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Breaking Up is Hard to Do: A Look at *Brazen v. Bell Atlantic* and the Controversy over Termination Fees in Mergers and Acquisitions

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COMMENT

BREAKING UP IS HARD TO DO: A LOOK AT *BRAZEN V. BELL ATLANTIC* AND THE CONTROVERSY OVER TERMINATION FEES IN MERGERS AND ACQUISITIONS*

INTRODUCTION

Buy on the rumor, sell on the fact. Nowhere is this axiom more applicable than in the fast-paced, high stakes world of mergers and acquisitions, where fortunes are won and lost in a New York minute. The combination or consolidation of several companies can have tremendous ramifications on the professional and financial well-being of both the most intimately connected and the most remotely interested parties. When considering a potential merger, the companies involved invest time, effort, and capital in order to determine such factors as economic feasibility and corporate compatibility.[1] Make no mistake–tremendous resources are devoted when pursuing such a transaction. However, what happens if the transaction is never completed because one party terminates the agreement and breaks up the deal? What if the rumor never becomes fact?

Generally, the contemplated scenario proceeds in the following manner. One company bids on another and the bid is accepted. The two companies reach a final agreement on the terms of the merger or acquisition, but before the transaction closes, a third company enters the game by making a higher bid for the company to be acquired.[2] Clearly, it is in the inter-

* This Comment was selected as the winner of the Commercial Law Foundation's writing competition at Brooklyn Law School in the Fall of 1998.

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

[2] This exact situation can be seen in the case of MCI. British Telecom made a

ests of the shareholders of the target company that they receive the highest possible value for their stock.[3] However, what about the original bidder, who invested great effort in pursuing the transaction, possibly in lieu of a different transaction? Common sense dictates that the suitor will seek some sort of protective provision to shield it from exposure to such situations.

This provision is formally called a termination fee, but the term most often used is "break-up fee."[4] Break-up fees are paid to the suitor of a company by the target company in the event that the contemplated transaction fails to be consummated for reasons set forth in the purchase agreement.[5] At its most basic level, the fee protects the potential purchaser of a business.[6] The bidder often invests a great amount of time and money in determining the value of the target business[7] and turns to the advice and counseling of lawyers, investment bankers, accountants, lending institutions and various other highly paid professionals.[8] The out-of-pocket expenses related to an attempted acquisition represent a tidy sum, and the break-up fee is often viewed as compensation for the failed bidder for its expenses in pursuing the transaction.[9] Without a guarantee of some reimbursement, potential bidders might be hesitant to expend time and effort on this costly courtship.[10]

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bid of approximately $21 billion, which had been accepted by MCI. But before the deal was able to close, MCI received another bid from Worldcom of nearly $30 billion.

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

[4] *See* Joseph Samet, *Use of Break-Up and Topping Fees in Asset Sales*, 746 PLI/COMM 129 (Nov. 1996). In certain arrangements, as in mergers between companies of roughly similar economic strength, the break-up fees will be reciprocal, as was the case in the NYNEX/Bell Atlantic merger.

[5] *See id.*

[6] *See* Hebbeln, *supra* note 1, at 475.

[7] *See id.* at 475.

[8] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 164-65 (1991).

[9] *See* Samet, *supra* note 4, at 133.

[10] *See* Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1814 (1994) (citing MacAndrews & Forbes Holdings, Inc. v. Revlon, 501 A.2d 1239, 1250 (Del. 1985)) ("A lock-up provision . . . must advance or stimulate the bidding process, not retard it . . . ."). However, Fraidin and Hanson also cite to Richard A. Posner who gives the opposing argument, suggesting that the pre-bid expenses are considered sunk costs and should not affect the

The break-up fee has also been understood to compensate the potential acquirer for indirect expenses related to the acquisition.[11] In any acquisition, the bidder forgoes a different course of action which may prove to be just as profitable, if not more, than the path chosen.[12] There are opportunity costs[13] associated with any course of action in business, and for a company looking for acquisitions, the time spent pursuing a transaction that ultimately fails produces not only expenses related to the failed transaction, but also forgone profit from a potentially successful alternative acquisition.[14] The break-up fee compensates the failed bidder for the opportunity costs of proceeding with the unsuccessful deal.

As with most major transactions, there are several phases typical to every merger or acquisition. First, there are negotiations during which the basic terms of the agreement are determined. After an agreement is reached, the deal goes to contract. And eventually, after the terms of the contract are satisfied, the transaction closes and the deal is consummated. Clearly, the break-up fee is designed to compensate for expenses incurred in the negotiations stage of the transaction, but it is also conceivable that the fee is intended to compensate for any loss incurred during the delay between contract and closing.[15] There are a variety of risks to which the bidder is subjected between the time of the bid and the time of the closing, such as market fluctuations and other unanticipated developments in the value of the target company.[16] The bidder assumes that risk by "locking in" at the proposed price. In effect, the bidder gives the target company an option to sell its shares at the price determined.[17] Therefore, as compensation for that option, the target company offers a break-up fee to the potential acquirer to offset the level of risk and uncertainty.[18]

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future behavior of rational parties. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 7 (4th ed. 1992).

[11] *See* Fraidin & Hanson, *supra* note 10, at 1812-18.

[12] *See* Brazen v. Bell Atlantic Corp., 695 A.2d 43, 49 (Del. 1997).

[13] *See* PAUL A. SAMUELSON, ECONOMICS 448 (11th ed. 1980).

[14] *See* Samet, *supra* note 4, at 133.

[15] *See* David Skeel, *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564, 568 (1996) (citing Fraidin & Hanson, *supra* note 10, at 1815).

[16] *See* Fraidin & Hanson, *supra* note 10, at 1816.

[17] *See* Fraidin & Hanson, *supra* note 10, at 1816.

[18] Fraidin and Hanson raise the issue of "inherent delays" in the bidding pro-

It might seem that the benefits of a break-up fee are extremely one-sided, but this is not so. The target company reaps several advantages by offering such a fee to a potential acquirer. Most significantly, for a company that is actively seeking to merge or be acquired, the termination fee acts as an inducement for the initial bidder.[19] It may also entice a possible "white knight"[20] to come to the aid of the target company. The first bidder or white knight will often attract other such bidders and will become, in effect, the "stalking horse."[21] The stalking horse's offer is generally considered to be the initial bid that is then "shopped around" to attract higher offers.[22] Thus, the termination fee can be beneficial to all parties involved by minimizing risk for the acquirer and sparking interest in a target company.

This Comment examines the controversy surrounding termination fees. In light of the recent decision of *Brazen v. Bell Atlantic Corp.*[23] ("*Brazen*") by the Delaware Supreme Court, there are several aspects of the termination fee analysis which have come under fire. Prior to this most recent decision, termination fees were analyzed under the umbrella of the business judgment rule,[24] where the focus of the analysis appeared to be more procedural than substantive. However, in this latest decision, the Delaware Supreme Court enunciated what has come to be known as the "liquidated damages rubric."[25] In this analysis, the substance of the fee, not just the procedure by which it is agreed upon, is open to judicial scruti-

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cess and propose the delays as part of the justification for break-up fees. However, they also argue that there are holes in the analysis of the justification. They contend that the break-up fees do not necessarily eradicate the risk that a pending takeover may "lose some of its appeal." Fraidin & Hanson, *supra* note 10, at 1817. Furthermore, they correctly point out that some of the very same risks that are supposedly being reduced by the break-up fee could be reduced directly in the merger agreement. *See id.*

[19] *See* Samet, *supra* note 4, at 135.

[20] For the definition of "white knight," see BLACK'S LAW DICTIONARY 1596 (6th ed. 1990).

[21] Samet, *supra* note 4, at 135.

[22] *See* Hebbeln, *supra* note 1, at 478 (citing *In re* Integrated Resources, Inc., 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992)).

[23] 695 A.2d 43 (Del. 1997).

[24] *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (Draft No. 11, Apr. 25, 1991).

[25] *See* Brazen v. Bell Atlantic Corp., 695 A.2d 43, 49 (Del. 1997).

ny. It is this Comment's contention that the two methods of analysis are actually quite similar, yielding effectively identical results.

Part I of this Comment examines the two different methods of analysis used in each of the *Brazen* decisions: the business judgement rule analysis of the Delaware Court of Chancery, and the liquidated damages rubric developed by the Delaware Supreme Court. After the discussion of *Brazen*, this Comment reviews issues surrounding the inclusion of break-up fees in merger agreements. Part II examines the several aspects of contract law implicated in this discussion, the most significant being the issue of whether the termination fee constitutes liquidated damages or a penalty. Included in this discussion of contract law is a brief foray into such fundamental topics as unconscionability, just compensation theory, and economic policy. Part III scrutinizes the several aspects of corporate law raised by this analysis. The fiduciary duties of the board of directors of the target corporation are discussed, and great attention is given to the business judgment rule. Finally, this Comment examines the effect of the issue of coercion on transactions requiring shareholder approval.

