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A. Gilchrist Sparks III

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# Merger Agreements Under Delaware Law— When Can Directors Change Their Minds?

A. GILCHRIST SPARKS, III\*

The 1985 decision of the Delaware Supreme Court in *Smith v. Van Gorkom*<sup>1</sup> is best known for its ultimate holding that the directors of Trans Union Corporation were personally liable for failing to exercise due care in considering and approving an arm's length, cash-out merger with a company affiliated with the Pritzker family. The focus of this paper is a less dramatic holding in that case, but one which has enduring practical consequences and is occasionally overlooked even by sophisticated practitioners.

The initial merger agreement at issue in *Van Gorkom* was approved on September 20, 1980. On January 26, 1981, shortly before the stockholder vote on the merger, the board of Trans Union took occasion to review all of the facts surrounding the merger known as of that date. Because the complaint in the *Van Gorkom* case had already been filed and discovery had been taken, the review included the information gleaned in discovery supposedly supporting the plaintiffs' claims of gross negligence on the part of the Trans Union directors. Following this review, counsel advised the directors that they could "(a) continue to recommend to the stockholders that the latter vote in favor of the proposed merger, (b) recommend that the stockholders vote against the merger, or (c) take no position with respect to recommending the proposed merger and simply leave the decision to stockholders."<sup>2</sup> After considering that advice and the information presented at the meeting, the board voted to continue to recommend that the stockholders vote in favor of the proposed merger.

At trial and on appeal, the defendants urged that the time frame for determining whether director approval of the merger was the product of an informed business judgment should include the entire four-month period during which the board considered the matter and that, given the board's review and deliberations on January 26 (with the benefit of hindsight that existed at that date), the board's action was not reckless or

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\* Mr. Sparks is a partner in the Wilmington, Delaware law firm of Morris, Nichols, Arsht & Tunnell and was litigation counsel for certain parties in a number of the cases discussed herein, including *Smith v. Van Gorkom* and *Paramount Communications Inc. v. QVC Network Inc.*

1. 488 A.2d 858 (Del. 1985).

2. *Id.* at 886-87 n.30.

imprudent. The Delaware Supreme Court disagreed, holding that giving any legal effect to the action taken by the board on January 26 would be “contrary to the provisions of [8 Del. C.] [section] 251(b) and basic principles of contract law.”<sup>3</sup>

The Supreme Court’s holding was premised in part upon its conclusion that, absent a breach by the Pritzker interests, the only contractual right to terminate the merger reserved by the Trans Union board in the merger agreement was if Trans Union had, prior to the stockholder vote, either consummated a merger with a third party or entered into a “definitive” merger agreement with a third party which was more favorable and for greater consideration than the Pritzker merger.<sup>4</sup> Prior to reaching that conclusion, the Court analyzed the following paragraph in the merger agreement:

The Board of Directors shall recommend to the stockholders of Trans Union that they approve and adopt the Merger Agreement . . . and to use its best efforts to obtain the requisite votes therefor. *GL acknowledges that Trans Union directors may have a competing fiduciary obligation to the shareholders under certain circumstances.*<sup>5</sup>

Focusing on the italicized sentence, the Court held that “clearly” it did not confer a right to terminate the merger agreement.<sup>6</sup>

The Court then turned its focus to the legal advice the board received at its January 26 meeting. The Court held that options (b) and (c) described above, namely, to recommend that the stockholders vote against the merger or to take a noncommittal position on the merger and simply leave the decision to the shareholders, “were not viable or legally available to the Board under 8 *Del. C.* [section] 251(b).”<sup>7</sup> The Court reasoned:

The Board could not remain committed to the Pritzker merger and yet recommend that its stockholders vote it down; nor could it take a neutral position and delegate to the stockholders the unadvised decision as to whether to accept or reject the merger. Under 251(b), the Board had but two options: (1) to proceed with the merger and the stockholder meeting, with the Board’s recommendation of approval; *or* (2) to rescind its agreement with Pritzker, withdraw its approval of the merger, and notify its stockholders that the proposed shareholder meeting was canceled. . . . But the second course of action would have clearly involved a substantial risk—that the Board would be faced with suit by Pritzker for breach of contract. . . . [Under the

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3. *Id.* at 888.

