief or declines to award damages, the acquirer either loses an attractive deal, becomes exposed to competition and consequently has to increase its consideration, or will not recoup its investments.

Proponents favoring a resolution of the conflict that attaches more weight to contract law concerns than on corporate law values emphasize the mutually agreed upon risk allocation embodied in contracts.[237] They correctly point out that one of the fundamental functions of contracts and contract law is to enable parties to agree upon a risk allocation for unforeseen and unanticipated occurrences.[238] Further, they argue that any contracted risk allocation is in vain, if courts and other state authorities will not recognize and enforce it.[239] Finally, they conclude that courts—at least in the deal protection context—should not second guess the reasonableness of the parties' risk allocation or intervene with it.[240] This final conclusion, however, is a fallacy. It is based upon the presumption that the benefits of the enforcement of the contract in question outweigh the social costs that go along with it. In the deal protection context, this presumption was valid if the enforcement of the contracted deal protection would be socially more valuable than the protection of the target's shareholders' interests. This is exactly the starting question. Therefore, the recourse to contract law principles is only of restricted help.

The more viable argument supporting the contract law proponent's case would be that risk allocation is not only legitimate, but is so essential to a society whose economy is based upon the exchange of products and services and a society which encourages the planning of future market transactions that the denial of its enforcement is only warranted under very special and limited circumstances.[241] For example, one could argue that courts should only disregard contracts if their implementation clearly entails a severe negative impact upon society as established by law, i.e., in the case of contracts pertaining to criminal activities. Deal protection would hardly meet this prerequisite.

Ironically, a better argument for the proposition that strengthens contract law values at the detriment of corporate law concerns is to be found in corporate law doctrine. This is best illustrated by a

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[237] *See* Taylor, *supra* note 20, at 579.

[238] *See id.*

[239] *See id.*

[240] *See id.*

[241] *See* Taylor, *supra* note 20, at 579.

hypothetical.[242] Assume that the XY corporation is in dire need for a piece of land to build another plant on. Assume further that the financially inexperienced widow Roe wants to give up her house and the surrounding acres of land. The house and land have a market value of $2.3 million. Now assume that XY corporation's board of directors and widow Roe sign a contract of sale that stipulates that widow Roe will pass title to the house and land to XY corporation for $5 million in consideration. Both XY corporation's board and widow Roe were content with the deal and unaware of the inadequate price. Finally, assume that four weeks after signing the contract, but before widow Roe had passed title to the house and land, Mr. Doe offers XY corporation a similar piece of property for only $2.3 million that he had been advertising for that price for three months in both local and regional papers.

In the above hypothetical, XY corporation's board breached its fiduciary duties. The decision to buy widow Roe's house and land for $5 million is not protected by the otherwise applicable business judgment rule because the board had not studied the real estate advertisements in local and regional papers, and therefore had not duly informed itself of all material information pertaining to the purchase of the real estate property. Nonetheless, XY corporation cannot simply walk away from its deal with widow Roe. If it did, widow Roe would be entitled to damages and possibly specific performance. This is so because XY's board's breach of its fiduciary duties is outside widow Roe's sphere of responsibility. Also, widow Roe was unaware of the overcharging, and she was not obliged to safeguard XY corporation's interests. Thus, in this hypothetical, contract law values clearly prevail over corporate law concerns. XY corporation's shareholders will not be protected from their board of directors, and they will bear the consequences of their directors' misconduct. Because the above hypothetical strongly resembles a corporate transaction where the target board unduly agreed to deal protection devices and subsequently is offered a more valuable deal by a competitive bidder, one might ask why deal protection covenants should be treated differently from the contract of sale with widow Roe.

Delaware courts provide a good answer to this question, reasoning that the distinction is found in the different nature of the contract

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[242]The following hypothetical was brought to the author by Professor Cyril Moscow in a discussion on the matter. Professor Moscow has been adjunct professor at the University of Michigan School of Law since 1973.

partners.[243] A publicly held acquirer engaging in corporate transactions does not exactly resemble widow Roe. A publicly held acquirer is a sophisticated player with in-house counsel and access to outside legal advice. Such a sophisticated player—unlike widow Roe—can be expected to evaluate whether the target board breached its fiduciary duties by agreeing to a deal protection device, and whether a covenant is permissible.[244] This sophisticated player either knew or should have known of the target board's breach of fiduciary duties.[245] Thus, the publicly held acquirer's invocation of the contract law principle of *pacta sunt servanda* will not be heard by the Delaware courts.