I. CASE STUDY: *BRAZEN V. BELL ATLANTIC CORP.*

A. *Facts*

In 1995, Bell Atlantic Corp. and NYNEX Corp. entered into merger negotiations.[26] NYNEX circulated a draft merger agreement in January 1996 that included, among other things, a termination fee provision.[27] The parties had agreed that the deal was to be structured as a stock-for-stock transaction, and it would be considered a merger of equals.[28] Therefore, it was

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[26] *See id.* at 45. During these merger negotiations, the parties considered the potential losses each would have suffered as a result of devoting all of its attention on the merger at hand, to the exclusion of some other possible mergers and acquisitions in the telecommunications industry. *See id.* With the passage of the Telecommunications Act of 1996, a competitive arena had been transformed for the regional Bell operating companies, creating numerous opportunities for business consolidations and combinations. *See id.*

[27] *See id.*

[28] *See Brazen*, 695 A.2d at 45.

understood that the provisions of the draft merger agreement, the break-up fees in particular, were to be reciprocal.[29]

Throughout the negotiations, the main problem surrounding the termination fee was in determining how to value lost transactions for either party. Both parties agreed that the possibility of forgoing alternative transactions pending the completion of this merger was a real concern and that the opportunity cost of a failed consummation should be a serious consideration.[30] Furthermore, in valuing the break-up fee, negotiators took into account the size of such fees in other merger agreements found reasonable by Delaware courts, as well as the time during which the parties would be subject to restrictive covenants under the draft merger agreement while regulatory approvals were sought.[31]

In the end, the two companies, in the Amended and Restated Agreement and Plan of Merger dated as of April 21, 1996 (the "Merger Agreement"), agreed that $550 million, which represented approximately 2% of Bell Atlantic's market capitalization, was a fair and reasonable estimate of the value of the opportunity cost and other losses associated with a termination of the merger.[32] Moreover, the termination fee represented a percentage of the market capitalization consistent with percentages previously approved by Delaware courts in earlier transactions.[33]

The fee was broken down into two parts. The first tier of the fee provided that either party would be required to pay $200 million if there were both a competing acquisition offer for that party and either (a) a failure to obtain stockholder approval or (b) a termination of the agreement.[34] The second tier provided that if a competing transaction were consummated within eighteen months of the termination of the Merger

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[29] *See id.*

[30] *See id.*

[31] *See id.*

[32] *See id.* Courts have taken several factors into account in considering the "reasonableness" of a termination fee. In one instance, the court stated: "[A] break-up fee should constitute a fair and reasonable percentage of the proposed purchase price, and should be reasonably related to the risk, effort and expense of the prospective purchaser." *In re* Integrated Resources, Inc. 147 B.R. 650, 662 (Bankr. S.D.N.Y. 1992).

[33] *See Brazen*, 695 A.2d at 45.

[34] *See id.*

Agreement between Bell Atlantic and NYNEX, the consummating party would be required to pay an additional $350 million to its disappointed merger partner.[35]

In February of 1997, Lionel I. Brazen, a Bell Atlantic stockholder, filed a class action suit against Bell Atlantic and its directors for declaratory and injunctive relief.[36] He alleged that Bell Atlantic's Board of Directors had breached their fiduciary duty to the company's shareholders by negotiating an unconscionably high termination fee in the Merger Agreement.[37] He further alleged that they had done this in order to restrict and impair the exercise of the fiduciary duty of the

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[35] *See id.*

[36] *See* Brazen v. Bell Atlantic Corp., No. Civ. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997).

[37] *See Brazen*, 695 A.2d at 46 & n.1. The relevant section of the Agreement stated the following regarding termination fees:

> "If (I) this Agreement (A) is terminated by NYNEX pursuant to Section 9.1(f) hereof or NYNEX or Bell Atlantic pursuant to Section 9.1(g) hereof because of the failure to obtain the required approval from the Bell Atlantic stockholders or by Bell Atlantic pursuant to Section 9.1(h) hereof, or (B) is terminated as a result of Bell Atlantic's material breach of Section 7.2 hereof which is not cured within 30 days after notice thereof to Bell Atlantic and (ii) at the time of such termination or prior to the meeting of Bell Atlantic's stockholders there shall have been an Acquisition Proposal (as defined in Section 6.3 hereof) involving Bell Atlantic or any of its Significant Subsidiaries (whether or not such offer shall have been rejected or shall have been withdrawn prior to the time of such termination or of the meeting), Bell Atlantic shall pay to NYNEX a termination fee of $200 million (the "Initial Bell Atlantic Termination Fee"). In addition, if, within one and one-half years of any such termination described in clause (I) of the immediately preceding sentence that gave rise to the obligation to pay the Initial Bell Atlantic Termination Fee, Bell Atlantic, or the Significant Subsidiary of Bell Atlantic which was the subject of such Acquisition Proposal (the "Bell Atlantic Target Party"), becomes a subsidiary of the person which made (or the affiliate of which made) an Acquisition Proposal described in clause (ii) of the immediately preceding sentence or of any Offering Person or accepts a written offer to consummate or consummates an Acquisition Proposal with such person or any Offering Person, then, upon the signing of a definitive agreement relating to any such Acquisition Proposal, or, if no such agreement is signed then at the closing (and as a condition to the closing) of such Bell Atlantic Target Party becoming such a subsidiary or of any such Acquisition Proposal, Bell Atlantic shall pay to NYNEX an additional termination fee equal to $350 million."

Id. (quoting Amended and Restated Agreement and Plan of Merger § 9.2(c) (Apr. 21, 1996). The court noted that section 9.2(b) contained identical language, except that the term "NYNEX" replaced the term "Bell Atlantic" and vice versa. *See id.* at 46 n.1.

Bell Atlantic Board and to coerce the shareholders to vote to approve the proposed merger between Bell Atlantic and NYNEX.[38]

More specifically, the stockholders contended that

> "by agreeing to force their companies to pay up to $550 million in fees for the failure to obtain the required shareholder approval of the merger, the Bell Atlantic and NYNEX Boards of Directors have abdicated and impaired their fiduciary duties and effectively deprived their shareholders of their voting rights, since if they do not approve the merger, their company will suffer stiff penalties."[39]

Furthermore, the stockholders alleged that the termination fee provision failed as a valid liquidated damages clause because it did not represent an estimate of actual expenses incurred in preparation for the merger.[40] Plaintiffs stated in their complaint that the fees "'cannot possibly bear a reasonable relationship to the actual costs incurred in structuring the transaction, they constitute a penalty, rather than liquidated damages—a penalty that is borne by the shareholders.'"[41] Brazen's contention that the fee represented a penalty and not liquidated damages contradicted a provision of the Merger Agreement, which (perhaps anticipating such a suit) chose to characterize the break up fee provisions as "'an integral part of the transactions contemplated by this Agreement and constitute *liquidated damages and not a penalty*.'"[42] Thus, we arrive at the heart of the issue: how should termination fees be characterized? Are they liquidated damages or are they a penalty? Furthermore, what are the duties of the directors in negotiating such fees?

B. *Court of Chancery of Delaware Decision: The Business Judgment Rule Analysis*

The first issue discussed by the court of chancery was whether the provision in question constituted a termination fee

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[38] *See Brazen*, 1997 WL 153810, at *1 (citing Class Action Complaint ¶ 1).

[39] *Id.* at *2 (quoting Class Action Complaint ¶ 21).

[40] *See Brazen*, 695 A.2d at 46.

[41] *Brazen*, 1997 WL 153810, at *2 (quoting Class Action Complaint ¶ 22).

[42] *Brazen*, 695 A.2d at 46 (quoting Merger Agreement § 9.2(e)) (emphasis added).

or liquidated damages. Plaintiffs alleged in the complaint[43] that the termination fee constituted a breach of fiduciary duty and that it was a penalty, not merely liquidated damages. In its reply, defendant stated that plaintiff's

> "attack on the Agreement's liquidated damage clause is not based on a breach of fiduciary duty. Rather, plaintiff's claim arises from the fact that Section 9.2(c) of the Agreement is a legally invalid liquidated damage provision because it does not represent a reasonable forecast of damages resulting from any breach of the Agreement."[44]

The defendants argued that the Boards' determination to include the termination fee fell under the umbrella of the business judgment rule, and thus should be upheld absent a showing that the decision was "the product of disloyal action or a grossly negligent process."[45]

The court of chancery held that "the validity of termination fees depends upon the particular circumstances of each case."[46] The court looked to the most recent decision to consider the matter, *QVC Network, Inc. v. Paramount Communications, Inc.*[47] In that case, the court found that no fiduciary duty had been breached with respect to termination fees. Moreover, the Vice Chancellor found that the $100 million termination fee was the result of an "arm's length" negotiation and represented 1.2% of the value of the merger.[48] Thus, the fee "reasonably reflected the actual expenses Viacom estimated it would incur in making and defending its bid."[49]

The defendants, who argued that plaintiffs had made a claim neither based on a breach of fiduciary duty nor on the assumption that the magnitude of the termination fee discouraged other bidders, drew the court's attention to a previous case, *In re J.P. Stevens & Co.*,[50] in which the court stated,

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[43] *See Brazen*, 1997 WL 153810, at *2 (citing Class Action Complaint ¶ 22).

[44] *Id.* (quoting Plaintiff's Reply Brief, at 2).

[45] Defendants relied on the language of the court in the recent decision of *QVC Network, Inc. v. Paramount Communications, Inc.*, 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1993).

[46] *Brazen*, 1997 WL 153810, at *3.

[47] 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1993).

[48] *Brazen*, 1997 WL 153810, at *3.

[49] *QVC Network, Inc.*, 635 A.2d at 1271.

[50] 542 A.2d 770 (Del. Ch. 1988).

> if, as appears to be the case here, [a termination fee] is negotiated in good faith by a board with no apparent conflict, that is well-advised and follows a responsible, deliberate procedure, I am at a loss as to know what basis exists for declaring such a provision a violation of shareholder's rights.[51]

The plaintiffs, however, suggested that the directors failed to ensure that the fees were valid liquidated damages "reflective of a reasonable estimate of expenses that either party would incur in preparation for the merger and contend that this court's analysis should follow the analysis employed by the court in *Wilmington Housing Authority v. Pan Builders, Inc.*"[52] In *Wilmington Housing*,[53] the federal district court of Delaware enunciated a test to determine whether a liquidated damages provision was valid or whether it constituted an unenforceable penalty.[54] The test, now accepted in Delaware, is as follows:

> Where (1) the damages that would result from a breach are uncertain or incapable of accurate calculation by any accepted rule of law, and (2) the amount fixed is a reasonable forecast of such damages, the provision is one for liquidated damages and will be enforced like any other. Conversely, if the provision fails to meet one of these criteria, the damages stemming from a breach being easily ascertainable or the amount fixed excessive, the provision is void as a penalty.[55]

Taking the above arguments into consideration, the *Brazen* court decided that a liquidated damages analysis was not appropriate in this case.[56] Simply because the Merger Agreement referred to the fees in question as a "liquidated damages" provision, did not make the provision liquidated damages.[57] The court reasoned that liquidated damages, by definition, are

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[51] *Id.* at 783.