4. *Id.* at 883. Neither of those termination events had occurred as of the January 26 board meeting.

5. *Id.* at 879 (emphasis in original).

6. *Id.* at 887.

7. *Id.* at 888.

merger agreement], the Board's only ground for release from its agreement with Pritzker was its entry into a more favorable definitive agreement to sell the Company to a third party. Thus, in reality, the Board was not "free to turn down the Pritzker proposal" as the Trial Court found. Indeed, short of negotiating a better agreement with a third party, the Board's only basis for release from the Pritzker Agreement without liability would have been to establish fundamental wrongdoing by Pritzker.<sup>8</sup>

This holding by the Delaware Supreme Court makes it clear that under Delaware law there is no implied fiduciary out or trump card permitting a board to terminate a merger agreement before it is sent to a stockholder vote. In other words, a merger partner may insist upon an enforceable contract right that a merger be submitted to a vote of the opposite party's stockholders, even if intervening events make the merger agreement unattractive as of the date of the stockholder vote.<sup>9</sup>

Four years later, in *Corwin v. deTrey*, the Court of Chancery summarized the rule laid down in *Van Gorkom* succinctly: "In such a third-party transaction, the directors of the selling corporation are not free to terminate an otherwise binding merger agreement just because they are fiduciaries and circumstances have changed."<sup>10</sup> In *Corwin*, the court went on to dismiss a complaint which claimed that, notwithstanding the absence of a contractual termination right, directors as fiduciaries nonetheless had the right to, and should have, terminated a merger agreement because market conditions had changed adversely from the time the merger agreement was executed.

The Delaware Supreme Court's conclusion that there is no implied "fiduciary out" which permits a board to terminate a merger agreement before stockholders vote on it is diametrically opposed to the reasoning of the Nebraska Supreme Court, purportedly applying Delaware law, in *ConAgra, Inc. v. Cargill, Inc.*<sup>11</sup> There the Court concluded that a merger agreement confers no rights on an acquiror until approved by stockholders, and that even without a reserved contractual termination right, if a better offer emerges, directors may invoke their fiduciary duties to renege on their promise to submit the agreement to a stockholder vote. In reaching that conclusion, the Nebraska court, while citing *Van Gorkom*, failed to address the holding in that case that under Section 251

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8. *Id.* at 888.

9. By the analysis quoted above as well as a cross-reference to it in its opinion, the Supreme Court specifically rejected Mr. Van Gorkom's erroneous understanding of corporate law that "directors always have an inherent right, as well as a fiduciary duty, to accept a better offer notwithstanding an existing contractual commitment by the Board." *Id.* at 879.

10. *Corwin v. deTrey*, Del. Ch., C.A. No. 6808, at 8, Berger, V.C. (Dec. 1, 1989) (citation omitted).

11. 382 N.W.2d 576 (Neb. 1986).

of the Delaware General Corporation Law a withdrawal of a recommendation and termination of a merger before the stockholder vote would subject the terminating corporation to contractual liability.<sup>12</sup>

*Van Gorkom's* holding also means that, absent the simultaneous exercise of an effective contractual reservation to terminate a merger before the stockholder vote, a board cannot change its recommendation to stockholders that the merger be approved. This conclusion follows from the Delaware Supreme Court's apparent reading of section 251 of the Delaware General Corporation Law as containing a "recommendation" requirement which it assumes must stay in place so long as the merger agreement has not been terminated. As a result, the option of reserving a right to withdraw a recommendation in a merger agreement is, to borrow the Delaware Supreme Court's language, "not legally available" unless the board also reserves the correlative right to terminate.

