1999

Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups

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ARTICLES

GREAT EXPECTATIONS? A CONTRACT LAW ANALYSIS FOR PRECLUSIVE CORPORATE LOCK-UPS

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INTRODUCTION

Contract law plays a vital role in our market economy. With its long-standing emphasis on "freedom of contract,"[1] contract law promotes individual entrepreneurial activity and advances our society at large by encouraging and protecting consensual bargain-exchange transactions.[2] Contract law encourages the assumption of economic risks inherent in any entrepreneurial endeavor by protecting the individual party's contractual expectation interest. Traditionally, the judicially enforced fulfillment of justified

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The author gratefully acknowledges Chancellor William B. Chandler, III, Alan E. Garfield, Lawrence A. Hamermesh, Robert S. Saunders, D. Gordon Smith, and Ann C. Stilson for their assistance and helpful comments. The author also expresses his gratitude to Carol Hawk, Patricia Uhlenbrock, and Susan Unterberger for their valuable research assistance.

1 *See* Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. L. & ECON. 293, 315 (1975):

> [I]f there is one thing which more than another public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice.

Id. (quoting Printing and Numerical Registering Co. v. Sampson, L.R., 19 Eq. 462, 465 (1875). *See generally* E. ALLAN FARNSWORTH, CONTRACTS § 1.7 (3d ed. 1999).

2 *See* FARNSWORTH, *supra* note 1, § 1.7 ("From a utilitarian point of view, freedom to contract maximizes the welfare of the parties and therefore the good of society as a whole."); *see also* JOHN E. MURRAY, MURRAY ON CONTRACTS § 5 (1990) ("The institution of contract brings persons and resources together as a necessary condition to the operation of the market system because the institution of contract facilitates future exchanges.").

expectations that arise from promises for future exchanges affords such protection.[3]

The relevant "market" with which this Article is concerned is the arena of the routinely extraordinary transaction: the market for corporate control. The "entrepreneurs" in this setting are corporate entities whose wealth is comprised of vast aggregations of capital contributed by various capital participants, from senior lenders to common stockholders as residual claimants.[4] In

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[3] *See* E. ALLAN FARNSWORTH & WILLIAM F. YOUNG, CASES AND MATERIALS ON CONTRACTS 2 (5th ed. 1995) (stating that one of the "fundamental assumptions made by courts in enforcing promises . . . is that the relief granted to the aggrieved promisee should generally protect the promisee's *expectation* by attempting to put the promisee in the position in which it would have been had the promise been performed"); *see also* MURRAY, *supra* note 2, § 5 ("A reliable system of assured future exchanges provides a basis for understanding the purpose of contract law: to ascertain the fulfillment of those expectations that have been induced in the promisee by the voluntary conduct of the promisor in making the promise."); Alan E. Garfield, *Promises of Silence: Contract Law and Freedom of Speech*, 83 CORNELL L. REV. 261, 298 (1998) ("Contract law exists in recognition of the benefits of private contracting. By insuring that the justified expectations of a non-breaching party will be protected when another breaches, the law promotes contracting among private individuals.").

[4] This Article is modestly premised on the courts' traditional approach, in which stockholders are seen as the "owners" of the corporate enterprise to whom the directors owe fiduciary duties. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("The board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners."); Shaw v. Agri-Mark, Inc., 663 A.2d 464, 467 (Del. 1995) ("As an equitable owner of the corporation's assets, a stockholder possessed a right to reasonable information concerning the conduct of corporate management, as well as the condition of the corporation's business and affairs."); Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 266 (Del. 1995) (describing "stockholder's change in status from equity owner to corporate creditor" when stockholder perfects statutory claim for appraisal arising out of cash-out merger); Stahl v. Apple Bancorp, 579 A.2d 1115, 1124 (Del. Ch. 1990) (referring to "the traditional model of the nature of the corporation that sees shareholders as 'owners'"). There are, of course, alternative perspectives, the most significant of which is the contractarian model of the firm as shaped by law and economics scholars. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 5 (1991) ("Investors and other participants agree on the stakes: money. They, therefore, would agree unanimously to whatever rule maximizes the total value of the firm."); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 100-01 (1989) ("[I]t is often suggested in the economic literature on the theory of the firm that the productive role of common shareholders is that of risk bearers rather than owners."); *id.* at 100 (conceptualizing the corporation as a state-recognized "nexus of contracts" among managers, capital participants—including debt and equity providers—and human capital providers); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 261 (1962) ("It is commonplace to observe that the modern shareholder is a kind of a investor and does not think of himself as or act like an 'owner.' He hires his capital out to the mangers and they run it for him . . . ."). For an interesting discussion of the "communitarian" or "progressive" corporate law perspective, with its emphasis on upholding the interests of nonshareholder constituencies, see David Millon,

particular, this Article focuses on the "bet-the-company" decision by the board of directors of a publicly owned corporation to cause the company to undergo a sale or change of control.[5] It emphasizes the effect of the board's decision on the stockholders—the only class of capital participants to whom the directors owe fiduciary duties.[6] The fiduciary obligations of the selling corporation's directors converge sharply in this rarefied setting into one overarching obligation: "to secure the transaction offering the best value reasonably available for the stockholders."[7]

Communitarians, Contractarians, and the Crisis in Corporate Law, 50 WASH. & LEE L. REV. 1373, 1374 (1993); Marleen O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 958 (1993); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 281-82 (1998).

[5] A board's decision to resist a hostile takeover by deploying defensive measures in the hopes of remaining independent is thus beyond the scope of this Article. Such decisions also have "bet-the-company" significance for the target's stockholders, as a consequence of which the courts have developed a body of fiduciary duty jurisprudence to promote the proper functioning of corporate governance. *See, e.g.*, Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Nevertheless, it is argued here that a board's decision to cause the company to undergo a change of control transaction is far more significant and far more vital to stockholder interests than a board's successful campaign to repel an unwanted takeover. In the latter instance, the corporation's inherent value invariably remains, and the stockholders' prospects for obtaining a change of control premium for their shares, though deferred, likewise remain. In the former context, however, there is no tomorrow. Whatever change of control premium the target company's stockholders may hope to realize will be irrevocably and irretrievably fixed by the conduct of their board of directors in negotiating the change of control transaction. *Paramount* appropriately communicates this urgency. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1994) ("Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium."); *id.* at 44 (noting that meaningfully comparing competing bids is "important because the selection of one alternative may permanently foreclose other opportunities"); *id.* at 45 (justifying enhanced judicial scrutiny of the board's decision based in part on "the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again. . .").

[6] *See, e.g.*, Metropolitan Life Ins. Co. v. RJR Nabisco Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989) (rejecting bondholders' fiduciary duty claim against corporate issuer in context of leveraged buy-out of RJR Nabisco because bondholders do not stand in a fiduciary relationship with corporate debtor); Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature.").

[7] *Paramount*, 637 A.2d at 44; *see also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989) ("[I]n a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders."); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.").

A persistent problem in this context involves the myriad forms of compensation that the board of the selling corporation may offer to a potential acquiror as an inducement to making an acquisition proposal. Even friendly bidders incur substantial reliance costs (in the form of out of pocket expenses and opportunity costs) in formulating and extending a tender offer or merger proposal.[8] As further discussed below,[9] the selling corporation may therefore agree to pay a termination or break-up fee to the bidder, as liquidated damages, in the event the transaction is not completed. The target often promises additional compensation to the bidder through the device of a lock-up option that involves assets or unissued shares of stock of the selling corporation. In the event that the bid fails—for example, when another bidder emerges with a superior offer—the first bidder will exercise its option against the target (that is, to acquire its assets or shares at prices typically reflecting a substantial built-in profit) and realize the gain inherent in the value of the option.[10]

When a selling corporation grants a favored bidder a lock-up option (which, if triggered, alone or in combination with the break-up fee effectively overcompensates that bidder for its reliance and opportunity costs) the effect is to deter—perhaps even to preclude—other bidders from making a superior offer, all

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8 Such expenses—including fees to lenders (supplying extraordinary financing for the transaction), lawyers, and investment bankers—can easily involve several million dollars in a multi-billion dollar acquisition proposal. *See, e.g.*, Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 378 (1987) (defining a permissible cancellation fee as one that compensates a bidder for its "reasonable negotiation expenses, such as attorneys fees, accounting fees, standby financing fees and related items"); Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1547 (1996) (noting that the "substantial costs" of bidding include "the costs of investigating and estimating the value of the target company, lining up financing, complying with governmental regulations, preparing documentation, and potentially litigating"). The opportunity cost of foregoing other transactions while pursuing an extraordinary acquisition may be equally significant and yet hard to quantify. *See, e.g.*, Brazen v. Bell Atlantic Corp., 695 A.2d 43, 45 (Del. 1997) ("[T]he parties took into account the losses each would have suffered as a result of having focused attention solely on the merger to the exclusion of other significant opportunities. . . . The 'lost opportunity' cost issue loomed large.").