[52] *Brazen*, 1997 WL 153810, at *3.

[53] 665 F. Supp. 351 (D. Del. 1987).

[54] *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981) ("A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.").

[55] *Wilmington Hous. Auth.*, 665 F. Supp. at 355; *see also* Lee Builders v. Wells, 103 A.2d. 918 (Del. Ch. 1954).

[56] *See Brazen*, 1997 WL 153810, at *4.

[57] *See* Brazen v. Bell Atlantic Corp., 695 A.2d 43, 46 (Del. 1997) (citing Merger Agreement § 9.2(e)).

damages paid in the event of a breach of contract.[58] In the case at hand, however, the event which triggered the fee was not a breach, but rather a termination of the contract.[59] The court recognized that, in many cases, termination fee provisions have been "likened" to liquidated damages, but it nonetheless refused to continue such a tradition here due to the absence of a breach.[60] Referring to a prior out-of-state opinion, the court explained its understanding of the essential elements of liquidated damages: (1) the parties must intend to liquidate damages; (2) at the time the parties made the contract, the amount of liquidated damages must have been a reasonable estimate of the presumed actual damages the *breach* would cause; and (3) at the time the parties made the contract, it must have been difficult to determine the amount of actual damages that would have resulted from a *breach*.[61] The court held that implicit in all three of these elements is a breach of contract.[62]

The *Brazen* court further reasoned that even in-state, the breach of contract is an essential element implicit in liquidated damages provisions.[63] And to assuage any doubt that the fees in the instant case were triggered by termination rather than breach, the court pointed to the language of the Merger Agreement which stated that nothing in the Agreement (including the payment of termination fees) "'shall relieve any Party from liability for any willful *breach* hereof.'"[64] In other words, the Agreement itself conceded that the fees were triggered by something other than a breach. Therefore, the court concluded that the termination fees, which did not interfere with either party's right to recover damages from a *breach*, were protected by the business judgment rule and would not be invalidated absent a showing by plaintiff that the fees' inclusion in the Agreement was a result of disloyal or grossly negligent acts.[65]

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[58] *See Brazen*, 1997 WL 153810, at *4.

[59] *See id.*

[60] *Id.*

[61] *See* St. Jude Medical, Inc. v. Medtronic, Inc., 536 N.W.2d 24, 28 (Minn. Ct. App. 1995).

[62] *See Brazen*, 1997 WL 153810, at *4.

[63] *See id.* (citing Wilmington Hous. Auth. v. Pan Builders, Inc., 665 F. Supp. 351, 355 (D. Del. 1987)).

[64] Brazen v. Bell Atlantic Corp., 695 A.2d 43, 46 (Del. 1997) (quoting Merger Agreement § 9.2(a)(ii)).

[65] *See Brazen*, 1997 WL 153810, at *4 (citing QVC Network, Inc. v. Paramount

Once the *Brazen* court determined that the fees in question constituted "termination fees" rather than liquidated damages, it then examined the very validity of such termination fees. The plaintiffs asserted that Bell Atlantic's directors "'breached their fiduciary duty owed to the Company's common shareholders . . . by effectively depriving themselves and the shareholders of their right to approve or disapprove the merger transaction.'"[66] In particular, plaintiffs alleged that the shareholders were deprived of their rights because the excessive termination fees loomed like a black cloud, and, in effect, coerced the Bell Atlantic shareholders into approving the merger.[67]

To determine the validity of the termination fees, the court articulated a two-prong test. The first prong analyzed whether the directors had breached their fiduciary duty to the common shareholders. As the court noted, the record revealed that the termination fees were the result of an arm's length negotiation.[68] Although the fee was initially proposed by NYNEX, it was understood from the outset that the provision was to be reciprocal.[69] Thomas McKeough, Bell Atlantic's Vice President of Mergers and Acquisitions, Associate General Counsel, and senior negotiator testified that the parties negotiated the size of the termination fee,[70] guided by a desire to reflect the out-of-pocket costs that each party would incur in preparation for the merger, as well as each party's lost opportunity costs incurred as a result of focused efforts on the deal at hand.[71] Both parties recognized that due to the recently enacted Telecommunications Act of 1996, which allowed the regional Bell

Communications, Inc., 635 A.2d 1245, 1270 (Del. Ch. 1993); *In re* J.P. Stevens & Co., Inc., 542 A.2d 770, 783 (Del. Ch. 1988)).

[66] *Brazen*, 1997 WL 153810, at *4 (quoting Class Action Complaint ¶ 23).

[67] *See id.*

[68] *See id.*

[69] *See id.* (citing Thomas R. McKeough, Bell Atlantic's Vice President of Mergers and Acquisitions, Associate General Counsel, and senior negotiator [hereinafter McKeough Affidavit]).

[70] Originally, the proposal was for a two-tiered $750 million termination fee, with $400 million payable if a competing acquisition proposal was received prior to either a shareholder rejection or other termination of the agreement, and $350 million payable if the competing acquisition proposal resulted in a merger. *See id.* (citing Klaunder Deposition at 17-18, 19-20; Defendant's Objections and Responses to Plaintiff's First Set of Interrogatories at 3-4).

[71] *See Brazen*, 1997 WL 153810, at *2 (citing McKeough Affidavit at 2).

companies to enter into new fields of business, a flurry of merger activity was sure to sweep over the industry.[72] McKeough stated, "'the prospect of missing out on alternative transactions due to the pendency of the merger was a very real one.'"[73]

The parties eventually agreed upon the $550 million fee in question. During negotiations, the parties also discussed various justifications for the fee, including the relationship between the fee and market capitalization, and evaluated the negotiated fee in light of Delaware rulings on the reasonableness of such fees. Because the plaintiffs offered no evidence to rebut defendant's explanation of the decision-making process, the court concluded the plaintiffs "fail[ed] to identify any act revealing that the directors were disloyal or grossly negligent."[74]

The second prong for the court to consider was whether the Bell Atlantic shareholders were coerced by the termination fee. The court first explained its understanding of the business judgment rule and reiterated its conclusion that the termination fees in the Merger Agreement resulted from a valid exercise of business judgment. However, the court recognized the exception to the business judgment rule. It noted that the business judgment rule will not protect the Board of Directors if the existence of the fee and the threat of payment "inequitably coerced shareholder approval of the Merger Agreement."[75]

The court's analysis of coercion was extremely fact sensitive.[76] The court explained that what might be construed as inequitably coercive in some circumstances might still be coercive in others, but not inappropriately so.[77] Further, the court stated that in order to determine whether a particular circumstance of the shareholder vote was impermissibly coercive, one must consider whether the existence of that circumstance oper-

[72] *See* ANDREWS CORP. OFFICERS & DIRECTORS LITIG. REP. 21, 105 (June 25, 1997), *available in* WL Andrews Corp. Off. & Directors Liab. Litig. Rep. 21403.

[73] *Brazen*, 1997 WL 153810, at *2 (quoting McKeough Affidavit at 2).

[74] *Id.* at *4.

[75] *Id.* at *5; *see also* Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051 (Del. Ch. 1987); Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986).

[76] *See* Williams v. Geier, 671 A.2d 1368, 1383 (Del. 1996).

[77] *See Brazen*, 1997 WL 153810, at *5.

ated inequitably to coerce shareholders into approving the Merger Agreement for reasons other than the benefits of the transaction itself.[78]

Upon examination of the whole transaction, the court stated that it could not conclude that the existence of the termination fee actually coerced shareholder approval of the merger. The court recognized that the "possibility of paying the fee may have influenced the vote," but the court also noted that the shareholders did not have a chance to consider the Merger Agreement without the fee, so there was no definitive proof that the fee had any effect on the outcome.[79] As the expected benefits of the merger far outweighed the potential costs of the fees,[80] the court could not conclude that the termination fees had been impermissibly coercive and found in favor of the defendant, Bell Atlantic.[81] The *Brazen* plaintiffs appealed to the Supreme Court of Delaware.[82]

C. *Supreme Court of Delaware Decision: Liquidated Damages Rubric*

The first issue considered on appeal was whether to view the provision in question as liquidated damages or as a "termination fee." Unlike the lower court, the Supreme Court of Delaware was swayed by the plaintiffs' arguments and determined that the proper characterization of the fee was as liquidated damages.[83] It therefore follows that the supreme court abandoned the use of the business judgment rule in favor of using a different test to analyze the validity of the termination fee provision.[84]

The court placed great emphasis upon the stated intentions of the parties. The court found the express language of the Merger Agreement characterizing the termination fee provision as "'liquidated damages and not a penalty'" to be persua-

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[78] *See id.* (citing *Williams*, 671 A.2d at 1383).
[79] *Id.*
[80] *See id.*
[81] *See id.*
[82] *See* Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997).
[83] *See id.* at 47.
[84] *See id.*

sive.[85] Furthermore, the supreme court acknowledged that the Delaware Court of Chancery had correctly found that liquidated damages are damages paid in the event of a breach of contract,[86] however, unlike the court of chancery, the supreme court took the position that the termination fee could, in fact be triggered by a breach as opposed to an outright termination.[87] The supreme court stated:

> While a breach of the merger agreement is not the only event that would trigger payment of the termination fee, the express language of section 9.2(c) states that a party's breach of section 7.2 (which provides that the parties are required to take all action necessary to convene a stockholder's meeting and use all commercially reasonable efforts to secure proxies to be voted in favor of the merger), coupled with other events, may trigger a party's obligation to pay the termination fee.[88]

In light of the expressed intent of the parties, then, the supreme court found no justification for regarding the termination fee in the Agreement as anything other than a liquidated damages provision.[89]

After the supreme court determined that the provision constituted liquidated damages, the court proceeded to analyze the validity of the liquidated damages and eventually concluded that the provision was, in fact, sound. The court enunciated a two-prong test to be used in analyzing the validity of liquidated damages: "'Where the damages are uncertain and the amount agreed upon is reasonable, such an agreement will not be disturbed.'"[90] Plaintiffs argued that the termination fee would fail as liquidated damages, as both tiers of the two-tiered fee were punitive rather than compensatory, not related to the actual damages, but instead designed to punish Bell Atlantic stockholders and the subsequent third-party acquirer supposing Bell Atlantic were to ultimately merge with another entity.[91] The Supreme Court of Delaware disagreed.[92] In its

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[85] *Id.* at 46 (quoting Merger Agreement § 9.2(e)).