The flip side to this argument is revealed when the above hypothetical is slightly altered. Assume that, all other facts being the same, XY corporation had not bought the house and land from widow Roe, but from KB corporation, a company dealing in real estate with considerable experience and expertise in the local real estate business. Applied to this varied scenario, the courts' analysis would render XY corporation free to walk away from its deal with KB corporation and to alternatively accept Doe's offer. This is so because KB corporation is a sophisticated player, its board knew that it was overcharging XY corporation, and it must have sensed that XY's board was uninformed about the local real estate prices and offers, and was thus breaching its fiduciary duties. Consequently, the courts would deny KB corporation the enforcement of its contract. In the end, the courts' argument would generate a rule under which corporate and sophisticated market participants must not only comply with their own

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[243] *See, e.g.*, *QVC*, 637 A.2d at 51. Chief Justice Veasey stated:

> Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable features of the Stock Option Agreement. It cannot be now heard to argue that it obtained vested contract rights by negotiating and obtaining contractual provisions from a board acting in violation of its fiduciary duties.

Id. See also ACE Ltd., 747 A.2d 95, at 109. Vice Chancellor Strine stated:

> As a sophisticated party who bargained for, nay demanded, § 6.3 of the Merger Agreement [the no-talk clause], ACE was on notice of its possible invalidity. This factor therefore cuts against its claim that its contract rights should take precedence over the interests of the Capital Re stockholders who could be harmed by enforcement of § 6.3.

Id.

[244] *See ACE Ltd.*, 747 A.2d at 105-06.

[245] In *ACE Ltd.*, Vice Chancellor Strine held that it suffices if the acquirer did not actually, but should have known about the deal protection device's impermissibility. *Id.* at 106. "[W]hether ACE should have known that § 6.3 [the no-talk clause] was so restrictive that the Capital Re board could not properly agree to it necessarily regulates any examination of its actual operative effect." *Id.* The Vice Chancellor further held that even the knowledge of the "possible, if not likely, invalidity" of a deal protection device may cut against the acquirer's claim. *Id.* at 106 n.32.

fiduciary duties, but also supervise their—equally sophisticated—contracting partner's board's conduct. Such a rule, however, does not find support in Delaware corporate law outside the deal protection context. Furthermore, it seems questionable whether an acquirer board of directors can be expected to watch over the target board and to safeguard the target shareholders' interests. An acquirer board's primary duty is to attain the best deal for its own stockholders, and to pursue interests that are inherently detrimental to the target shareholders. Finally, the rule's practical implications pose obstacles. For example, there is considerable debate over what characterizes a sophisticated player and what circumstances allow the inference of knowledge or warrant the conclusion that the acquirer should have had knowledge.

It is important to note, however, that the Delaware courts' reasoning is consistent with and probably implicitly derived from trust and agency law.[246] Directors of a corporation and trustees are both fiduciaries. Directors owe fiduciary duties to their corporation and their shareholders, and trustees owe fiduciary duties to the trust's beneficiaries.[247] Thus, it is not surprising that courts frequently look at trust law when resolving corporate fiduciary duty questions.[248] According to the *bona fide* purchaser doctrine in trust law, a purchaser of trust property whose sale constituted a breach of fiduciary duties by the trustee is nonetheless entitled to the property if he did not have notice of the breach of trust and did not knowingly take part in an illegal transaction.[249] Under the *Restatement (Second) of Trusts*, section 297(a) (1959), however, "[a] person has notice of a breach of trust if he knows or should know of the breach of trust . . . ."[250]

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[246]*See* Regan, *supra* note 15, at 63-84. In *ACE Ltd.*, Vice Chancellor Strine, citing Professor Regan's article, explicitly refers to trust and agency law rules. *See ACE Ltd.*, 747 A.2d at 104.

[247]*See* RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959). This section states: "The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary." *Id.*

[248]*See* Regan, *supra* note 15, at 63.

[249]*See* RESTATEMENT (SECOND) OF TRUSTS § 284 (1959). This section states:

> (1) If the trustee in breach of trust transfers trust property to, or creates a legal interest in the subject matter of the trust in, a person who takes for value and without notice of the breach of trust, and who is not knowingly taking part in an illegal transaction, the latter holds the interest so transferred or created free of the trust, and is under no liability to the beneficiary.
>
> (2) In the Restatement of this Subject such a transferee is called a "bona fide purchaser."

Id.

[250]*Id.* § 297(a).