9 *See infra* Part I.

10 In ordering injunctive relief precluding the enforcement of an asset lock-up option agreement in connection with a takeover battle for SCM Corporation, the United States Court of Appeals for the Second Circuit explained that "the optioned assets were worth considerably more than their option prices. Indeed . . . the very purpose of an asset option in a takeover context is to give the optionee a bargain as an incentive to bid and an assured benefit should its bid fail . . . ." Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 276 (2d Cir. 1985).

to the detriment of the selling corporation's stockholders.[11] This deterrence results from the huge diminution in the target's value that would result from an exercise of the option if the later bidder's higher offer should succeed. Because such diminution in value would destroy the economics of the transaction for the later higher bidder, the higher bidder's offer either is never made, or is made conditioned on obtaining judicial relief that would invalidate the lock-up option agreement.

In the landmark case of *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*,[12] the Delaware Supreme Court summarized the law and the prophets on the use of lock-ups in terms that continue to guide the courts' resolutions of disputes in this area: "While those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment."[13] In applying these principles as the basis for invalidating the lock-up stock option in *QVC Network, Inc. v. Paramount Communications, Inc.*,[14] Vice Chancellor Jacobs determined that the option granted by target Paramount to favored bidder Viacom was not only improperly designed "to deter other potential bidders but also had a preclusive effect"[15] in this regard. In conjunction with preclusive lock-ups, this Article also examines the enforceability of no-shop provisions—that is, contractual promises for an "exclusive" whereby the target promises the favored bidder that it will neither solicit nor (in some cases) receive a competing offer from rival bidders.

This Article focuses on the apparent but largely unexplored tension between: (1) the common law fiduciary duty principles governing the relationship between the directors and stockholders

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11 *See* David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lock-ups*, 90 NW. U. L. REV. 564, 573 (1996).

12 506 A.2d 173 (Del. 1986).

13 *Id.* at 183; *see also* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: The Impact of* QVC *and Its Progeny*, 32 HOUS. L. REV. 945, 974 (1995) (reviewing Delaware law on stock options and termination fees as permitting "[b]idder favoritism" that induces bidder participation but disfavoring such agreements when "design[ed] to preclude a bidding contest").

14 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, *Paramount*, 637 A.2d at 34.

15 *Id.* at 1271. The term "preclusive" corporate lock-up, as used in the title and throughout this Article, is intended broadly to include any contractual device by which the directors or a selling corporation run afoul of their fiduciary obligations to the stockholders by promising to overcompensate a favored bidder in a manner which—intentionally or not—improperly deters other bids.

of a corporation undergoing a sale or change of control; and (2) the law of contract insofar as it defines the rights and interests of a third party acquiror corporation that has bargained for and obtained a lock-up option and/or a no-shop agreement with the selling corporation. Historically,[16] the judicial impulse in cases challenging the validity of break-up fees, lock-ups and no-shops amidst a proposed change of control transaction has been to protect the interests of the target corporation's stockholders (the "owners") from potential lapses in fidelity by their duly elected directors, without much mention of the favored bidder's contractual interest. Indeed, courts tend to rely almost exclusively on common law fiduciary duty principles as the governing normative standards for resolving such disputes. The contractual interests of the third party acquiror corporation that arise under a merger agreement or similar contract with the selling corporation

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[16] "History," in this context, refers principally to the extraordinary level of mergers and acquisition ("M&A") activity that has occurred since the early to mid 1980s. *See* Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1185 (Del. Ch. 1998):

> Some history may elucidate the ["dead hand" poison pill] issue by locating its relevance within the dynamic of state corporate takeover jurisprudence. Since the 1980s, that body of law, largely judge-made, has been racing to keep abreast of the ever-evolving and novel tactical and strategic developments so characteristic of this important area of economic endeavor that is swiftly becoming a permanent part of our national (and international) economic landscape.

Id.; *see also* Dennis J. Block et al., *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 BROOK. L. REV. 65, 79 (1993) ("The 1980s represented 'a decade in which unprecedented merger and acquisition activity raised issues of corporate law that had lain dormant for fifty years.'") (quoting William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2055 (1990)). Following a relatively brief respite in the early 1990s, M&A activity has continued at record pace in the mid to late 1990s. Indeed, in testimony before the Senate Judiciary Committee in mid-1998, Federal Reserve Chairman Alan Greenspan declared that the United States economy is currently experiencing the "fifth wave" of concentrated merger activity this century, the earlier waves having occurred at the turn of the century, in the 1920s, the 1960s, and the 1980s. *See* Mark Helm, *Mergers—Greenspan Warns against Intervening in Linkups*, COM. APPEAL, June 17, 1998, at B4. Remarkably, the Justice Department estimates some $1.75 trillion in merger activity the United States for 1998 alone, a figure which exceeds the combined value of mergers for all years from 1990 through 1997. *See id.*; *see also* Michelle Wirth Fellman, *Behind the Scenes Mergers, Spin-offs Keep Brand Identity Consultants Busy*, MARKETING NEWS, Aug. 3, 1998, at 1 ("Business deals have been making headlines day after day as one of the biggest merger waves this century sweeps the U.S. economy."); Miriam P. Hechler, *Toward a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319, 326-27 (chronicling new wave of mergers and acquisitions activity in mid-1990s and calling for increased legal protection for shareholders of bidders against losses resulting from large premiums paid by acquirors); Mark L. Sirower, *What Acquiring Minds Need to Know*, WALL ST. J., Feb. 22, 1999, at A18 ("It's the age of the mega-acquisition.").

are seldom evaluated.[17] Consequently, whether such contractual interests warrant any protection invariably turns on whether the court is satisfied that the directors of the selling corporation have fulfilled their fiduciary duties to the stockholders.

This Article proposes an analysis by which the courts should address these contractual principles more fully in response to an acquiror's argument (like Viacom's argument in *Paramount*) that, in the context of a change of control transaction,[18] the acquiror's contractual interests deserve protection, irrespective of whether the selling corporation's directors have breached their fiduciary duties to their stockholders.[19] Part I begins with a background of the problem, including the uses and abuses of lock-ups, termination fees, and no-shop agreements and the courts' responses—under the guise of fiduciary duty principles—to stockholder attacks on such provisions where a change of control transaction is proposed.

Part II initially examines the general underpinnings of contract law, including the policy of protecting the stability of commercial transactions and the law's emphasis on upholding the reasonable expectations that arise from promise-making.[20] It then

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17 *Paramount* is a rare case because bidder Viacom's contractual claims were, at least tentatively, considered independently of the fiduciary duty claims against target Paramount's directors. *See Paramount*, 637 A.2d at 50-51; *see also infra* Part I.A.

18 *See infra* Part I.

19 In *In re RJR Nabisco, Inc. Shareholders Litig.*, Civ. No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989), Chancellor Allen cautioned that, while some Delaware cases state that an innocent third party will not be preliminarily enjoined from proceeding with a tender offer, none of these cases involved a breach of fiduciary duty by the target's directors in negotiating for or endorsing the tender offer. *See id.* at *13. Consequently, none of these earlier cases involved what Chancellor Allen characterized as the "hard choice between two innocent parties":

> [I]n none of the[se cases] was the court actually faced with the hard choice between two innocent parties, one of which will suffer by its decision: the innocent third party who would lose his bargain if the injunction issued or the innocent shareholders who would be injured by the denial of the relief and the consummation of the transaction.

Id. The court in *RJR Nabisco* likewise was not required to make this "hard choice" because there was no evidence that the directors of RJR Nabisco breached their fiduciary duties in authorizing the sale of the company to Kohlberg Kravis Roberts & Co. in a $25 billion leveraged buyout. The contractual analysis suggested in this Article is intended to assist the courts in future cases where the evidence requires the court to make the "hard choice" that was avoided in *RJR Nabisco*.