[86] *See Brazen*, 1997 WL 153810, at *4; RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981).

[87] *See Brazen*, 695 A.2d at 47.

[88] *Id.* at 47-48.

[89] *See id.* at 48.

[90] *Id.* (quoting Lee Builders v. Wells, 103 A.2d 918, 919 (Del. Ch. 1954)); *accord* Wilmington Hous. Auth. v. Pan Builders, Inc., 665 F. Supp. 351, 354 (D. Del. 1987); RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981).

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

analysis, the court noted that plaintiff did not attack the fee on the first prong of analysis. That is, the plaintiffs conceded that the damages that would result from a breach of the Merger Agreement would be uncertain or incapable of accurate calculation.[93] The court reasoned that because of the uncertainty in the telecommunications industry and, specifically, the recent ratification of the Telecommunications Act of 1996, the potential damages from a breach of the merger agreement would be nearly impossible to calculate with any precision or accuracy.[94]

However, Brazen did attack the second prong of the liquidated damages test. The plaintiffs contended that the $550 million termination fee was not a reasonable forecast of the actual damages that would result from a breach, but rather was a penalty intended to punish the Bell Atlantic shareholders for not approving the merger.[95] The court summarily dismissed plaintiffs' attack. The court explained that there are two factors to consider when determining whether the amount fixed as liquidated damages is reasonable. First, the court had to consider the anticipated loss to either party had the merger not occurred, and second, the court had to consider the difficulty in calculating that loss. The greater the difficulty in calculating the anticipated loss, the more likely it will be that the court will find the amount fixed reasonable.[96] The court concluded that in order to fail the second prong of the liquidated damages test, as first enunciated in *Lee Builders v. Wells*, the fixed amount at issue must be "unconscionable or not rationally related to any measure of damages a party might conceivably sustain."[97]

In order to ascertain whether the fee was reasonable, the supreme court examined the factors that were considered by each of the parties in negotiating the termination fee provision of the Merger Agreement. The court recognized four distinct factors in composing the fee: (a) the opportunity costs of each party associated with their agreement to deal exclusively with

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[92] *See id.*
[93] *See id.*
[94] *See id.*
[95] *See id.*
[96] *See Brazen*, 695 A.2d at 48.
[97] *Id.*

one another; (b) the expenses incurred over the course of negotiating the transaction; (c) the likelihood of a higher bid emerging for the acquisition of either party; and (d) the size of the termination fees in other merger transactions.[98] The court also recognized that the parties took all of these considerations into account when negotiating the $550 million fee.[99] In its analysis, the court concentrated heavily on the last factor—the relative size of the termination fee as a percentage of the market capitalization of the entire transaction—and eventually agreed with Bell Atlantic that the fee was reasonable and did not constitute a penalty.[100]

Having decided on the two prongs of the liquidated damages analysis, the court further discussed the differences between the business judgment rule and the liquidated damages rubric. Whereas the business judgment rule analysis pays no respect to the reasonableness, or the substance of the decision, the liquidated damages rubric pays close attention to the substance of the decision.[101] It is because of this distinction, the court stated, that the business judgment rule was inapplicable in this case.[102] The business judgment rule is simply a process inquiry into the board's decision-making. Under such an analysis, courts generally give deference to the substance of the decisions so long as the appropriate steps are taken by the board in reaching the given decision.[103] In the instant case, however, at issue was not simply the decision-making process by which the directors reached the termination fee. At issue

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[98] *See id.* at 48-49.

[99] *See id.* at 49.

[100] *See id.*

[101] *See Brazen*, 695 A.2d at 49.

[102] *See id.*

[103] *See* Paramount Communications, Inc., v. QVC Network, Inc., 637 A.2d 34, 42 (Del. 1993) ("Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled . . . . Nevertheless, there are rare situations . . . [where the business judgment rule does not apply and] a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable."); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose.").

was the fee itself. Therefore, the only way to analyze the substance of the fee was to utilize a test other than the business judgment rule. In this case, the liquidated damages rubric was applicable.

The last issue that the court addressed was that of stockholder coercion. The plaintiffs argued that the fee was coercive to the stockholders in that the stockholders never had the option to consider the Agreement without the termination fee, and thus regardless of what they thought of the merits of the transaction, the possibility of the termination fee was a looming factor. Plaintiffs contended that the termination fee was so large that it actually influenced the vote.[104] The court was not persuaded by plaintiffs' arguments, however, and found no grounds to hold the fee coercive.[105]

The court analyzed the issue of coercion on three levels. First, the court had already determined that the fee was not egregiously large.[106] Second, the court argued that the fact that the stockholders knew of the termination fee and the effect it might have did not, by itself, constitute coercion. Last, the court was unable to find authority to support plaintiffs' contention that the fee was coercive because it was triggered by shareholder disapproval of the merger rather than other events resulting in termination of the Agreement.[107]

The test for stockholder coercion was enunciated in *Williams v. Geier*.[108] The *Williams* court explained that impermissible coercion occurs "'where the board or some other party takes actions which have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction.'"[109] However, as a qualification, the court in *Williams* also stated, "[i]n the final analysis . . . the determination of whether a particular stockholder vote has been robbed of its effectiveness by impermissible coercion depends on the facts of the case."[110]

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[104] *See Brazen*, 695 A.2d at 49.
[105] *See id.* at 50.
[106] *See id.*
[107] *See id.*
[108] 671 A.2d 1368, 1382-83 (Del. 1996).
[109] *Brazen*, 695 A.2d at 50 (quoting *Williams*, 671 A.2d at 1383).
[110] *Williams*, 671 A.2d at 1383.

In *Brazen*, the Supreme Court of Delaware reasoned that the plaintiff had provided no evidence to show that the stockholders voted for the merger for reasons other than the merits of the transaction. In fact, the court proposed that the reciprocal fees may have been an integral part of the merits of the transaction.[111] Therefore, the court found that "although the termination fee may have influenced the stockholder vote, there were 'no structurally or situationally coercive factors' that made an otherwise valid fee provision impermissibly coercive in this setting."[112] Thus, the court concluded that because actual damages in this case were not easily calculable, because the $550 million termination fee represented a reasonable forecast of damages, and because the fee was neither coercive nor unconscionable, the fee was a valid liquidated damages provision.[113]

II. CONTRACT LAW ISSUES SURROUNDING THE BREAK-UP FEE

The main problem when dealing with the validity of termination fees is whether to consider the fee as liquidated damages or as a penalty. This issue is at the crux of the analysis of the break-up fee and influences how the other contested issues will be handled by the courts. As seen in *Brazen v. Bell Atlantic Corp.*,[114] the Supreme Court of Delaware was convinced, in large part by the intentions of the parties, that the liquidated damages rubric was the appropriate analysis.[115] However, this was the first Delaware Supreme Court decision of its kind, for up until this point, the court had utilized the business judgment rule to support the validity of the termination fee as just that, a fee, and not as liquidated damages.[116]

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[111] *See Brazen*, 695 A.2d at 50.

[112] *Id.* (quoting Brazen v. Bell Atlantic Corp., No. Civ. A. 14976, 1997 WL 153810, at *5 (Del. Ch. Mar. 19, 1997)).

[113] *See id.*

[114] 695 A.2d 43 (Del. 1997).

[115] *See id.* at 47 (referring to section 9.2(e) of the Merger Agreement, which stated that the termination fee provisions "'constitute liquidated damages and not a penalty.'").

[116] *See, e.g.*, Brazen v. Bell Atlantic Corp., No. Civ. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997); QVC Network, Inc. v. Paramount Communications, Inc., 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1993).

A. *Liquidated Damages v. Penalties*

Determining whether to view the termination fee as either a fee or as liquidated damages has major ramifications with regard to its validity. Under the business judgment rule analysis, a termination fee may be deemed valid, but under a heightened analysis such as the liquidated damages rubric, the same fee may be deemed invalid.[117]

It has long been the rule that penalties agreed upon by contracting parties will not be enforced by the courts.[118] This equitable rule, now widely adopted by courts, was designed to prevent over-reaching and to avoid unconscionable bargains.[119] In general, the courts show great deference to the longstanding principle of freedom of contract, and they allow parties to contract with great leeway regarding primary rights.[120] However, courts reserve the right to intervene with regard to remedial rights.[121] Legal remedies are provided by the state in the public forum and are not defined in private law.[122] Thus, parties to a merger agreement, intending the termination fee to be a valid provision of the agreement, would not want the termination fee to be viewed as a penalty.

Although parties may not expressly provide for penalties in a contract in the event of a breach, they are entitled to predetermine what damages will be assessed in the event of a breach of contract by one of the parties.[123] These are "liquidated damages."[124] As first enunciated in *Lee Builders v. Wells*,[125] several criteria distinguish penalties from liquidated

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[117] Of course, there is the possibility of the fee being deemed valid under both analyses, as was the case in *Brazen v. Bell Atlantic Corp.* The Court of Chancery of Delaware validated the fee using the business judgment rule analysis, *see Brazen*, 1997 WL 153810, and the Supreme Court of Delaware affirmed the judgment, but used the liquidated damages rubric instead. *See Brazen*, 695 A.2d at 43.

[118] *See* JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 14-31 (3d ed. 1987).

[119] *See id.* § 14-31. The courts' refusal to enforce such penalties, as provided in contracts, is somewhat at odds with the deep-rooted principle of freedom of contract.

[120] *See id.*

[121] *See id.*

[122] *See id.*

[123] *See* CALAMARI & PERILLO, *supra* note 118, § 14-31.