Under agency law—and a board of directors is nothing else but its corporation's and shareholder's agent[251]—a principal is generally held liable for contracts made by his agent.[252] The underlying rationale for this is the principal's ability to control his agent.[253] Furthermore, the principal is the one who created and exposed both himself and other market participants to the risks inherent to deferring authority upon agents. Also, the principal is the one who, being the residual claimant, benefits from the division of labor and the deferential business organization. There is, however, an exception to the principal's liability for his agent. If the agent exceeds his authority and if the other party knows or should know about this circumstance, the agent's principal is exempted from liability.[254] The underlying rationale to this rule is that a contract partner who is or should be fully aware of the agent's misconduct does not have any valid reason to and cannot in good

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[251]Some scholars deny directors the status of agents and therefore do not apply agency rules to directorial behavior directly, but analogously. *See* ROBERT CHARLES CLARK, CORPORATE LAW § 3.3, at 113-14 (1986); Regan, *supra* note 15, at 75-76. This intellectual frivolity, however, does not have any impact on the validity of the argument.

[252]Note also the concept of apparent and inherent authority. *See* RESTATEMENT (SECOND) OF AGENCY § 140 (1958). This section states:

> The liability of the principal to a third person upon a transaction conducted by an agent, or the transfer of his interests by an agent, may be based upon the fact that:
>
> a) the agent was authorized;
> b) the agent was apparently authorized; or
> c) the agent had a power arising from the agency relation and not dependent upon authority or apparent authority.

Id.

[253]KLEIN & COFFEE, *supra* note 36, at 14-15.

[254]*See* Regan, *supra* note 15, at 83. *See also* RESTATEMENT (SECOND) OF AGENCY § 166 cmt. a (1958). This section states that "[i]If a person has information which would lead a reasonable man to believe that the agent is violating the orders of the principal or that the principal would not wish the agent to act under the circumstances known to the agent, he cannot subject the principal to liability." *Id.* § 27. This section of the *Restatement (Second) of Agency* further states:

> [A]pparent authority to do an act is created as to a third person by written or spoken words or any other conduct of the principal which, *reasonably interpreted*, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him.

Id. (emphasis added). *See also id.* § 49 (providing that "[t]he rules applicable to the interpretation of authority are applicable to the interpretation of apparent authority except that: a) manifestations of the principal to the other party to the transaction are interpreted in light of what *the other party knows or should have known*) (emphasis added). German agency law provides that: "[e]in Geschäftsgegner, der den Missbrauch der Vertretungsmacht erkannte oder dem sich aufgrund der Umstände aufdrängen musste, dass der Vertreter die ihm eingeräumte Vertretungsmacht missbraucht, ist in seinem Vertrauen auf den Bestand der Vertretungsmacht nicht schutzwürdig." *Translated to* "[a] business partner who recognized the abuse of authority or who compellingly had to infer from the circumstances that the agent abused his authority, is not worthy of protection with respect to his reliance interest." BGHZ 113, 315, 320; Palandt/Heinrichs, BGB 62. Aufl. § 164 Rdn. 13 f.

faith rely upon the agent's conduct.[255] Therefore, such a contract partner is not worthy of the courts' protection. Regarding agency law, these liability rules are undisputed. A conflict between agency law values and contract law values is not discussed here. An excess of authority, however, is not the same as a breach of fiduciary duties.[256] Nonetheless, the underlying idea to the agency rules is equally applicable in both contexts. Principals are liable for and bound by their agents, unless their contract partner is not worthy of protection because he knew or should have known that the agent abused his position and violated his internal relationship with his principal. Thus, Delaware courts are probably right when invalidating impermissible no-shop clauses. The better explanation for such a treatment of undue no-shop clauses, however, is to be found in established trust and agency law.[257] It is not to be found in the acquirer's sophistry, as the Delaware court's reason.[258] The acquirer's degree of sophistry, however, gains relevance when ascertaining whether the acquirer knew or should have known about the target board's breach of fiduciary duties. In that sense, Delaware courts are on the right track.

It must be pointed out, however, that the Delaware courts' assumption and expectation that sophisticated acquirers knew or should have known about the impermissibility of the deal protection device when adopting it comes close to a fiction. In many cases, both acquirer and target boards, notwithstanding their access to profound legal advice, will be insecure about or unaware of a deal protection device's impermissibility. Thus, the stringent and merciless treatment of acquirers in that respect might reflect and be more honestly accounted for by a valuation that ranks the protection of the target stockholders from a breach of fiduciary duties and their ownership interest—including the ability to sell and resell the company at will—higher than the acquirer stockholders' expectation and reliance interest.

Of course, this explanation recalls attention to the question of whether the Delaware courts' invalidation of impermissible deal protection

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[255]KLEIN & COFFEE, *supra* note 36, at 29-30.