20 *See* E. ALLAN FARNSWORTH, CONTRACTS § 9.1 (2d ed. 1990) ("The idea that finality is desirable in consensual transactions, lest justifiable expectations be disappointed, is expressed in the maxim, *pacta sunt servanda* ('agreements are to be observed')."); *see also* MURRAY, *supra* note 2, §1 ("Historically and philosophically, the most fundamental concept of contract is that promises ought to be kept—*pacta sunt*

explores various well-established constraints on upholding contractually generated expectations in contexts involving such seemingly diverse problems as incapacity (e.g., immaturity or mental infirmity), bargaining misbehavior (e.g., fraud, misrepresentation, duress, or undue influence), unconscionability, mistake (mutual and unilateral), frustration, and impracticability. From this seemingly disparate mix of contractual problems emerges a coherent theme that offers a meaningful application to the corporate/contractual problem addressed in this Article. Courts are reluctant to police agreements so as not to undermine "the policy favoring the stability of transactions and the protection of the parties' expectations."[21] Yet, where the evidence establishes that the bargaining process was undermined by the presence of some fundamental distortion, the law's faith in private autonomy and freedom of contract is broken, and the court may subordinate the policy favoring transaction stability and the realization of expectations in favor of a countervailing concern for preventing unfairness and overreaching.[22]

In examining the manner in which the courts in these varied contexts determine which policy should take precedence, there emerges a shared set of principles, summarized below, by which contract law calibrates the tension between upholding transaction stability and expectations, on one hand, and ensuring essential fairness on the other. These principles for resolving the expectations/fairness conflict, woven through all of contract law, are strikingly relevant to the bidder's claim of vested contract rights in the corporate takeover context. In determining whether to enforce a contract which is attacked on some ground of unfairness, a court will inquire into some or all of the following: (1) whether the party seeking to enforce the contract knew or had "reason to know" of the presence of bargain-undermining distortions that compromised the integrity and/or effectiveness of their contracting counterpart; (2) whether the agreement in dispute remains wholly executory (that is, whether the timing of the request for judicial intervention affords the court an

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servanda.").

21 FARNSWORTH, *supra* note 20, § 4.1.

22 As discussed in Part I, the transaction stability/fairness tension woven throughout contract law bears a remarkable resemblance to corporate law's business judgment rule jurisprudence, whereby a court presumptively will defer to the decision of a corporate board (so as to uphold the value of centralized management) and yet, for fairness, scrutinize those board decisions which are shown to be the product of a flawed or distorted process. *See also infra* Part IV.

opportunity to address the fairness concerns before the transaction contemplated by the agreement has been consummated); (3) whether the particular fairness challenge to the contract arises out of an especially strong policy concern (for example, protecting minors and persons with cognitive mental infirmities from their own improvidence); and (4) whether reliance damages are available to compensate a wholly innocent party if contractual expectations are to be frustrated by judicial intervention in furtherance of some overriding fairness policy.

Part III discusses the special problems and limits on enforceability of contracts that potentially arise when a party bargains with representatives who act on behalf of others, as in the context of trusts and agency relationships. Contract law's related concern for limiting the enforcement of agreements on public policy grounds is also examined in this context. In these instances, closely analogous to the takeover problem involving the negotiating directors' fiduciary responsibilities to the stockholders, the courts again tend to rely on one or more of the four principles described above to resolve what in each instance reduces to the same fundamental tension: whether to uphold expectations or ensure fundamental fairness. Part IV then examines the acquiror's contractual expectations from the perspective of established corporate governance principles, including the special risks that are presented in the extraordinary context of a change of control transaction and the implications of such risks for defining the reasonableness of an acquiror's contractual expectations ex ante.

Lastly, Part V suggests an analytical model based on a synthesis of contract law and fiduciary principles for determining the degree of contractual protection, if any, that should be afforded to an acquiror if the directors of the selling corporation are found to have breached their fiduciary duties in approving a change of control transaction with the acquiror. In particular, this Article proposes that courts should resolve the innocent acquiror's[23] contractual assertions by explicit reference to contract law's well-established principles (summarized above) for resolving expectation and fairness concerns in any number of contexts. In so

[23] "Innocent," as used here, refers to an acquiror that neither aided and abetted nor subjectively knew of the target board's breach of fiduciary duties. Any assertion of vested contract rights by an acquiror that failed to qualify as "innocent" under this definition would be frivolous. Indeed, a court would only need to apply the first contract principle to determine that the acquiror was directly responsible for the bargaining misbehavior and, therefore, entitled to no protection of its expectation interest.

doing, the courts should continue to give priority to the especially strong policy of upholding the integrity of the fiduciary relationship between the directors and stockholders in the extraordinary setting of a change of control transaction.[24]

Timing here is also paramount. When a court is confronted with a question of "transactional justification"—as when a stockholder challenge to a preclusive, yet unexercised, lock-up option is asserted on a motion for a preliminary injunction amidst an ongoing bidding contest—the matter should almost always turn on the fiduciary question.[25] Indeed, this Article argues, by analogy to the trust law doctrine of bona fide purchaser for value (including the limitations of this trust law concept), that even a wholly innocent third party acquiror loses the status of bona fide purchaser in the corporate setting when a court, prior to consummation of the transaction, determines that the pertinent merger agreement is the product of the target directors' breaches of fiduciary duty.[26] Lastly, the court should determine whether the acquiror, though subjectively unaware, had reason to know of the target board's breaches of fiduciary duty.[27] In the context of

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[24] As the Delaware Supreme Court emphasized in *Revlon*, "[m]arket forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity." Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).

[25] A judicial pronouncement—made while a transaction is pending but not yet consummated—that the target directors have breached their fiduciary duties typically will occur in the context of a target stockholder's and/or rival bidder's motion for a preliminary injunction. *See, e.g.*, Paramount Communications v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); *Revlon*, 506 A.2d at 173. In this preliminary injunction posture the only litigation issue, in terms of fiduciary precepts, is whether the business judgment rule is available to protect the transaction itself from interference by the courts, an analysis known as "transactional justification." *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1374 (Del. 1995) (applying "transactional justification" analysis to uphold defensive measures deployed by target board's directors to resist takeover); *Revlon*, 506 A.2d at 180 n.10 (using "transactional justification" terminology to describe cases in which a board's "decision itself" is attacked). The altogether different question of whether the business judgment rule protects the target's directors from personal liability is typically not presented at this stage. *See Unitrin*, 651 A.2d at 1374 (stating that if directors first satisfy the threshold enhanced scrutiny test in a transactional justification case, then the "traditional business judgment rule is applied to shield the directors' . . . decision rather than the directors themselves"); *Revlon*, 506 A.2d at 180 n.10; *see also* Joseph Hinsey, IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 611-12 (1985) ("The business judgment rule shields individual directors from liability for damages stemming from decisions, whereas the business judgment *doctrine* protects the decision itself.").

[26] *See infra* Part III.A.2.

[27] Because lock-ups, break-up fees and no-shops are specifically negotiated between buyer and seller in each deal, this notice component should be satisfied in most cases

transactional justification, this inquiry should have little or no bearing on the enforceability of the challenged agreement; but it should contribute to a principled consideration of whether to award the genuinely innocent bidder, whose expectations will have been disappointed, some measure of reliance damages.[28]

In *Paramount*, the Delaware Supreme Court summarily rejected acquiror Viacom's assertion of vested contract rights without extensively analyzing whether Viacom's expectations merited any protection under contract law.[29] Instinctively, however, the *Paramount* court mentioned facts—including acquiror Viacom's sophistication and its awareness of the extraordinary and "unusual" nature of concessions it sought and obtained from seller Paramount—which would contribute to a meaningful contract law analysis.[30] In effect, *Paramount* was properly decided, but it is an opinion in need of an analytical model with regard to the validity and scope of the acquiror's contractual interest. Hence, this Article proposes a contractual analysis for judicially invalidating, and thereby denying, enforcement to those lock-ups, termination fees, no-shop provisions, and other contractual arrangements that tend to preclude a selling corporation from realizing the best value reasonably available to its stockholders.

I. LOCK-UPS AND THE CORPORATE-CONTRACTUAL PROBLEM

When presented with a lock-up option agreement, break-up fee commitment, or other contractual device that is alleged to impede a selling corporation from realizing optimal value for the company's stockholders, courts have invariably invoked corporate fiduciary principles—the directors' duties of care, loyalty, and good faith—to resolve the dispute. Indeed, in this context, courts tend to focus almost exclusively on whether the directors of the selling corporation have breached one or more of these fiduciary

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where a breach of fiduciary duty is found.

28 In this regard it is interesting to note that, in *Paramount*, Vice Chancellor Jacobs enjoined a preclusive lock-up stock option granted by Paramount to favored bidder Viacom, but upheld Paramount's agreement to pay Viacom a $100 million termination fee as "represent[ing] a fair liquidated amount to cover Viacom's expenses should the Paramount–Viacom merger not be consummated." QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245, 1271 (Del. Ch. 1993); *see also id.* at 1272 n.49 ("[I]t has not been shown that Viacom has committed any wrongdoing."); Skeel, *supra* note 11, at 602.

29 *See Paramount*, 637 A.2d at 51.