[124] BLACK'S LAW DICTIONARY 391 (6th ed. 1990).

[125] 103 A.2d 918 (Del. Ch. 1954).

damages. The court in *Lee Builders* stated, "Where the damages are uncertain and the amount agreed upon is reasonable, such [a liquidated damages] agreement will not be disturbed."[126] Two components, uncertain damages and reasonableness of the amount, constitute the basis of valid liquidated damages clauses.

John D. Calamari and Joseph M. Perillo break down the analysis further, identifying three parts to a valid liquidated damages provision.[127] The first part requires that the parties must intend for the provision in question to constitute liquidated damages rather than a penalty.[128] The second and third parts are similar to the guidelines put forth in *Lee Builders*. The second part requires that the damages be uncertain or difficult to quantify.[129] In discussing this component, Calamari and Perillo list five kinds of uncertainty: (1) difficulty in producing proof of damages after the breach has occurred, (2) difficulty in determining which damages were a direct result of the breach, (3) difficulty in determining what damages were contemplated at the time of contract, (4) absence of any standardized measure of damages for a certain breach, and (5) difficulty in forecasting, at the time of contract, all of the possible damages stemming from any possible breaches.[130] All five of these possibilities are entirely applicable to the uncertainty surrounding damages resulting from a failed merger or acquisition. The liquidated damages provision must also be reasonable.[131] Specifically, the damages stipulated in the contract

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[126] *Id.* at 919.

[127] *See* CALAMARI & PERILLO, *supra* note 118, § 14-31.

[128] *See id.* However, it should be noted that Calamari and Perillo go on to minimize the importance of the "intent" component of valid liquidated damages. *See id.* In many cases, courts have upheld provisions labelled as penalties, while they have struck down provisions labelled as liquidated damages. Most importantly, neither section 2-718 of the Uniform Commercial Code nor section 356 of the Restatement (Second) of Contracts list intention as a relevant factor for determining the validity of such provisions. In fact, section 356 of the Restatement (Second) of Contracts states: "Neither the parties' actual intention as to its validity nor their characterization of the term as one for liquidated damages or a penalty is significant in determining whether the term is valid." RESTATEMENT (SECOND) OF CONTRACTS § 356 (Comment (c) (1981)).

[129] *See* CALAMARI & PERILLO, *supra* note 118, § 14-31(b).

[130] *See id.* (citing Ian R. Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 502 (1962)).

[131] *See id.* § 14-31(c).

must be a reasonable estimate of the provable loss.[132] As stated in the Restatement (Second) of Contracts, the reasonableness of the amount is measured "in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss."[133] If a liquidated damages clause is deemed to be unreasonably high, then it will be found void as a penalty.[134]

The *Lee Builders* analysis of a liquidated damages clause is really paradoxical, then. On the one hand, courts insist that the damages be uncertain; on the other hand, the stipulated damages must be a reasonable estimate. As would be expected, it is the reasonableness component and not the uncertainty component that is most often the issue contested, hence *Brazen*.[135] However, as with the case of uncertainty, there are several sub-issues that arise amid the discussion of reasonableness. Disputes arise in a number of different situations. Sometimes damages clauses seem reasonable when drafted, but then appear unreasonable in light of the circumstances surrounding the breach.[136] Some damages provisions seem reasonable with regard to some types of breaches, but not with regard to others.[137] Finally, some clauses are drafted to limit damages to an amount far below those foreseeable.[138] As for break-up fees in mergers and acquisitions, the actual damages at the time of breach (or termination) could conceivably be inaccurately estimated at the time of drafting, especially in cases like *Brazen*, where the dynamics of the telecommunications industry have a tremendous and volatile effect on the opportunity costs associated with any transaction within that industry. In order to understand how the court deals with these various issues, it is important to recognize the policy behind invalidating certain stipulated damages provisions.

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[132] *See id.* § 14-31.

[133] RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981).

[134] *See* CALAMARI & PERILLO, *supra* note 118, § 14-31(c).

[135] *See* Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense of Nonsense?*, 1978 WIS. L. REV. 351, 355-56 (1978).

[136] *See id.* at 356.

[137] *See id.*

[138] *See id.*

B. *Unconscionability*

One of the main grounds on which a liquidated damages provision may be deemed unreasonable is that of unconscionability.[139] The vast topic of unconscionability can be divided into two main categories: procedural and substantive.[140] Procedural unconscionability refers to the bargaining process by which the damages provision is negotiated and finalized.[141] In the field of mergers and acquisitions, procedural unconscionability can occur where the two companies are not of equal strength and bargaining power.[142] In effect, one party bullies the other party over the course of the negotiations as a result of its position of relative bargaining superiority. However, in a case where the two contracting companies are of equal bargaining power, and thus there is no procedural impropriety, a court may still find a damages provision to be substantively unconscionable.[143] Where the stipulated damages in question are deemed excessive, a court may find them substantively unconscionable, as was argued in *Brazen*.[144] The key, then, is determining precisely what constitutes an "excessive amount."

C. *Just Compensation*

Put simply, just compensation represents the theory that "'justice requires nothing more than compensation measured by the amount of the harm suffered.'"[145] At the heart of the theory of just compensation is the central assumption that enforcement of an *in terrorem* provision will overcompensate

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[139] *See id.* at 357.

[140] *See* Clarkson et al., *supra* note 135, at 357 (citing Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. LAW & ECON. 293, 301-15 (1975); Arthur Allen Leff, *Unconscionability and the Code–The Emperor's New Clause*, 115 U. PA. L. REV. 485, 489-528 (1967)).

[141] *See* Clarkson et al., *supra* note 135, at 358. Procedural unconscionability would be required to invalidate a liquidated damages provision under the business judgment rule analysis, which was used in the Delaware Court of Chancery decision of *Brazen v. Bell Atlantic Corp*, No. Civ. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997).

[142] *See* Clarkson et al., *supra* note 135, at 358.

[143] *See id.*

[144] *See id.*

[145] *Id.* (quoting A. CORBIN, CORBIN ON CONTRACTS: A COMPREHENSIVE TREATISE ON THE WORKING RULES OF CONTRACT LAW § 1057, at 334 (1964)).

the non-breaching party.[146] The rule against penalties is designed as a protection against unfair recovery in excess of justifiable reliance,[147] as well as a protection against performance of a contract out of fear of a penalty in a situation where it would be more economically efficient to breach.[148] Both of these concepts are closely related to the termination fee analysis, falling under the headings of unreasonableness and shareholder coercion, respectively.

This modern view of contractual damages is founded upon the premise that a contractual duty is not necessarily an obligation to perform.[149] Rather, the contractual duty is, in effect, an option to choose between performance of the obligation or compensatory damages.[150] Once the contract has been negotiated and finalized, the parties are required to provide compensation equivalent to the value of performance.[151] In the context of the current discussion, the parties may either complete the contemplated transaction or pay the break-up fee. Provided that the compensation closely reflects the value of performance, this damages rule is efficient.[152] However, if the compensation constituted in the stipulated damages clause is grossly disproportionate to the value of performance, then the damages scenario is inefficient, because one party will be induced to breach in order to reap the benefits of the discrepancy between the value of damages and the value of performance.

The invalidation of liquidated damages clauses has traditionally been based on one of two theories.[153] The first is that the stipulated damages are unreasonable—that they are so disproportionate to actual damages as to require the court to infer that the agreement was procured by fraud, oppression, or

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[146] *See* Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 556 (1977).

[147] *See id.* (citing Ian R. Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495, 499-501 (1962)).

[148] *See id.* (citing R. POSNER, ECONOMIC ANALYSIS OF LAW, 55-60 (1973); H. Richard Hartzler, *The Business and Economic Functions of the Law of Contract Damages*, 6 AM. BUS. L.J. 387, 392-93 (1968)).

[149] *See id.* at 558.

[150] *See id.*

[151] *See* Goetz & Scott, *supra* note 146, at 558.

[152] *See id.*

[153] *See id.* at 560.

mistake.[154] This broadly falls into the category of procedural unconscionability, as previously discussed. The second theory for striking down liquidated damages clauses is based upon the concept of just compensation, which is closely related to substantive unconscionability.[155] The idea is that since the courts set damages based on the theory of just compensation, individual parties should not be able to recover more than just compensation through a privately negotiated agreement, even if the contract was reached through the fairest of ways.[156]

D. *Economic Policy*

By examining the economic distinction between liquidated damages and penalties, the court can often map out the costs and benefits of the given clauses and, on that basis, decide whether to let the stipulated clause stand or declare it invalid.[157] There are costs involved in all transactions, and mergers and acquisitions often produce some of the highest costs of all.[158] The stipulated damages agreement allows the contracting parties to allocate certain costs in the event that the transaction is not completed. In the event that a contract does not provide for liquidated damages, though, the courts have well-defined guidelines for allocating these costs.[159] Thus, any damages stipulated in the agreement should be in accord with the guidelines used by the courts in order to insure economic efficiency and fairness.

III. CORPORATE LAW ISSUES SURROUNDING THE BREAK-UP FEE

Adopting the liquidated damages rubric, the Delaware Supreme Court focused on the contractual issues surrounding the termination fee. The court analyzed the substance of the fee, not simply the process by which the fee was negotiated. In the

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[154] *See id.* (citing Sun Printing & Publ'g Ass'n v. Moore, 183 U.S. 642 (1901)).
[155] *See id.* at 561.
[156] *See* Goetz & Scott, *supra* note 146, at 561 (citing Jaquith v. Hudson, 5 Mich. 123, 133 (1858)).
[157] *See* Clarkson et al., *supra* note 135, at 366.
[158] *See* Skeel, *supra* note 15, at 567-68.
[159] *See* Clarkson et al., *supra* note 135, at 367.

cases prior to the most recent *Brazen* decision by the Delaware Supreme Court, however, the termination fee was scrutinized with the focus on corporate law issues. To understand the differences between the old analysis and the new liquidated damages rubric, it is necessary to discuss the corporate law issues on which these prior decisions relied.