[256]Directors who agree to impermissible deal protection devices have authority to do so. A breach of fiduciary duties itself does not implicate the ultra vires doctrine. Therefore, it is unnecessary to invoke the doctrine of apparent authority. An excess of authority, however, always constitutes a breach of fiduciary duties. This is so because an agent is a fiduciary with respect to matter within the scope of his agency. *See* RESTATEMENT (SECOND) OF AGENCY § 13 (1958).

[257]As opposed to trust law, agency law is directly applicable in the deal protection context. With respect to agency law, it is not even necessary to fall back on agency law principles or to draw analogies.

[258]*See, e.g.*, Regan, *supra* note 15, at 83-84 (falling back upon trust and agency law principles when evaluating under what circumstances impermissible deal protection devices should be invalidated).

devices is socially desirable and warranted. A quick glance at EC-law on impermissible subsidies may provide some guidance. The invalidation of impermissible deal protection devices and the somewhat fictive assumption that the acquirer knew or should have known of the deal protection device's impermissibility reminds the European reader of the EC-law on impermissible subsidies. To establish fair competition within the Common Market, Article 93 of the EC-contract stipulates that member states must seek the Commission's approval prior to granting subsidies to an enterprise (this is known as the requirement of notification). If the member state fails to do so, EC-law requires that the member state reclaim the already paid out subsidy. European courts also argue that recipients are sophisticated players which knew, should have known, or at least could have known about the requirement of notification, the subsidy's lack of notification and thus its impermissibility. Therefore, recipients do not deserve any protection and are not unduly burdened when the allocation of the subsidy is rescinded and when they are ordered to repay the received subsidy. Just like in the deal protection context, however, the assumption of the recipient's knowledge or his possibility to acquire such knowledge is often a mere fiction. A recipient cannot fairly be expected to evaluate a subsidy's requirements and permissibility more accurately than the member state's authority that granted it. The more honest explanation for the harsh treatment of recipients of impermissible subsidies is that EC-conform competition is attached more importance than the recipient's reliance interest. The German Bundesverwaltungsgericht reasoned that generally the principle of protection of reliance is only discarded when the party invoking it either knew of or ignored the illegality of the contract or act with gross negligence.[259] When balancing the recipient's reliance upon the legal validity of the administrative act against the public interest of its revocation, however, the protection of reliance must step behind the extraordinary importance of the enforcement of the EC-order of competition.[260] Applied to the deal protection context, the underlying rationale of the law on impermissible subsidies transforms the question of whether the strict and undifferentiated invalidation of impermissible deal protection devices is desirable and justified into the question of whether the protection of target shareholders from a breach of fiduciary duties and of

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[259]*See* BVerwGE 92, 81.

[260]*See id.* at 92, 81. Another argument for this policy is that EC-member states would be induced to unduly support their own economies by granting impermissible subsidies, if they could get away with it.

their ownership rights serves and promotes a public interest of extraordinary importance.[261]

As recently demonstrated in the wake of Enron, Tyco International, Xerox, or MCM WorldCom, the loss of investor confidence has a tremendous negative impact upon the stock market. This, in turn, does not pass by the real economy. A tumbling stock market decreases consumer confidence and consumption, and may ultimately lead into an overall economic recession. Thus, the maintenance or restoration of investor confidence might well qualify as an extraordinarily important public interest. The question remains, however, whether the preferential treatment of target shareholders at the detriment to acquirer shareholders enhances investor confidence. For acquirer shareholders are investors, too, who if frustrated, might lose their faith in and abandon the capital markets. Thus, the question is whether deference to target shareholders' protection of a breach of fiduciary duties and of their ownership interests, or deference to the acquirer shareholders' reliance interest, is more constructive to the promotion of overall investor confidence.

The current investor confidence crisis has many origins, such as the discovery of improper accounting and defrauding recommendations by analysts. Another reason that has attracted a lot of attention by the media and the public is the realization that not all executives and directors have always acted in the best interest of their corporation, but rather pursued personal interests when conducting the corporation's affairs. Into this category fall excessive compensation packages—especially regarding stock-option plans. Also included are cases of insider trading and astronomical redemption sums in the mergers and acquisitions context. Therefore, the protection of shareholders from selfish and disloyal executives and directors appears to be of considerable weight when ascertaining the factors that influence investor confidence.