30 *See infra* Part I.

duties by improperly favoring one bidder, to the detriment of the stockholders in failing to achieve the best value reasonably available for the company. As demonstrated below, in the earliest major takeover cases in the modern era—beginning with *Hanson Trust PLC v. ML SCM Acquisition Inc.*[31] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[32] in the mid-1980s—through more recent cases like *Paramount*[33] in the mid-1990s, courts have paid little, if any, attention to the contractual interests of the third party bidder in preliminarily enjoining, on fiduciary grounds, the enforcement of any preclusive lock-up or similar agreement between the bidder and the selling corporation. This section briefly examines the leading cases in which courts have invalidated preclusive lock-ups and/or related contractual devices by which the directors of a selling corporation are found to have improperly overcompensated a favored bidder, thereby foreclosing further bidding for the company.[34] From a corporate law perspective, insight is gained into the uses and abuses of lock-ups, break-up fees, and no-shops as a matter of the board's fiduciary responsibility.[35] This section also demonstrates the almost

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31 781 F.2d 264 (2d Cir. 1986).

32 506 A.2d 173 (Del. 1986).

33 637 A.2d 34 (Del. 1994).

34 Cases where courts sustained lock-ups, or similar contractual devices, as the product of a proper exercise of director fiduciary responsibility are not examined here because such cases do not implicate the apparent conflict between corporate and contractual principles with which this Article is concerned. *See, e.g.*, Rand v. Western Air Lines, Inc., Civ. No. 8632, 1994 WL 89006, at *7 (Del. Ch. Feb. 25, 1994) (granting summary judgment for defendants on stockholder plaintiffs' Revlon-based attacks on decision of selling corporation's board, made after "the market of potential acquirors had been fully canvassed," to grant acquiror a lock-up stock option and no-shop exclusive); *In re* J.P. Stevens & Co., Inc., 542 A.2d 770 (Del. Ch. 1988) (upholding topping fee arrangement that favored one bidder but benefited target's shareholders by eliciting higher bid when active auction may otherwise have ended); Thompson v. Enstar Corp., 509 A.2d 578, 583-84 (Del. Ch. 1984) (holding that directors of target corporation acted reasonably in granting asset lock-up option in the form of a voting trust granting control in target's subsidiary to favored acquiror).

35 Much commentary has been written on the subject of lock-up options from the corporate perspective and the courts' approach (in particular, the Delaware courts' approach), in terms of fiduciary precepts, to resolving stockholder claims in this context. *See, e.g.*, Ian Ayres, *Analyzing Stock Lock-ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 704 (1990) ("When treasury sales provide extreme forms of overinsurance, courts should reach the conclusion that the primary purpose of the sale was to foreclose third-party bidders, and thus that the target management has breached its fiduciary duties to its shareholders."); Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 251 (1990) ("Although a target board may use an asset lock-up option to entice a prospective bidder, boards principally use them to end or prevent competitive bidding for the target."); Rutherford B. Campbell, Jr., *A Positive*

exclusively "corporate" approach that the courts have taken in this context. To the extent that a court even briefly considers the contractual position of the bidder, it does so in dismissive terms and almost as afterthought to the fiduciary question.

A. *Fiduciary Challenges to Preclusive Lock-Ups*

1. The *Hanson-Revlon* Model

The United States Court of Appeals for the Second Circuit invalidated an asset lock-up option that was granted by target SCM Corporation ("SCM") to a favored bidder in *Hanson Trust* on the grounds that SCM's directors breached their fiduciary duty of care under New York law by approving the lock-up.[36] In response to a hostile tender offer by an affiliate of Hanson Trust PLC ("Hanson") to acquire SCM for $72 in cash per share,[37] the SCM board of directors approved a white knight acquisition of SCM by Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill") for $74 per share (in cash for up to 80% of SCM's shares and junk bonds ostensibly worth $74 for the remaining 20%).[38] In

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Analysis of the Common Law of Corporate Fiduciary Duties, 84 KY. L.J. 455, 482 (1995-96) (suggesting a per se prohibition against lock-ups may be "the most effective and cost effective way to drive managers to conduct consistent with Pareto criteria"); Christopher H. Dorn, *Defending Lockups: Adequate Consideration and the Business Judgment Rule*, 24 COLUM. J. L. & SOC. PROBS. 481, 497-98 (1991) ("Courts currently review lockups with a critical eye since they are perceived as impinging on the free market forces which should determine the outcome of takeover contests."); Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739 (1994) (arguing that courts should enforce all lock-ups); Johnson & Siegel, *supra* note 8, at 373 (advocating statutory limits on the use of lock-ups: "To the extent a lock-up or cancellation fee makes a merger a foregone conclusion, it removes any real choice from the shareholders."); Kahan & Klausner, *supra* note 8, at 1541, 1565 (arguing that courts should closely scrutinize lockups granted to "white knight" bidders from the perspective of target directors' fiduciary duties and "[i]f the value of a lockup exceeds a reasonable estimate of the lockup bidder's costs of bidding, the lockup should be invalidated"); Skeel, *supra* note 11, at 605 (suggesting judicial scrutiny of lock-ups should focus on "whether the lockup is a reasonable estimate of a bidder's damages, measured in reliance terms"). This Article proceeds on the assumption that the courts' fiduciary-based analysis of lock-ups is fundamentally sound as a matter of corporate law. This Article maintains that courts in this context, in addition to employing established fiduciary precepts to identify actionable shortcomings by corporate boards, should also apply contractual principles to determine the degree, if any, to which a favored bidder's contractual interests will receive protection.

36 *Hanson Trust*, 781 F.2d at 264.

37 Hanson originally offered to acquire SCM for $60 per share in cash but later increased its offer to $72 per share after Merrill, before any lock-up option was granted, offered $70 (in cash and junk bonds).

38 The court noted that arbitrageurs valued Merrill's blended offer of $74 (in cash and junk bonds) as worth only $.75 to $1.00 per share more than Hanson's all cash $72 offer.

conjunction with the agreement for an acquisition by Merrill at $74 per share, the SCM directors acceded to Merrill's demands for an asset lock-up option to acquire two of SCM's core businesses (which together represented approximately one-half of SCM's present and projected operating income). Under the terms of the lock-up, Merrill could acquire the two businesses for a combined price of $430 million—a figure which was at least $80 million below the combined fair value for such assets—if any other party (i.e., Hanson) acquired one-third of SCM's shares.[39]

The *Hanson* court, in reversing the trial court's denial of a preliminary injunction restraining enforcement of the lock-up, concluded that the SCM directors breached their fiduciary duty of care by: (1) not requiring their investment banker to specify a range of fair values for these two assets; and (2) failing to consider the significance of selling two businesses that accounted for one-half of SCM's operating income.[40] Moreover, the court concluded that the SCM directors "knew or should have known that the lock-up would foreclose any better offers."[41] Thus, relying solely on the fiduciary principles underlying the obligations of SCM's directors to their stockholders, the Second Circuit in *Hanson* ordered the trial court to issue a preliminary injunction barring SCM and third party acquiror Merrill from exercising the lock-up option. Neither the majority nor the dissent in *Hanson* addressed the contractual interests of favored bidder Merrill under the lock-up option.[42]

The judicial tendency to rely exclusively on fiduciary principles in this context is also plainly seen in the landmark *Revlon* decision,[43] in which the Delaware Supreme Court invalidated the efforts of Revlon's directors to avert a hostile takeover by Ronald Perelman's MacAndrews & Forbes ("MacAndrews") by causing Revlon to enter into agreements

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See Hanson Trust, 781 F. 2d at 281. Following SCM's announcement of the "white knight" deal with Merrill at $74 and the accompanying asset lock-up option, Hanson improved its offer to $75 (all cash) per share, conditioned on "the withdrawal or judicial invalidation of the subject lock-up options." *Id.* at 267.

39 *See id.* at 267, 279-80.

40 *See id.* at 271.

41 *Id.* at 282. The *Hanson* court reasoned that the lock-up "threaten[ed] to dissipate the company for inadequate consideration . . ." and thus imperiled Hanson with the risk of "holding over one third of a denuded company." *Id.* at 282-83. In light of such dire threats, "Hanson's only rational move, [absent judicial intervention, was] to tender into the . . . Merrill offer, thereby ending the bidding." *Id.* at 283.

42 A sharply worded dissent challenged only the majority's factual conclusions on the fiduciary duty of care issue. *See id.* at 285 (Kearse, J., dissenting).

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

(including an auction-ending lock-up agreement)[44] to sell the company in pieces to rival bidders at a lower price than MacAndrews eventually proposed.[45] Just five days after MacAndrews had offered $56.25 per share to acquire Revlon (an improvement of $.25 above the previous bid of $56 by white knight acquiror Forstmann Little & Co. ("Forstmann")), the Revlon directors approved an acquisition of the company by Forstmann for $57.25 per share. In approving the acquisition by Forstmann for an additional $1.00 per share over MacAndrews's then latest offer,[46] the Revlon directors acceded to Forstmann's demand for an asset lock-up option to acquire Revlon's Vision Care and National Health Laboratories divisions at a bargain price. Under the terms of this lock-up option, Forstmann became entitled to acquire both Revlon divisions for $525 million—approximately $100 to $175 million below the value Revlon's investment banker attributed to such assets—if another acquiror (i.e., MacAndrews) obtained 40% of Revlon's shares.[47]

Relying exclusively on the Revlon directors' fiduciary duties of care and loyalty, the *Revlon* court affirmed the Delaware Court of Chancery's order that preliminarily enjoined effectuation of the lock-up (along with certain no-shop and cancellation fee provisions). The Delaware Supreme Court cited *Hanson* with approval in declaring the Forstmann lock-up option to be improperly destructive of what had been an ongoing bidding process.[48] The court similarly declared the no-shop provision "impermissible" because the Revlon board, having embraced a

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44 *See infra* note 47 and accompanying text.