A. *Fiduciary Duties of the Board of Directors*

Courts, in applying the fiduciary duty analysis, have consistently held that the use of break-up fees in merger and acquisition agreements is not per se illegal.[160] Under such an analysis, judicial review has generally been restrained to a procedural one—namely, the process by which the directors make the decision regarding the inclusion of the termination fee.[161] This limited review theoretically leads to a result in which the termination fee would be found valid more frequently than under the heightened analysis of liquidated damages, in which the substance (not just the procedure) is considered. As discussed *infra*, though, this is not case. In general, there are several fiduciary duties owed to a corporation and its shareholders, and a breach of any one of these duties may result in the invalidation of the termination fee by the courts.[162]

1. Duty of Loyalty

Primarily, the duty of loyalty demands that the director place the interests of the corporation ahead of his own personal interests.[163] The director has an obligation to refrain from any conduct that may damage the corporation, deprive it of profits, or disable it from making reasonable business decisions and exercising its lawful powers.[164] The duty requires that the director maintain an unselfish loyalty to the corporation

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[160] *See* Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 373 (1987).

[161] *See id.* at 374.

[162] *See* Ellen Taylor, *New and Unjustified Restrictions on Delaware Director's Authority*, 21 DEL. J. CORP. L. 837, 879 (1996).

[163] *See id.*

[164] *See* Curtis Huff, *Fiduciary Obligations of Directors in Considering and Responding to Acquisition Proposals*, 1013 PLI/CORP 561, 566 (1997).

and that there not be any conflict between the director's duty to the corporation and his self-interest.[165] If the case arises where there is a potential conflict of interest, the director is required either to disclose the conflict or to abstain from participating in any decision which may have a hint of impropriety.[166]

Stephen Bainbridge argues that inherent in all mergers and acquisitions is the potential for a conflict between the interests of the shareholders and the interests of the target directors.[167] He notes that, in hostile takeovers, if the bidder is successful, then the target directors face the probability that they will lose their jobs; yet, if the target directors can successfully ward off the hostile raider, then the target directors will retain their positions, but the shareholders will forgo a premium for their shares.[168]

Similarly, in negotiated acquisitions of a friendly nature the directors and management are often tainted by self-interest as well.[169] Because board approval is required in most cases for a transaction to occur, the bidder may find it useful to offer certain enticements to the target directors in order to sway their decision.[170] Generally, these "side payments" will

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[165] *See* Guth v. Loft, 5 A.2d 503, 509 (Del. 1939). The court stated that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . . [A]n undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest." *Id.* at 509. This has come to be known as the "corporate opportunity doctrine."

[166] *See* Taylor, *supra* note 162, at 880.

[167] *See* Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 272 (1990). In a footnote, Bainbridge explains that corporate acquisitions constitute a classic example of what economists refer to as "final period problems." *Id.* at 272 n.152. When two parties conducting business expect that they will conduct repeat transactions, the likelihood of self-dealing by one party is reduced by the risk that the other party will punish that cheating party in future transactions. However, in "final period" transactions, the constraint and threat of retribution disappears. *See id.* (citing R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 579 (1986)).

[168] *See id.* at 273.

[169] *See id.*

[170] *See* Bainbridge, *supra* note 167, at 273. These enticements can include, but are not limited to, such arrangements as the "golden parachute," equity in the surviving entity, employment contracts, fringe benefits, or other compensation schemes. The "golden parachute" refers to "substantial severance payments." *Id.* at 273-74 (citing Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 618 (S.D.N.Y. 1987) (white knight offered target management equity stake); Singer v.

not be influential enough to materially affect the transaction price, but they may be influential enough to affect the target board's decision to accept the proposed bid.[171] Ultimately, that board decision may be contrary to the shareholder's best economic interests.[172] In terms of this discussion, the effect could be that directors would approve a merger agreement including an oppressive termination fee provision simply because their interests were tainted by the consideration of enticements or "side payments."

2. Duty of Care

The fiduciary duty of care requires a director to exercise his business judgment in acting on behalf of the corporation.[173] The director must act in good faith and with due care and must inform himself of all material information reasonably available to him at the time of a decision.[174] Prior to *Smith v. Van Gorkom*,[175] the Delaware courts required plaintiffs to show that directors had been grossly negligent in order to prove a case of director liability for breach of duty of care.[176] However, in that case, rather than continue the grossly negligent standard, the Delaware Supreme Court found Van

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Magnavox Co., 380 A.2d 969, 974 (Del. 1977) (target directors offered employment contracts); Repairman's Service Corp. v. National Intergroup, Inc., No. 7811, slip op. (Del. Ch. Mar. 15, 1985), *reprinted in* 10 DEL. J. CORP. L. 902, 907 (1985) (plaintiff claimed target managers sought "preferences for themselves" in surviving entity); Gilbert v. El Paso Co., 490 A.2d 1050, 1054 (Del. Ch. 1984), *aff'd*, 575 A.2d 1131 (Del. 1990) (plaintiff alleged tender offeror modified bid to benefit target managers)).

[171] *See* Bainbridge, *supra* note 167, at 274. Bainbridge explains that in negotiated acquisitions, there may be a "'force more subtle than a desire to maintain a title or office in order to assure a continued salary or perquisites.'" *Id.* (quoting Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989)). He argues that many directors and top managers derive their identity, in part, from their organization, and conversely, these directors and top managers feel that they contribute to the identity of the organization. *See id.* It is not a purely economic consideration, in other words–there is a sentimental and emotional attachment between the organization and its directors. *See id.*

[172] *See id.* at 275.

[173] *See* Huff, *supra* note 164, at 565.

[174] *See id.* at 566 (citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)).

[175] 488 A.2d 858 (Del. 1985).

[176] *See* Taylor, *supra* note 162, at 882 (citation omitted).

Gorkom liable for a breach of duty of care for his failure to "'act in an informed and deliberate manner.'"[177]

However, there are additional specifications for the duty of care when it comes to a change in control of the corporation. When the directors of a corporation are faced with the possibility of a sale or change of control of the corporation, the directors have one primary concern. They must attempt to secure the best value reasonably available to the shareholders, and to that end, the directors must be painstakingly thorough.[178] The Delaware Supreme Court stated this clearly in *Paramount Communications, Inc. v. QVC Network, Inc.*[179] when it held, "[A] change of control imposes on directors the obligation to obtain the best value reasonably available to the stockholders . . . ."[180] Yet there are several nuances to these enhanced duties.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[181] the Delaware Supreme Court held that after the point at which it is clear that the corporation will be sold, the duty

[177] *Id.* at 882 (quoting *Van Gorkom*, 488 A.2d at 873).

[178] *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 44 (Del. 1994).

[179] 637 A.2d 34 (Del. 1994).

[180] *Id.*

[181] 506 A.2d 173 (Del. 1986). In *Revlon*, a bidding war broke out over Revlon between Pantry Pride, Inc. and Forstmann Little & Co. Pantry Pride initiated the bidding by offering $47.50 per share for Revlon, and Revlon immediately defended itself from this unsolicited bid by rearranging its debt/equity ratio and other various defensive measures. After several changes in the Pantry Pride bid, Revlon entered into an agreement with Forstmann Little, as a "white knight," in which Revlon would be sold to Forstmann in the form of a leveraged buy-out at a price of $56.00 per share. Pantry Pride then increased its offer to $56.25 per share and Forstmann countered with $57.25 per share, subject to a lock-up provision, a no-shop provision, and a break-up fee. This Forstmann offer was unanimously approved by the board of Revlon. Immediately following, Pantry Pride sought a preliminary injunction against Forstmann and sought to set aside the lock-up and termination fee. In conjunction with that, Pantry Pride increased its offer to $58.00 per share. The Chancery Court of Delaware struck down the lock-up provision as being tainted with management's desire to protect themselves from liability as against noteholders. *See* MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985). The Supreme Court of Delaware affirmed the decision. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). With respect to the break-up fee and the lock-up option, the Court commented that while provisions of that nature may entice some bidders to enter a bidding war, if the provisions effectively end an ongoing auction and terminate continued bidding then it may exist to the stockholders' detriment rather than their benefit. *See Revlon*, 506 A.2d at 183.

of the board becomes analogous to that of the "auctioneer"–both have the responsibility of fetching the highest price for the corporation and the shareholders they represent.[182] These duties are not absolute, however. There are several variations depending on the nature of the transaction at issue.

In a hostile takeover, the Delaware Supreme Court articulated a standard of judicial review to be applied to the Board of Directors in *Unocal Corp. v. Mesa Petroleum Co.*[183] The court enunciated a two-part test for determining whether the actions taken by the Board of Directors will be afforded the protection of the business judgment rule. First, the burden of proof will be on the directors to show that they had reasonable grounds for believing that there existed a danger to the corporate policy, and second, the defensive measure in question must be shown to have been reasonable in light of the takeover threat.[184] The Delaware Supreme Court stated in *Unitrin, Inc. v. American General Corp.*,[185] however, that these "*Unocal* standards" would not apply to responses to offers to merge, i.e., negotiated friendly transactions.[186] The court made a clear distinction between hostile, unsolicited takeovers and friendly, negotiated merger transactions.

Paramount Communications, Inc. v. Time Inc.[187] illustrates exactly that contention. The Delaware Supreme Court identified two scenarios in which the enhanced "*Revlon* duties" would be implicated. Firstly, these duties would be implicated "when a corporation initiates an active bidding process seeking to sell itself or effect a business reorganization involving a clear break-up of the company," and secondly, "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the break-up of the company."[188] However, in the case of a stock merger between two corporations in which there would

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

[183] 493 A.2d 946 (Del. 1985).

[184] *See* Huff, *supra* note 164, at 955 (citing Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985)).

[185] 651 A.2d 1361 (Del. 1995).

[186] *Id.* at 1375 n.16.

[187] 571 A.2d 1140 (Del. 1989).