Initially, *Van Gorkom's* holding that directors who have approved a merger agreement without a reserved right to terminate before the stockholders' meeting must continue to "recommend" the merger, although the merger terms are no longer viewed by the directors as beneficial to the shareholders, would appear to conflict with the more recent holding of the Delaware Supreme Court in *Paramount Communications Inc. v. QVC Network Inc.*<sup>13</sup> There, the court held that merger provisions which purport to require a board to act or not to act in such a fashion as to limit the exercise of fiduciary duties are invalid, unenforceable, and vest no contract rights in the merger partner.<sup>14</sup> This holding was made with specific reference to a no-shop provision and a stock option agreement which the court concluded were improperly designed to deter potential bidders for Paramount in violation of the Paramount directors' fiduciary duty, first announced in *Revlon, Inc. v. MacAndrews & Forbes Hold-*

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12. On the other hand, the Delaware Supreme Court's decision is consistent with that of the Ninth Circuit Court of Appeals in *Jewel Cos. v. Pay Less Drug Stores Northwest, Inc.*, 741 F.2d 1555 (9th Cir. 1984), holding under California law that a board may, consistent with its fiduciary duties, enter into an "exclusive" merger agreement obligating it to hold a stockholders' meeting to consider a merger and to refrain from negotiating or accepting another merger proposal prior to that meeting. However, the *Jewel* court expressly declined to decide the specific question, seemingly resolved as a matter of Delaware law in *Van Gorkom*, of whether, upon the unsolicited receipt of a more favorable offer after signing a merger agreement, the board still must recommend to its shareholders that they approve the initial proposal. *Id.* at 1564, n.13. *Cf.* *Belden Corp. v. InterNorth, Inc.*, 413 N.E.2d 98, 102 (Ill. App. Ct. 1980) (holding that, under New York law, a merger agreement may "give [ ] Belden [the acquiring firm] an unequivocal right to receive the performance of Crouse's [the target firm] management, i.e., Belden is entitled to have the merger presented and recommended to Crouse's shareholders").

13. 637 A.2d 34 (Del. 1994).

14. *Id.* at 51.

ings, Inc.,<sup>15</sup> to obtain the best value reasonably available for stockholders in a sale of a company.<sup>16</sup>

However, given the Delaware Supreme Court's emphasis on directors' fiduciary duty of complete disclosure in the merger context,<sup>17</sup> it must be assumed that, if asked, the Delaware Supreme Court would conclude that a merger agreement provision which precludes directors from freely communicating to stockholders material facts concerning a merger for which their approval is sought is invalid.<sup>18</sup> Thus, one must reconcile the contractual right of an acquiror to insist that a merger "recommendation" to stockholders remain in place despite a negative change of circumstances with the directors' fiduciary duty to disclose all material facts to stockholders in connection with a merger vote.

As a matter of theory, and consistent with the thrust of the Delaware Supreme Court's reasoning, one can best view the "recommendation"<sup>19</sup> requirement read into the merger statute in *Smith v. Van Gorkom* not as a disclosure requirement, but instead as a requirement that, at the time a merger agreement is approved by directors, they must also substantively endorse the transaction, as distinguished from merely passing it on to stockholders for their consideration. So viewed, the "recommendation" is an integral part of the statutory approval process and speaks as of the date the directors initially approve the merger agreement under the statutory scheme. The holding that, absent a contract right to terminate the merger agreement, the "recommendation" cannot be rescinded before the stockholder vote without breaching the merger agreement is, under this reading of *Van Gorkom*, no more than a recognition of the acquiror's right as a matter of contract to secure the first-step board approval under section 251 of the Delaware General Corporation Law and proceed to a stockholders' meeting.

Thus, if it is the law of Delaware that in order for a merger agreement to reach stockholders it must be accompanied by a director recommendation, then the directors cannot subvert their promise to submit the agreement for stockholder approval simply by withdrawing their recom-

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15. 506 A.2d 173 (Del. 1986).

16. Interestingly, Chancellor William T. Allen has described *Van Gorkom* as "an early and, as of its date, not yet fully rationalized, 'Revlon' or 'change in control' case." *Gagliardi v. Trifoods Int'l. Inc.*, 683 A.2d 1049, 1051 n.4 (Del. Ch. 1996).

17. *See, e.g.*, *Arnold v. Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994).

18. *See also Jewel Cos. v. Pay Less Drug Stores Northwest*, 741 F.2d 1555, 1564 (1984) ("Even after the merger agreement is signed a board may not, consistent with its fiduciary obligations to its shareholders, withhold information regarding a potentially more attractive competing offer.").