45 *See Revlon*, 506 A.2d at 183-85 (invalidating asset lock-up option as breach of Revlon board's fiduciary duties of care and loyalty).

46 Perelman had recently stated his intention to engage in fractional bidding by topping any Forstmann offer with a slightly higher bid. *See id.* at 178-79.

47 Revlon also granted Forstmann a "no-shop" provision precluding Revlon from shopping the company for higher offers and committed to pay Forstmann a $25 million cancellation fee if the acquisition agreement between Forstmann and Revlon terminated, or if another acquiror obtained 19.9% of Revlon's stock. *See id.* at 178.

48 In assessing the validity of the Forstmann lock-up in light of the Revlon directors' fiduciary duties, the *Revlon* court stated—in general terms that continue to guide courts in this area today—the following principle: "While those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose bidding operate to the shareholders' detriment." *Id.* at 183. *See, e.g.*, Stephen P. Lamb & Andrew J. Turezyn, Revlon *and* Hanson Trust*: Unlocking the Lock-Ups,* 12 DEL. J. CORP. L. 497, 509 (1987); Ragazzo, *supra* note 13, at 974 (describing Delaware fiduciary law on stock options and termination fees as allowing "[b]idder favoritism" that induces bidder participation but disfavoring such agreements when "designed to preclude a bidding contest").

breakup of the company, had become charged with the "primary duty . . . of selling the company to the highest bidder."[49] Significantly, Forstmann's contractual interests as an ostensibly innocent third party purchaser for value went virtually ignored in *Revlon*.[50]

2. The *Hanson–Revlon* Legacy: *Macmillan* and *Holly Farms*

a. Macmillan

Corporate law fiduciary precepts also exclusively controlled the outcome of the protracted 1988 takeover battle for control of publisher Macmillan, Inc. ("Macmillan") in *Mills Acquisition Co. v. Macmillan, Inc.*[51] After steadfastly resisting acquisition attempts—first by Robert M. Bass Group, Inc. ("Bass Group"), and then by Robert Maxwell ("Maxwell")[52]—the Macmillan board of directors eventually embraced the inevitability of a change of control transaction. After Bass Group's withdrawal from the fight, Maxwell and Kohlberg Kravis Roberts & Co. ("KKR") (joined by certain participating Macmillan executives aligned with KKR) traded competing offers to acquire the company in an auction that

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[49] *Revlon*, 506 A.2d at 184. The supreme court also affirmed the award of preliminary injunctive relief preventing payment of the $25 million fee (a relatively small sum given the magnitude of the billion dollar transaction proposed by Forstmann). *See id.*; *see also* Kenneth J. Nachbar, Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.—*The Requirement of a Level Playing Field in Contested Mergers, and Its Effect on Lock-Ups and Other Bidding Deterrents*, 12 DEL. J. CORP. L. 472, 485 (1987) (observing that the chancery court found this provision to be "part of the overall plan to thwart [MacAndrews's] efforts").

[50] The chancery court simply brushed aside Forstmann's contractual interests as part of the "balancing of hardships" analysis required under Delaware's standard for granting preliminary injunctive relief, remarking that "the need for both bidders to compete in the marketplace far outweighs *the limiting of Forstmann Little's contractual rights*." MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1252 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986) (emphasis added). In affirming, the Delaware Supreme Court approvingly referred to the chancery court's conclusion in this regard, although the supreme court notably declined to characterize Forstmann's interests as "contractual" in nature and openly suggested that it was at least arguable whether granting injunctive relief would cause Forstmann to suffer "any" cognizable harm: "The [chancery] court also held that the need for both bidders to compete in the marketplace outweighed *any injury* to Forstmann. . . . We are satisfied that the plaintiff has shown the need for an injunction to protect it from irreparable harm, which need outweighs *any harm* to the defendants." *Revlon*, 506 A.2d at 184-85 (emphasis added).

[51] 559 A.2d 1261 (Del. 1988).

[52] Mr. Maxwell's ultimately successful campaign to acquire Macmillan was pursued through corporate entities under his control, Mills Acquisition Co. (a Delaware corporation) and affiliates Tenderclass Limited and Maxwell Communications Corp., PLC (both United Kingdom corporations). *See id.* at 1264.

investment banker Bruce Wasserstein of Wasserstein Perella & Co. effectively mismanaged on behalf of the Macmillan board.[53]

With the bidding virtually even at approximately $89 per share[54] (representing a transaction of approximately $2.5 billion in overall value),[55] Macmillan's advisors arranged for one last round of final bidding. Maxwell declined to increase his bid further because he mistakenly believed he was already the highest bidder. Knowing Maxwell was mistaken in this regard, Wasserstein, as "auctioneer," nevertheless failed to disabuse Maxwell of his mistaken perception.[56] Consequently, KKR prevailed with a modestly increased bid of $90 per share (later negotiated to $90.05 per share) that was conditioned on receipt of an asset lock-up option on four highly valued Macmillan subsidiaries, which were among the company's "crown jewels,"[57] for an exercise price of $775 million.[58]

In declaring the asset lock-up option invalid, the Delaware Supreme Court chastised Macmillan's directors—particularly its inappropriately passive "outside" directors—for their failure to meet their fiduciary duties under *Revlon* by not realizing the highest value reasonably attainable for the stockholders.[59] Citing

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53 *See Mills Acquisition Co.*, 559 A.2d at 1281.

54 Maxwell bid $89 per share (in cash) while KKR offered a blended bid of $89.50 per share (consisting of $82 in cash and the balance in subordinated securities). *See id.* at 1275.

55 This approximate transaction value figure is derived by multiplying $89 per share times the 27.87 million shares of Macmillan stock which the opinion states were outstanding at the time of the auction. *See id.* at 1265.

56 *See id.* at 1276; *see also id.* at 1281 ("Macmillan's financial advisors ... deliberately misled Maxwell in the final stage of the auction by perpetuating the mistaken belief that Maxwell had the high bid."). KKR also benefited in the final stages of the auction from two improper "tips," the first revealing Maxwell's $89 per share all cash bid and the second suggesting special guidelines to KKR in proposing any asset lock-up option as part of its bid. *See id.* at 1275-76.

57 *See id.* at 1286.

58 *See id.* at 1276. Maxwell later offered to purchase these same four subsidiaries for $900 million. *See id.* at 1278. In negotiating KKR's final bid up to $90.05 (an additional $1.6 million in the context of a $2.5 billion transaction), Macmillan acceded to KKR's request that the asset lock-up be expanded to capture three additional Macmillan divisions for an additional $90 million, leaving an aggregate exercise price of $865 million for seven key Macmillan divisions. *See id.* at 1277. Moreover, although Macmillan and KKR knew they could have structured this asset lock-up on an installment sale basis, so as to enable Macmillan to avoid $250 million in federal income tax liability upon the exercise of the option, they declined to do so. *See id.*

59 *See id.* at 1280 ("The board was torpid, if not supine, in its efforts to establish a truly independent auction ...."); *see also id.* at 1281 ("When presumably well-intentioned outside directors remove themselves from the design and execution of an auction, then what occurred here, given the human temptations left unchecked, was virtually

Revlon's enduring but generalized formulation on lock-ups (that is, those lock-ups which draw bidders into a contest are beneficial to stockholders, while those which end an active auction are detrimental) the court found the asset lock-up that Macmillan granted to KKR was improper because it ended the auction for only a "nominal" improvement in the bidding.[60] The court's lengthy opinion in *Macmillan* contains much discussion and elaboration on the fiduciary duties of directors of a Delaware corporation, but it contains no analysis of the contractual expectations of KKR under the doomed merger agreement.[61]

b. Holly Farms

Right on the heels of the battle for control for Macmillan came *In re Holly Farms Corp. Shareholders Litigation*,[62] a case in which then-Vice Chancellor Hartnett (who is now a Delaware Supreme Court Justice) invoked the fiduciary principles of *Revlon* and *Hanson* (along with the supreme court's bench ruling in *Macmillan*) in preliminarily enjoining effectuation of a merger agreement that contained an asset lock-up option and other auction impeding devices. Holly Farms Corporation ("Holly Farms") initially rebuffed an unsolicited acquisition proposal from Tyson Foods, Inc. ("Tyson") by asserting that the Holly Farms board had determined that the company should remain independent. Without ever informing Tyson that they had decided to sell the company, the Holly Farms directors then approved a merger agreement with ConAgra, Inc. ("ConAgra") that called for an acquisition of Holly Farms by ConAgra in a stock for stock merger transaction.