[188] Huff, *supra* note 164, at 589-90 (citing *Paramount Communications, Inc.*, 571 A.2d at 1150).

be formed an ongoing business combination permitting stockholders to retain equity in the new entity, the Court held that this would not constitute a "break-up" or "sale" of the corporation and, thus, would not implicate the "*Revlon* duties."[189] In other words, because there was no sale or break-up of the company, the court viewed the transaction as a strategic business combination in which price may not be the primary motivating factor.[190]

3. Business Judgment Rule

The business judgment rule represents the basic recognition by the courts that it is the role of businessmen, not judges, to manage corporations.[191] As Fred B. White, III, and Steven M. Cooperman put it, "[e]ssentially, the business judgment rule stands for the proposition that, when making a decision, directors must honestly try to be right–if they do, they will not be second-guessed about whether they were in fact 'right.'"[192] As shown in the lower court *Brazen* decision, the business judgment rule is primarily an inquiry into the decision-making process, not an analysis of the substance of the decision.

The rule has four major components, as described by Melvin Aron Eisenberg.[193] First, the director must have made a decision and taken some action (or omission).[194] Second, the director must have used a reasonable decision-making process that was appropriate under the given circumstances.[195] Third, the decision must have been made in good faith.[196] And lastly, the decision must not be tainted by self-interest, as the director is forbidden from having any personal financial interest

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[189] *Id.* at 590.

[190] Fred B. White, III & Steven M. Cooperman, *Fiduciary Duties of Directors in Corporate Takeovers, Mergers and Acquisitions: Recent Developments*, 973 PLI/CORP 609, 613 (Feb. 1997).

[191] Diane Holt Frankle, *Fiduciary Duties of Directors Considering Business Combination*, 895 PLI/CORP 295, 297 (June-July 1995).

[192] White & Cooperman, *supra* note 190, at 611.

[193] *See* Melvin Aron Eisenberg, *The Director's Duty of Care in Negotiated Dispositions*, 51 U. MIAMI L. REV. 579, 582 (1997).

[194] *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (Draft No. 11, Apr. 25, 1991).

[195] *See id.* § 4.01(c)(2).

[196] *See id.* § 4.01(c).

in the subject matter of the decision.[197] The Delaware Supreme Court summarized this rule in *Unocal*, explaining:

> The business judgment rule is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company .... A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose ....[198]

If the above mentioned conditions are satisfied, the directors are ordinarily afforded the presumption that they acted in good faith and satisfied their duties of loyalty and due care.

B. *Heightened Fiduciary Duties*

As stated earlier, courts generally make a distinction between friendly business combinations and unsolicited hostile takeovers.[199] With regard to a proposal for a business combination, Delaware corporate law clearly states that a board of directors is under no obligation to approve a merger proposal based on price alone.[200] A merger may be approved regardless of whether the price proposed is the highest of all of the offers, simply because there are many more considerations to take into account than mere share price when forming a "synergistic business combination."[201] However, there is a different standard regarding transactions in which there is a sale of control or impediments to competing transactions.

These "higher stakes"[202] transactions trigger heightened duties under Delaware law in two instances: when a transaction will result in the sale of control of a corporation, as in the case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[203] and when the merger agreement being considered includes certain impediments to the pursuit of alternative

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[197] *See id.* § 4.01(c)(1).

[198] Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 954 (Del. 1985) (citations omitted); see also Frankle, *supra* note 191, at 297.

[199] *See supra* notes 185-190 and accompanying text.

[200] *See* Frankle, *supra* note 191, at 302-03.

[201] *Id.* at 306.

[202] *Id.* at 303.

[203] 506 A.2d 173 (Del. 1986).

transactions, as in *Unocal Corp. v. Mesa Petroleum Co.*[204] In the sale of control cases, the directors are obligated to obtain the best possible value for their stockholders, as described above.[205] Generally, though, this situation will not apply to the transactions in which break-up fees are involved, because the fees are usually the result of long, but friendly negotiations that both parties want to succeed. It is the second type of "higher stakes" transaction–those involving impediments to alternative transactions–that are of particular interest when discussing termination fees.

In the field of mergers and acquisitions, it has become relatively common to include in agreements provisions which might impede competing offers or compensate one party if the transaction is terminated by the other party.[206] Of course, the termination fee does just that: it compensates one party when the other party aborts the proposed transaction. It follows, then, that in transactions that include a termination fee, directors will be subject to heightened duties and enhanced scrutiny.

Where impediments such as the break-up fee are included in the terms of the merger agreement, Delaware directors have the duty to consider two factors: (1) whether the impediments are reasonably necessary to protect a legitimate corporate interest and (2) whether the impediments are reasonably tailored to achieve such a purpose.[207] Diane Holt Frankle explains that a "legitimate corporate interest" is an amorphous term, difficult to narrowly define.[208] One example of such an interest may be a "synergistic business combination" with long-term goals in which the target shareholders will reap increased long-term benefits stemming from the new business combination, above and beyond the immediate benefits of the merger.[209] Certainly, in the case of *Brazen v. Bell Atlantic Corp.*,[210] the merger was one between equals and was initi-

[204] 493 A.2d 946 (Del. 1985).

[205] *See Revlon*, 506 A.2d at 173.

[206] *See* Frankle, *supra* note 191, at 305-06.

[207] *See id.* at 306 (citing Unocal Corp. v. Mesa Petroleum, 493 A.2d 946 (Del. 1985)).

[208] *Id.*

[209] *Id.*

[210] No. Civ. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997)), *aff'd*, 695

ated for the strategic purposes of forming a combination that would be stronger than the sum of its parts.

In the event that the board of directors determines that the combined business entity will, in fact, create enhanced stockholder value beyond that of the immediate gain from the merger, the board may conclude "in the exercise of its business judgment" that certain impediments to alternative transactions may be necessary to protect the proposed synergistic business combination.[211] However, the board does have the affirmative duty to protect the interests of the shareholders by insuring that the impeding provisions are not so broadly drawn as to deter competing bids that may offer substantially greater value to the shareholders. In the end, though, it is a perfectly acceptable course of action for the board to conclude that the long-term value represented by the synergistic business combination far exceeds the value of any likely alternative transaction, thus justifying the impediments to competing offers.[212]

C. *Shareholder Coercion*

The last of the main issues surrounding the inclusion of termination fee provisions in merger agreements is whether such fees are inequitably or wrongfully coercive upon the shareholders, whose votes are required to approve the merger. In *Brazen v. Bell Atlantic Corp.*,[213] Brazen argued that the break-up fee was coercive on two levels. He claimed that the voting shareholders did not have a chance to consider the offer without the fee, and that regardless of what the stockholders believed about the merits of the transaction, they all realized that by voting against the merger they would be saddling their company with a $550 million fee.[214] Ultimately, the Supreme Court of Delaware found for the defendant, Bell Atlantic, and decided that there was no inequitable coercion stemming from

A.2d 43 (Del. 1997).

[211] Frankle, *supra* note 191, at 306.

[212] *See id.* at 306-07. These determinations of value should be made with the assistance of and consultation with the management and investment advisors of the company. *See id.*

[213] 695 A.2d 43 (Del. 1997)

[214] *See id.* at 49.

the existence of the termination fee.[215] The basis for this decision is an important part of the analysis of the termination fee and is a key element in predicting how courts will view the fee in the future.

The generic arguments on both sides are as follows. Generally, the party bringing suit will argue that the termination fee is so large as to coerce the shareholders to approve the merger simply to avoid the tremendous fee that would be incurred by the company in the event that the merger is not approved.[216] In other words, plaintiffs argue that the merits of the transaction will somehow be overshadowed by the looming possibility of a gigantic fine, in effect a penalty for failure to approve the transaction. Thus, the merits are never truly considered by the voting shareholders and the shareholder approval becomes an act that is finessed through coercion and the fear of a punitive fee, making the vote ineffective and the transaction voidable.[217]

On the other side of the argument, the defendant generally contends that the break-up fee is only as coercive as the other components of the merger agreement.[218] As the history of the *Brazen* case indicates, the defendant corporation tends to defend the validity of the termination fee under two alternative theories: either the fee is protected under the business judgment rule[219] or, in the alternative, the fee represents a valid liquidated damages clause.[220] Furthermore, the defendant corporation will argue that especially in the case of a merger between equals, as was the case in *Brazen*,[221] the termination

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[215] *See id.*

[216] *See generally id.*

[217] It is important to note the difference between "voidable" and "void." As defined in Black's Law Dictionary, "void" means "of no legal effect; null." BLACK'S LAW DICTIONARY 1568 (7th ed. 1990). Black's elaborates: "Whenever technical accuracy is required, *void* can be properly applied only to those provisions that are of no effect whatsoever–those that are an absolute nullity." *Id.* Whereas, Black's defines "voidable" as "valid until annulled; capable of being affirmed or rejected at the option of one of the parties." *Id.* Black's distinguishes "void" and "voidable" by stating that "[voidable] describes a valid act that may be voided rather than an invalid act that my be ratified." *Id.*

[218] *See generally* Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997).

[219] *See* Brazen v. Bell Atlantic Corp., No. Civ. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997).

[220] *See Brazen*, 695 A.2d at 50.

[221] *Id.* at 45. Bell Atlantic and NYNEX considered each other as equals, neither

fee acts as a definite benefit, rather than a potential detriment, to the company.[222] The fee is a calculated risk taken by the target company, whereby the potential benefits and losses are taken into account. The fee is an integral part of the deal–not an adjunct component designed to foster shareholder approval.[223]

D. *Case Law Regarding Shareholder Coercion*

"Coercion," by itself, is a broad term that can be used in a variety of contexts. With regard to a shareholder vote, some degree of coercion is arguably almost always present–be it coercion for financial gain, corporate power, or a host of other factors. However, in a purely legal analysis, this term is ineffective. The word "coercion" supplies no basis upon which to conclude whether a shareholder vote is impaired. The Delaware Court of Chancery described the problem in *Katz v. Oak Industries, Inc.*,[224] stating:

> [F]or purposes of legal analysis, the term "coercion" itself–covering a multitude of situations–is not very meaningful. For the word to have much meaning for purposes of legal analysis, it is necessary in each case that a normative judgment be attached to the concept ("inappropriately coercive" or "wrongfully coercive", etc.). What is legally relevant is not the conclusory term "coercion" itself but rather the norm that leads to the adverb modifying it.[225]

Therefore, in examining the issue of shareholder coercion, the key is not in the definition of "coercion," but rather in the definition of "*improper* coercion" which will determine when a vote is impaired.