With respect to deal protection, target shareholders are exposed to far greater dangers stemming from selfish and disloyal executives and directors than acquirer shareholders. It is almost always the target directors who are concerned about their positions and who are tempted to trade deal protection devices for attractive positions and compensation packages in the post merger corporation. On the other hand, the acquirer board, if it agrees or insists upon impermissible deal protection devices, will do so in

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[261]Once more a comparison to the equal protection clause in constitutional law comes to mind. Just like various degrees of perforation of the equal protection clause require either a reasonable, an important or a compelling state interest, one could argue that the infringement of contract law values and the principle of protection of reliance demand an extraordinary important or compelling public interest.

the pursuit of the corporation's best interest.[262] It is not clear how acquirer directors could personally profit from such conduct at the detriment of their shareholders.[263] Under current law, acquirer directors who agree to such deal protection measures may act negligently and, if they were uninformed about the device's legal prerequisites, might not be accorded the protection of the business judgment rule. At least, however, they are not guilty or suspected of selfish and disloyal behavior. On the other hand, a target board's approval of impermissible deal protection devices will always be tainted by suspicion of disloyal conduct.[264] In that sense there is—at least with respect to investors' perception—a qualitative difference between a target and an acquirer board's misconduct resulting in the adoption of impermissible deal protection devices. Therefore, a target board's breach of fiduciary duties is likely to shock investor confidence more intensely than an acquirer board's improper agreement to undue deal protection devices. This makes the invalidation of impermissible deal protection devices beneficial to overall investor confidence, and thus socially desirable and warranted.

This conclusion might further be supported by the distinction between damages caused to target and acquirer shareholders by impermissible deal protection or its invalidation respectively. Regarding target shareholders, impermissible deal protection interferes with already established ownership rights. It affects property and value already in the

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[262]This is so because the odds of getting away with an impermissible deal protection are estimated to be worth the try.

[263]Of course, acquirer directors often profit from a favorable transaction through shares or stock-options. This profit, however, is not detrimental to shareholders, but there is an inherent side effect of tying director and shareholder interests in the corporation by means of director shares or stock-options. It is noteworthy that a growing number of authors suggests that acquirer executives and directors have strong financial and psychological incentives to expand their "empire" and to engage in and hold onto transactions that are too costly and not in the acquirer shareholders' best interest. *See, e.g.*, James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333 (2001). This threat to acquirer shareholders' interests, however, is not manifested by the employment of deal protection devices and thus cannot be averted by a law on deal protection devices that either upholds or invalidates impermissible ones. If the acquisition price is too high, the target shareholders will be more than happy to accept it and there will be no need for the acquirer's management to insist upon impermissible deal protection.

[264]This assumption is admittedly somewhat daring. If incorrect, the invalidation of impermissible deal protection devices regarding the investor confidence argument was contingent upon whether the target board is capable of plausibly showing that it just acted plainly on an uninformed basis, but nonetheless in pursuit of the best interest for the company and not selfishly and disloyal. A conceivable situation like this might be, for example, where a target board is offered a totally inadequate premium to the acquisition price for the deal protection device. Here the target board might convincingly argue that it just misevaluated the adequacy of the premium, but that it did not derive any personal profit from it.

hands of the target stockholders. In contrast, the invalidation of impermissible deal protection devices primarily deprives acquirer shareholders of expected profits. Those might be less worthy of protection for two reasons. First, society and investors might value established financial positions more than expectations for profit.[265] Second, the acquirer will only lose the deal if a rival bidder with a more valuable offer emerges. This, however, is an indication that the acquirer's offer was inappropriate in the first place. The acquirer shareholders' profit would therefore result from an overreaching of the target shareholders, which is a result that made capital markets look predatory and piratical. This might deter investors from participating in the market.

It should be noted, however, that if Delaware courts were to revalue the conflicting interests and to pay more consideration to the acquirer's concerns, a more benign take on the acquirer with respect to his knowledge as to the deal protection device's impermissibility would be a consistent as well as easy way out.

Finally, the more practical, but nonetheless considerable and persuasive, argument of deterrence deserves a few lines. The uncompromising invalidation of impermissible deal protection strips the acquirer of all protection. It is a worst case scenario come true. Such a tough treatment of impermissible deal protection devices may induce acquirers to be moderate and settle for reasonable deal protection in the first place. Compared to an invalid severe deal protection, a more lenient but valid and enforceable one seems much more preferable. Thus, the categorical invalidation of impermissible deal protection devices might be the most efficient way to reduce their occurrence.

E. *Conclusion*

In summary, the Delaware law on impermissible deal protection devices and their invalidation is not absurd. Rather, it is both doctrinally consistent with agency law and sensible from a policy point of view. If, however, Delaware courts should perceive a need to take a more balanced approach to the conflict and to strengthen the acquirer's position, the current doctrinal approach provides them with the means to do so. All the Delaware courts would have to do is tie up the criteria indicative of the acquirer's knowledge of the impermissibility of the deal protection device.

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[265]This argument seems especially questionable regarding investments in publicly held corporations, because the sole reason for investing in publicly held corporations is the expectation of profit.