Significantly, the merger agreement between Holly Farms and ConAgra: (1) granted ConAgra an asset lock-up option on Holly Farms's prime poultry operations; and (2) obligated Holly Farms to pay ConAgra a $15 million termination fee and reimburse ConAgra's expenses. The lock-up option and related break-up fees were, respectively, exercisable by ConAgra and payable by

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inevitable.").

60 *See id.* at 1286; *see also id.* at 1264 ("[The lock-up] prematurely end[ed] the auction before the board had achieved the highest price reasonably available for the company.").

61 Independent of other criteria discussed in Part III, KKR may have been viewed as a complicitous wrongdoer undeserving of any contractual protection (having benefited from improper tips), or at least as a party that was aware, or should have been aware, that its contracting counterpart—the Macmillan board—was not functioning properly. *See infra* Part II.B.5.b.

62 Civ. No. 10350, 1988 WL 143010 (Del. Ch. Dec. 30, 1988).

Holly Farms if the merger with ConAgra was not consummated. In preliminarily enjoining effectuation of the lock-up and break-up fee provisions, the court relied exclusively on the corporate fiduciary precepts announced in *Revlon*.[63] As in *Revlon*, *Hanson*, and *Macmillan*, the court in *Holly Farms* paused nowhere to consider the contractual interests of ConAgra as an innocent third party.[64]

3. *Paramount:* A Tentative Contractual Reply for the Bidder

The Delaware courts' virtually exclusive reliance on fiduciary precepts in this setting was again on display in the more recent takeover battle between rival bidders Viacom, Inc. and QVC Network, Inc. for control of Paramount Communications, Inc.[65] Most of the opinion in *Paramount* was devoted to clarifying the manner in which Delaware's common law fiduciary principles apply to a board's decision to cause a corporation to undergo a sale or change of control, as well as the appropriate standard of judicial review (that is, enhanced judicial scrutiny) to be applied by the trial court in adjudicating claims by shareholders that the directors have not met such fiduciary duties.[66] As in *Revlon*, the

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63 The court reasoned that the Holly Farms board's failure to alert Tyson that a sale of the company was imminent "was . . . fatally flawed under the *Revlon* mandate." *Id.* at *5. In this light, the court regarded the lock-up as "nothing but a 'show stopper' that effectively precluded the opening act." *Id.* at *6 (quoting Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986)). The court also preliminarily enjoined effectuation of the termination fee and expense reimbursement provisions because these contractual commitments by Holly Farms to ConAgra "also appear[ed] likely to have been part of the effort to preclude a genuine auction." *Id.*

64 At best, ConAgra's contractual interests, if considered at all, arguably were included in the court's cryptic balancing of hardships analysis, in which the court concluded that Tyson's lost opportunity to bid for Holly Farms and its stockholders' lost opportunity to realize the highest value (were injunctive relief denied) "clearly outweigh[ed] any harm to the defendants." *Id.* This is similar to the treatment that third party Forstmann received in *Revlon*. *See supra* note 50.

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

66 *See id.* at 45-48. The *Paramount* decision has inspired much commentary from the perspective of corporate fiduciary precepts. *See, e.g.*, Campbell, *supra* note 35, at 480-82; Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty after* QVC *and* Technicolor*: A Unified Standard (and the End of* Revlon *Duties)?*, 49 Bus. Law. 1593 (1994); Janet E. Kerr, *Delaware Goes Shopping for a "New" Interpretation of the* Revlon *Standard: The Effect of the* QVC *Decision on Strategic Mergers*, 58 ALB. L. REV. 609 (1995); Melissa M. Kurp, *Corporate Takeover Defenses after* QVC*: Can Target Boards Prevent Hostile Tender Offers Without Breaching Their Fiduciary Duties?*, 26 LOY. U. CHI. L.J. 29 (1994); Ragazzo, *supra* note 13, at 974; Paul L. Regan, *The Unimportance of Being Earnest:* Paramount *Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers*, 46 HASTINGS L.J. 125 (1994); Edward B. Rock, *Saints and Sinners: How Does Delaware*

court in *Paramount* relied exclusively on these fiduciary principles in declaring "invalid and unenforceable"[67] certain provisions in a merger agreement between Viacom, Inc. and Paramount (including a stock option purchase agreement granted by Paramount to Viacom) that "were impeding the realization of the best value reasonably available to the Paramount stockholders."[68]

Unlike the courts in *Revlon* and its progeny, however, the *Paramount* court at least responded, albeit summarily, to the third party acquiror's (Viacom's) argument that it had "vested contract rights" under its acquisition agreement with Paramount, and that such contract rights merited protection irrespective of whether the Paramount directors breached their fiduciary duties to the shareholders in entering into the agreement with Viacom.[69] Unfortunately, the court's cryptic rejection of Viacom's "contract" argument was not especially meaningful or persuasive and appeared ultimately to turn, as in previous decisions, solely on the fiduciary duty question.[70] Nevertheless, the court alluded briefly to factors, such as Viacom's knowledge of the offending contractual features (which were declared "unreasonable" by the court ex post)[71] and the "unusual" nature of such provisions,[72] that could contribute in future cases to a more meaningful contract law analysis of the interests of similarly situated third party acquirors.[73]

4. *Brazen:* A Newly Emerging Concern for Contractual Protection?

The Delaware Supreme Court's more recent decision in *Brazen v. Bell Atlantic Corp.*[74] represents a tentative, yet

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Corporate Law Work?, 44 UCLA L. REV. 1009 (1997). Relatively little attention has been paid to the *Paramount* court's rejection of Viacom's vested contract rights argument. *See* A. Gilchrist Sparks, III, *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*, 51 U. MIAMI L. REV. 815 (1997); B. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837 (1996).

67 *Paramount*, 637 A.2d at 48.

68 *Id.* at 49 n.20.

69 *See id.* at 50-51.

70 *See id.* at 51 ("[W]e reject Viacom's arguments and hold that its fate must rise or fall, and in this instance fall, with the determination that the actions of the Paramount Board were invalid.").

71 *See id.*

72 *See id.* at 39, 49.

73 This Article revisits *Paramount* in Part V.B, as part of an illustration of how the analysis suggested in this Article would work as a practical matter. It concludes that *Paramount* presented arguably the strongest possible case, contractually, for refusing to enforce a lock-up option agreement.

74 695 A.2d 43 (Del. 1997). This case involved a stock for stock merger of equals that

potentially important, step forward in bringing contract law principles more meaningfully to bear in addressing stockholder challenges to termination or "break-up" fees and, by logical extension, lock-up options. The *Brazen* court, among other things, thoughtfully acknowledged and validated an acquiror's reliance interest (including the important, but hard to quantify, opportunity costs of foregoing other transactions) in pursuing an extraordinary merger transaction.[75]

In upholding a termination fee provision that potentially obligated Bell Atlantic to pay NYNEX $550 million (roughly 2% of Bell Atlantic's $28 billion market capitalization) in the event that Bell Atlantic shareholders voted not to approve a merger with NYNEX, the *Brazen* court relied not on fiduciary principles or the business judgment rule, but rather on the contract law test for determining the validity of an agreement to pay liquidated damages.[76] *Brazen,* of course, also offers helpful guidance, as a matter of Delaware corporate law, on the criteria for determining the reasonableness of termination fee provisions.[77] Nevertheless, the lasting significance of *Brazen* may well be the Delaware courts' increasing appreciation of the expense, risk, and opportunity costs

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did not result in a change of control. This Article does not focus on judicial review of directors' decisions involving mergers or other transactions where a change of control does *not* occur, such as a merger of equals (where the merging corporations are both owned by disaggregated shareholders) or the adoption of anti-takeover measures that do not involve a change of control.

[75] *See id.* at 45:

> In the negotiations where such a fee was discussed, the parties took into account the losses each would have suffered as a result of having focused attention solely on the merger to the exclusion of other significant opportunities for mergers and acquisitions in the telecommunications industry . . . . The "lost opportunity" cost issue loomed large.

Id.; *see also id.* at 48 (observing that the "lost opportunity cost[] associated with a contract to deal exclusively with each other" was a factor which the merger partners took into account in negotiating the termination fee).

[76] The contract law test for assessing the validity of a liquidated damages provision entails a two pronged analysis; namely, whether "the damages are uncertain and the agreed upon amount is reasonable." *Id.* (quoting Lee Builders v. Wells, 103 A.2d 918, 919 (Del. Ch. 1954)).