The leading and most recent case dealing with the issue of shareholder coercion is *Williams v. Geier*.[226] In that case, the Supreme Court of Delaware developed an analysis to determine whether there had been improper shareholder coercion in a given situation. Primarily, the court stated that "[a]n other-

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one in a position of bargaining superiority due to its power or size. For that reason, the termination fee was reciprocal. *See id.* at 44.

[222] *See id.* at 50.

[223] *See id.*

[224] 508 A.2d 873, 880 (Del. Ch. 1986).

[225] *Id.*

[226] 671 A.2d 1368 (Del. 1996).

wise valid stockholder vote may be nullified by a showing that the structure or circumstances of the vote were *impermissibly* coercive."[227] The court went on to explain that "wrongful coercion" can exist when, through an act of either the board or another party, the stockholders are caused "to vote in favor of the proposed transaction for some reason other than the merits of that transaction."[228] However, possibly the most important holding to come from *Williams* was its determination that the question of whether coercion reaches the level of "impermissible," "wrongful," or "inequitable," is extremely case specific.[229] The court stated, "In the final analysis . . . the determination of whether a particular stockholder vote has been robbed of its effectiveness by impermissible coercion depends on the facts of the case."[230]

For the purposes of predicting how courts will handle the issue of stockholder coercion in the future, the language in the *Williams* decision is not helpful. Since the court refuses to enunciate a clear and invariable test for determining "wrongful coercion," the best way to analyze the issue is through analogy. Shareholder coercion is certainly not an issue of first impression. Courts have been forced to deal with it on countless occasions to date.[231] However, cases involving shareholder coercion through the use of termination fees are not abundant. Thus, it may be helpful to see what circumstances surround general findings of wrongful coercion.

In *Eisenberg v. Chicago Milwaukee Corp.*,[232] the Court of Chancery of Delaware heard a case in which plaintiffs attacked the validity of a self-tender offer by the defendant corporation.[233] In effect, plaintiffs claimed that the tender offer was

[227] *Id.* at 1382 (emphasis added).
[228] *Id.* at 1382-83.
[229] *Id.* at 1383.
[230] *Id.*
[231] *See* Williams v. Geier, 671 A.2d 1368 (Del. 1996); Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051 (Del. Ch. 1987); Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585 (Del. Ch. 1987), *aff'd*, 535 A.2d 1334, (Del. 1987); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986); Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986); Katz v. Oak Indus. Inc., 508 A.2d 873 (Del. Ch. 1986); Kahn v. United States Sugar Corp., No. Civ. A. 7313, 1985 WL 4449 (Del. Ch. Dec. 10, 1985).
[232] 537 A.2d 1051 (Del. Ch. 1987).
[233] *See id.* at 1053.

not of a fully voluntary nature and was, *inter alia*, wrongfully coercive.[234] The court held that there are two situations that may deprive a tender offer of its voluntary character and may be wrongfully coercive: "(i) cases involving materially false or misleading disclosures made to shareholders in connection with the offer, and (ii) cases where the offer, by reason of its terms or the circumstances under which it is made, is wrongfully coercive."[235] The first case is not relevant to this discussion, but the second scenario is.

The importance of *Eisenberg* is the court's explanation that wrongful coercion can stem from nothing more than the terms or circumstances of the offer.[236] The decision clearly stated, "[t]he actionable coercion may inhere . . . in the terms of the offer itself."[237] As it relates to the analysis of termination fees, this ruling has major implications. In effect, a shareholder vote regarding a proposed transaction can be impaired due to wrongful coercion because of the terms of the transaction. If the termination fee is one of the terms of the proposed transaction, then it follows that the termination fee, itself, could potentially be the inequitably coercive component of the transaction.

In addition to the groundbreaking possibility of wrongfully coercive termination fees, *Eisenberg* makes other contributions to the understanding of coercion in shareholder votes. Citing *Ivanhoe Partners v. Newmont Mining Corp.*,[238] the court in *Eisenberg* explained that "[t]he standard applicable to the . . . claim of inequitable coercion is whether the defendants have taken actions that operate inequitably to induce . . . shareholders to tender their shares for reasons unrelated to the *economic* merits of the offer."[239] Like the test enunciated in *Williams*, this test evokes the question of whether to consider the termination fee as an essential, core component of the terms of the proposed deal, or whether to consider the fee as a peripheral element of the merger agreement whose existence merely clouds the judgment of those asked to consider the proposal. In

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[234] *See id.* at 1061.
[235] *Id.* at 1056 (citations omitted).
[236] *See id.*
[237] *Eisenberg*, 537 A.2d at 1056 n.7.
[238] 533 A.2d 585, 605 (Del. Ch. 1987), *aff'd*, 535 A.2d 1334 (Del. 1987).
[239] *Eisenberg*, 537 A.2d at 1061 (emphasis added).

other words, by considering the termination fee, do the shareholders consider a non-economic element of the proposal, thereby diverting attention from the core terms of the agreement and the true merits of the transaction?

In *Brazen*, the Supreme Court of Delaware ruled that while the break-up fee may have influenced voting shareholders, there were "'no structurally or situationally coercive factors'"[240] that would make an otherwise valid fee provision actionably coercive in a setting where there had been full disclosure and the proposed fee itself was not egregiously large.[241] In fact, the court found the termination fee to be an integral part of the merits of the transaction, especially in light of its reciprocal nature.[242]

In light of this, the claim of inequitable coercion regarding the use of reciprocal termination fees in mergers between equals seems weak. In both the Delaware Court of Chancery and the Delaware Supreme Court, the same decision was reached–termination fees were a core component of the proposed transaction and were not to be regarded as wrongfully coercive to the voting shareholders. The open-ended question remains, however, regarding the fact sensitive nature of the courts' shareholder coercion analysis. The fees may not be coercive when they are reciprocal between equals, but does that apply to one-sided fees, or lop-sided acquisitions? Judging from the groundwork laid in *Williams* and its predecessors, the field is wide open for the possibility of a fee to be found inequitably coercive. It simply depends on the facts of the case.

CONCLUSION

The controversy over termination fees in merger and acquisition agreements is two-fold. At the core of the debate are figures like Lionel Brazen, who instinctively cringe at the thought of having to pay such an enormous fee, in the hundreds of million of dollars, simply because the shareholders refuse to approve a transaction which has been presented to

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[240] Brazen v. Bell Atlantic Corp., 695 A.2d 43, 50 (Del. 1997) (quoting Brazen v. Bell Atlantic Corp., No. Civ. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997)).
[241] *See id.*
[242] *See id.*

them with such a threat in place. This is a guttural argument of outrage stemming from a proposed termination fee whose amount is so large as to cause one to cry foul. The sheer size of the fee alone, Brazen would argue, is punitive and oppressive in nature. On a more analytical level, though, the issue becomes simply one of just compensation and reasonable estimates.

In the final analysis, the business judgment rule analysis and the liquidated damages rubric are not far apart, except in spirit. The business judgment rule analysis purports to focus on the procedure by which the agreement, and thus the termination fee, was reached. It is, in effect, an examination of how the board of directors of a corporation carries out its fiduciary duties to the shareholders. Amidst that fiduciary duty analysis are several components that the courts consider. There are concerns over the duty of loyalty, the duty of care, the protection afforded by the business judgment rule in varying situations implicating heightened duties, and the issue of shareholder coercion. As for the duties of loyalty and care, the court's inquiry is generally procedural, as the business judgment rule dictates. However, the coercion component throws the proverbial cog in the wheel of that procedural inquiry.

Because it has been established that shareholder coercion can stem from the very terms of an agreement, it is obvious that the substance of that agreement must come under judicial scrutiny. And if a court should strike down a termination fee provision as being wrongfully coercive, then it has struck the fee on substantive grounds while utilizing the purportedly procedural business judgment analysis.

On the other hand, the liquidated damages rubric is a straightforward analysis of both procedure and substance and purports to be nothing less. Under this method of analysis, the courts will consider both procedural and substantive unconscionability, the concept of just compensation, and the economic motivations behind the fee. In effect, the liquidated damages rubric seems to be an enhanced scrutiny. It takes into account both procedure and substance, two hurdles the fee must jump in order to be found valid. However, upon close examination it becomes apparent that the standards of judicial scrutiny under the liquidated damages rubric are not very different from the standards under the business judgment rule analysis.

Both methods review the procedure by which the termination fee was negotiated. Under the business judgment rule analysis, a procedural inadequacy can invalidate the fee under the theory of breach of fiduciary duty of care. Along the same lines, under the liquidated damages rubric, a procedural failure can invalidate the fee under the theory of procedural unconscionability.

The key to this Comment's argument, however, is the comparison of how both methods will handle a substantive shortcoming–namely, a termination fee excessive in amount. Under the business judgment rule analysis, the court may invalidate the fee if it finds the terms of the fee to be wrongfully coercive. In other words, if the sheer size of the fee is so large as to coerce the shareholders to approve a transaction that they ordinarily would not, then the court may invalidate the fee. Under the liquidated damages rubric, the court may invalidate the fee on substantive grounds if the fee represents an unreasonable estimate of actual damages caused by the breach (or termination) of contract. It is a simple contract law examination of liquidated damages. The only real question, then, is whether a fee that has been found to be wrongfully coercive will necessarily be found to be an unreasonable estimate of actual damages, and vice versa. In other words, will all termination fees found invalid under the business judgment rule analysis remain invalid under the liquidated damages rubric? As long as common sense dictates, it seems clear that if a fee is wrongfully coercive, then it is, by its very nature, unreasonable.

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