19. The term "recommendation" does not appear in 8 Del. C. § 251, which provides only that directors must "adopt a resolution approving an agreement of merger" and that it be submitted to the stockholders."

mentation. Such a reading is also consistent with the concept that the board's statutory "approval" obligations are complete as of the time that execution of the merger agreement is authorized. Further, this view avoids a direct conflict with the board's clear fiduciary obligation to keep shareholders advised of material facts, both positive and negative, that may arise prior to any subsequent solicitation of shareholder approval of the merger.

As a matter of practice, the tension between the continuing "recommendation" requirement and the fiduciary duty of full disclosure can be addressed by proxy statement disclosures that leave the technical "recommendation" in place, but advise shareholders of material developments occurring after the signing of the merger agreement which stockholders should also consider in determining how to vote.<sup>20</sup> Such disclosures, while potentially somewhat clumsy and prolix, should not give rise to contractual liability to the merger partner by reason of the principle announced in *QVC* precluding enforcement of merger agreement provisions having the effect of preventing directors from fulfilling their fiduciary duties—a principle which should effectively preclude any interpretation of a merger agreement that would bar directors from fulfilling their fiduciary duty of disclosure.<sup>21</sup>

Under *Van Gorkom*, the board recommendation of a merger, which the Delaware Supreme Court has held to be a requirement of section 251 of the Delaware General Corporation Law, cannot be withdrawn before a shareholder vote without terminating the merger agreement itself, which in turn can only be accomplished if the merger agreement specifically reserves that right. However, this linking of the merger agreement and the directors' recommendation should be seen as a technical requirement. While it may produce somewhat schizoid proxy statement language, it should not be interpreted as preventing directors from communicating to stockholders any material facts arising after the execution of the merger agreement, whether positive or negative—including that a better offer has come along. Nonetheless, to increase certainty in the law and simplify disclosures, the Delaware Supreme Court should take the earliest opportunity to make clear that the references to "recom-

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20. By comparison, the federal securities laws require a company that receives a tender offer to determine whether to recommend the offer to its stockholders and to communicate the company's position and any change in that position to stockholders. See Securities Exchange Act of 1934, Rule 14e-2, 17 C.F.R. 240.14e-2, and Schedule 14D-9, 17 C.F.R. S 240.14D-9.

21. See also *Great Western Producers Coop. v. Great Western United Corp.*, 613 P.2d 873 (Colo. 1980) (applying Delaware law) (holding that the contractual obligation to use their "best efforts" to obtain shareholder approval of an asset sale is not violated by the directors' recommendation that shareholders vote against the transaction as the result of a dramatic and unanticipated increase in the value of the assets between the date of the asset sale agreement and the shareholder vote).

mendations" in *Van Gorkom* refer to the quality of a board's "approval" of a merger under section 251, and were not intended to inhibit a board from candidly disclosing to stockholders in a merger proxy statement any facts or board views arising as a result of changed circumstances which might be deemed important by shareholders in determining how to vote on the merger.

The fact that an acquirer may lawfully insist, and require by contract, that a merger proposal be submitted to the target's shareholders notwithstanding changed circumstances, has practical significance in a number of settings. First, target corporation directors faced with a merger which is no longer desirable should either seek to renegotiate or promptly hold a stockholders' meeting at which the merger will presumably be voted down. They should not cancel the meeting and risk contractual damages.

Second, acquirers may wish to bargain for tight control over the timing of the targets' shareholder meeting so as to maximize the value of the right to have it called. They should also obtain any agreements to vote for the merger or proxies, particularly irrevocable proxies, which may be secured so as to enhance the likelihood of a favorable stockholder vote.<sup>22</sup>

Finally, and most importantly, the fact that Delaware merger law implies no fiduciary outs and *Van Gorkom* makes clear that such an "out" must be clearly stated to be effective places specific burdens on the transactional lawyer to fashion effective termination provisions if a post-agreement market check is desired as a business matter or required by *Revlon* and its progeny.

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22. This raises the interesting question of whether stockholders, particularly those with arguably controlling positions, should bargain for the same kind of fiduciary out in voting agreements, including stock options and irrevocable proxies, that directors will want in the merger agreement.