[77] The *Brazen* court acknowledged that its contract law-based reasonableness test essentially resembles the reasonableness test that Delaware courts employ when applying enhanced judicial scrutiny to breakup fees and lockup options in transactions involving a change of control. *See id.* at 49; *see also* Lawrence A. Hamermesh, *Delaware Supreme Court Approves 2% Termination Fee Provision Applying Liquidated Damages Contract Law Test, and Rejects Application of Business Judgment Rule*, 18 BANK & CORP. GOVERNANCE L. REP. 957, 959 (1997) ("The Delaware Supreme Court's opinion in *Brazen* . . . may well inspire little commentary. After all, sustaining a 2% breakup fee is itself not a novel, let alone startling, occurrence.").

that an acquiror incurs in exploring and negotiating a definitive acquisition agreement and the validation of an acquiror's good faith attempt to bargain for compensation of its transaction costs—including opportunity costs—in the event the deal unravels.[78] Indeed, *Brazen* may signal a modest, yet encouraging, judicial shift toward affording greater contractual protection for any bidder who is promised reasonable—that is, non-preclusive—break-up fees if its role should transform from potential acquiror to mere "stalking horse" for some later-arriving higher bidder.[79]

B. *Fiduciary Limits on Directors' Contractual Power in Other Contexts*

Courts have occasionally confronted the interplay of contractual and corporate fiduciary principles in the context of a corporate breakup or change of control transaction that does not involve a lock-up option. Indeed, quite unlike the lock-up option cases discussed above, the boards of directors in such cases typically will not have breached their fiduciary duties in initially approving a merger agreement or similar contract calling for a sale of the company or its assets to a third party acquiror. The difficulty in such cases is that the underlying agreement commits the selling corporation and/or its board of directors to use their

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[78] At least one prominent New York law firm has suggested in its newsletter that third party acquirors may—in light of *Brazen*—wish to negotiate for termination fees as contractual liquidated damages provisions, with the hope that such provisions "may be less likely to be enjoined where directors [of the target corporation] are found to have breached fiduciary duties, as in *Revlon* or *QVC*." Dennis J. Block & Stephen A. Radin, *Termination Fees After Bell Atlantic*, 8 BUS. & SEC. LITIGATOR 1, 6 (Client newsletter, Weil, Gotshal & Manges, LLP, July 1997). *But see* Hamermesh, *supra* note 77, at 959 (cautioning against reading *Brazen's* apparent deference for liquidated damages provisions as offering contractual shelter for an acquiror where the target's directors have failed in their fiduciary responsibilities).

[79] Indeed, one is struck by the seemingly different approaches by which the Delaware Supreme Court has described the $100 million termination fee that was promised by target Paramount to favored bidder Viacom. In *Paramount*, Vice Chancellor Jacobs enjoined the preclusive lock-up stock option granted to Viacom, but declined to invalidate the $100 million termination fee promised to Viacom in the event the deal unraveled (a ruling from which plaintiff and rival bidder QVC took no cross-appeal). *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 39, 50 n.22 (Del. 1994). In affirming, the Delaware Supreme Court seemed to signal in *Paramount* that the termination fee, were it properly before the court on appeal, would have been vulnerable. *See id.* at 49 ("[T]he Termination Fee, whether or not unreasonable by itself, clearly made Paramount less attractive to other bidders, when coupled with the Stock Option Agreement."). The court in *Brazen* referred back to the $100 million termination fee in *Paramount* (and the chancery court's refusal to enjoin it) as an example of a reasonable contractual accommodation of a bidder's legitimate transaction risks. *See Brazen,* 695 A.2d at 49 n.20.

"best efforts" to convene a stockholders' meeting (to obtain the requisite stockholder approval for both the transaction and the events occurring post-contract) yet, prior to the stockholder vote, persuade the target board that the once attractive transaction under contract is no longer in the stockholders' best interests. As demonstrated below, the courts in this area, as in the lock-up cases, tend (although not without exception)[80] to regard fiduciary principles as preeminent, effectively allowing target boards to choose to disappoint the contractual expectations of the acquiror.

1. The "Best Efforts" Cases

a. Great Western United

The Colorado Supreme Court, applying Delaware corporate law, essentially determined that corporate fiduciary principles override contractual obligations in *Great Western Producers Co-operative v. Great Western United Corp.*,[81] a case involving a best efforts clause in an agreement calling for the sale of a company's principal subsidiary. The board of directors of the seller, Great Western United Corporation ("United"), duly advised by an investment banker as to the fairness of the transaction, approved an agreement with buyer Great Western Producers Co-operative ("Co-op") that called for the sale of United's wholly-owned subsidiary, Great Western Sugar Company ("Sugar Company") to Co-op. The transaction was conditioned upon approval by the "security holders"[82] of United, as the seller, because the asset to be sold, Sugar Company, constituted a "major asset" of United.[83] United, for its part, pledged in the agreement to "use its best efforts to obtain the approval of its shareholders and debentureholders."[84]

In keeping with its contractual obligations under the "best efforts" clause, United disseminated a proxy statement to its

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80 *See* Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555 (9th Cir. 1984); *see also* discussion *infra* Part I.B.1.b.

81 613 P.2d 873 (Colo. 1980).

82 *See id.* at 875; *see also* DEL. CODE ANN. tit. 8, § 271(a) (1985) (authorizing sale of "all or substantially all" of a corporation's "property and assets" upon approval by both the board of directors and "the holders of a majority of the outstanding stock of the corporation"). In *Great Western*, the voting "security holders" included United's common and preferred stockholders (as holders of "outstanding stock" under § 271(a)), as well as its debentureholders (presumably under an event risk covenant in the trust indenture governing the debentures). *See Great Western*, 613 P.2d at 875 n.1.

83 *See id.* at 875.

84 *Id.*

security holders disclosing that a majority of the board recommended its approval of the sale.[85] At first, the United directors' approval of the sale had been unanimous. But director support for the transaction began to slip as the price of sugar—and thus the actual and projected profits of Sugar Company—escalated during the pendency of the transaction.[86] Following this dramatic upward market shift in the price of sugar, United's investment banker opined that the transaction was no longer fair to United; consequently, a majority of the United board came to oppose the sale, and the company suspended its solicitation of proxies.[87] After struggling with the pull of seemingly inconsistent contractual and fiduciary obligations,[88] United eventually distributed a supplemental proxy statement advising security holders that the board had recommended against the sale. Although the meeting of security holders was held, the transaction failed to garner sufficient votes for approval.[89]

Co-op asserted a breach of contract claim against United, arguing that the United board's decision to reverse its original recommendation in favor of the transaction violated the "best efforts" clause in the purchase agreement. The Colorado Supreme Court rejected this assertion as a matter of law, reasoning that the United "directors may not lawfully agree to abrogate the continuing duty to exercise their independent judgment with respect to [their] determination" as to the advisability of a sale of assets under section 271(a) of the Delaware General Corporation Law ("DGCL").[90] In effect, the court determined that United's agreement with Co-op—indisputably the product of an informed and independent business decision by the United board—was both expressly conditional on the security holders' approval and implicitly subject to a continuing risk of termination on grounds of

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85 *See id.* at 876.

86 *See id.* at 875-76.

87 *See id.* at 876.

88 The United directors unsuccessfully tried to balance these concerns by: (1) recommending that security holders disapprove the transaction; and (2) simultaneously directing management to continue soliciting proxies in favor of the deal "in view of the Corporation's obligations to the Co-op[]." *Id.* After a federal court preliminarily enjoined United from using such conflicting solicitation materials, the company distributed a supplemental proxy statement containing the United board's adverse recommendation and the now consistent disclosure that any unmarked proxies would be voted against the transaction. *See id* at 876-77.

89 *See id.* at 877.

90 *Id.* at 878.

"overriding" fiduciary concerns.[91]

b. Jewel

The United States Court of Appeals for the Ninth Circuit's decision in *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.*[92] offers a rare example of a case in which a court arguably prioritized contractual obligation over corporate fiduciary principles in the context of a proposed change of control transaction.[93] The original bidder, Jewel Companies, Inc. ("Jewel"), entered into a board-approved merger agreement with target Pay Less Drug Stores ("Pay Less") under which the parties agreed to an acquisition of Pay Less by Jewel in a stock for stock merger transaction. Among other things, the merger agreement conditioned the transaction on the approving vote of Pay Less stockholders[94] and obligated the board of each company to use its "best efforts to fulfill those conditions . . . over which it has control

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91 *See id.* at 879 ("In short, the 'best efforts' obligation was tempered by the directors' overriding duties under §§ 141(a) and 271(a) of the 'General Corporation Law of the State of Delaware.'").

92 741 F.2d 1555 (9th Cir. 1984) (applying California law).

93 In *Belden Corp. v. InterNorth, Inc.*, 413 N.E.2d 98 (Ill. App. Ct. 1980), the court found no merit to a claim of tortious interference with contract that was asserted by initial bidder Belden, Inc. ("Belden") against InterNorth, Inc. ("InterNorth") as a competing bidder for target Crouse-Hinds, Inc. ("Crouse"). The court, however, did not assess the impact of fiduciary precepts upon the initial bidder's contractual expectations. Unlike the other "best efforts" cases discussed in this section, the board of target Crouse did not regard the subsequent InterNorth offer as superior to the original merger agreement with Belden. Crouse management therefore fully performed its contractual obligation to Belden by scheduling a meeting of Crouse stockholders to vote on the merger with Belden and by recommending approval of the merger. Thus, the court was not confronted with a case in which a target board seemingly reneged on contractual promises in the name of fiduciary duty. Nevertheless, it did emphasize that the merger agreement afforded Belden certain enforceable contractual rights:

> [W]e observe that Belden does have an enforceable contract with Crouse. This contract gives Belden an unequivocal right to receive the performance of Crouse's management, i.e., Belden is entitled to have the merger presented and recommended to Crouse's shareholders. Belden and its shareholders do not, however, have an unequivocal right to the benefits of the merger, since the power to approve the merger lies with the Crouse shareholders, and the contract imposes no duty on the shareholders to ratify the merger agreement.

Id. at 102; *see also In re* Mobile Communications Corp. of Am., Inc., Civ. Nos. 10627, 10638, 10644, 10657, 10697, 1991 WL 1392 (Del. Ch. Jan. 7, 1991) (rejecting stockholder plaintiffs' theory that a stock for stock merger agreement between acquiror BellSouth Corporation and target Mobile Communications Corporation of America ("MCCA") contractually permitted the MCCA board to terminate the transaction based on upward market shift—occurring after MCCA stockholder vote approving merger—in stocks of cellular telephone companies like MCCA).

94 *See Jewel*, 741 F.2d at 1558.

and to consummate the Merger."[95]

Shortly after the Jewel–Pay Less agreement was announced, an unrelated but similarly named rival suitor, Pay Less Drug Stores Northwest, Inc. ("Northwest"), announced a competing bid in the form of a cash tender offer, conditioned on the Pay Less board abandoning the company's transaction with Jewel. Initial bidder Jewel, as a 10% stockholder of Pay Less, reacted by calling for a stockholders' meeting to vote on the original merger agreement. Northwest then increased its tender offer price (from $22.50 to $24 per share) and the Pay Less board unanimously recommended that its stockholders accept the Northwest offer. Moreover, the Pay Less board then signed a merger agreement with Northwest.[96] Although the Pay Less board recommended the Northwest offer, Pay Less informed its stockholders that the meeting to vote on the Jewel merger would proceed as scheduled. This meeting never occurred, however, because Jewel withdrew its request for the meeting after a majority of Pay Less's shares was tendered to Northwest. Thereafter, Jewel pressed claims for damages against Northwest based on, among other grounds, tortious interference with contract. On appeal, the Ninth Circuit, applying California corporate law, concluded in *Jewel* that the district court's grant of summary judgment in favor of defendant Northwest was improper.[97]

In assessing Jewel's tortious interference claim, the *Jewel* court acknowledged that there are fiduciary constraints on the ability of a corporate board to contract.[98] Nevertheless, the court opined that the board of a target corporation may lawfully obligate the company to an initial bidder—"temporarily, and in limited areas"—to "forbear from negotiating or accepting competing offers until the shareholders have had an opportunity to consider the initial proposal."[99] Summary judgment on this question was

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[95] *Id.* at 1557.

[96] *See id.* at 1558. Pay Less also obtained Northwest's commitment that it would indemnify Pay Less and its directors "for any alleged breach of the Jewel Agreement." *Id.*

[97] The trial court concluded that Jewel's tortious interference claim failed based on the dubious premise—appropriately rejected by the Ninth Circuit—"that a merger agreement between boards of directors is of no legal effect prior to shareholder approval." *Id.* at 1564.

[98] *See id.* at 1560 n.5 ("Courts have held invalid attempts to curtail the board's traditional management function by contract."); *see also id.* at 1563 ("We do, of course, recognize that a board may not lawfully divest itself of its fiduciary obligations in a contract.").

[99] *Id.* at 1564. In this regard, the *Jewel* court's analysis somewhat resembles the Delaware Supreme Court's carefully measured suggestion in *Paramount* that a reasonable

nevertheless inappropriate, the court reasoned, because the factual record did not establish conclusively whether the Jewel–Pay Less merger agreement effectively obligated Pay Less in this fashion.[100]

To be sure, the opinion emphasizes, within limits, the validity and enforceability of contractual undertakings by fiduciaries.[101] Significantly, however, the court specifically declined to address whether a target still must recommend an initial proposal to its shareholders under a "best efforts" clause if a second bidder intervenes with an unsolicited superior offer, implying that corporate fiduciary precepts might indeed override contract in that instance.[102] Moreover, the court unambiguously declared that the directors' fiduciary responsibilities in such a setting, at a minimum, oblige them to disclose to their stockholders "information regarding a potentially more attractive competing offer."[103] Finally, as in the other "best efforts" cases, there was no suggestion that the Pay Less directors breached their fiduciary

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no-shop provision (in effect, a form of exclusive) that is operative at an early stage of the auction process might pass judicial muster:

> We express no opinion whether certain aspects of the No-Shop Provision here could be valid in another context. Whether or not it could validly have operated here at an early stage solely to prevent Paramount from actively "shopping" the company, it could not prevent the Paramount directors from carrying out their fiduciary duties in considering unsolicited bids or in negotiating for the best value reasonably available to the stockholders.

Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 49 n.20 (Del. 1994) (citations omitted). One notable difference between the approaches of the two courts is that the *Jewel* court suggested that a board might lawfully bargain away (for a limited time, until stockholders vote on the original proposal) the right to negotiate or accept "window shop" bids (i.e., unsolicited competing proposals), whereas the *Paramount* court implied that fiduciary constraints preclude a board from agreeing not to consider or negotiate an unsolicited competing bid.

100 The court suggested that the terms of the Jewel–Pay Less agreement literally appeared to preclude Pay Less from entering into a competing agreement with another acquiror, but concluded that a trial on the merits was necessary to resolve the factual question of the parties' intent on this important issue. *See Jewel*, 741 F.2d at 1567 ("The history of the particular negotiations and the custom and practice in the field of corporate acquisitions may well determine in large part the purpose and effect of these [contractual] provisions.").

101 *See id.* at 1567 n.15 ("Neither authority [relied on by the trial court in granting summary judgment to Northwest] suggests that a corporate fiduciary's duties justify abrogation of valid contractual agreements with third parties."); *id.* at 1568 ("No authority has previously suggested that the market for corporate acquisitions is unbounded by traditional principles of contract and corporate law.").

102 *See id.* at 1564 n.13 ("We do not decide the question whether upon the unsolicited receipt of a more favorable offer after signing a merger agreement the board still must recommend to its shareholders that they approve the initial proposal.").

103 *Id.* at 1564 ("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.").

duties in approving the original Jewel–Pay Less merger agreement.[104]

c. ConAgra

In *ConAgra, Inc. v. Cargill, Inc.*,[105] a divided Nebraska Supreme Court relied almost exclusively on fiduciary principles in excusing the decision of a target board of directors to cancel a stockholders' meeting to vote on a merger agreement—notwithstanding the directors' promise to use their "best efforts" to convene such a meeting—after a second bidder made a superior offer for the company. The directors of the target company, MBPXL Corporation ("MBPXL"), originally caused the company to enter into a merger agreement with ConAgra, Inc. ("ConAgra") under terms providing for ConAgra's acquisition of MBPXL through a stock for stock merger transaction. In the agreement with ConAgra, the MBPXL directors promised to use their best efforts to convene a special stockholders' meeting to vote on the ConAgra merger and to recommend that MPBXL stockholders vote in favor of the transaction. Although the MBPXL directors duly scheduled the stockholders' meeting, they later canceled the meeting after determining that Cargill, Inc.'s ("Cargill")

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104 Similarly, in the prominent 1984 battle for control of Getty Oil Company involving rival suitors Pennzoil Corporation and Texaco, Inc., there was no evidence that the directors of target Getty breached their fiduciary duties to Getty stockholders in initially agreeing with Pennzoil to an acquisition of Getty for $112.50 per share, simply because Getty thereafter proposed a transaction at $125 per share. *See* Pennzoil Co. v. Getty Oil Co., Civ. No. 7425, 1984 WL 15664 (Del. Ch. Feb. 6, 1984) (finding probable existence of contract among Pennzoil, Getty, and two substantial Getty stockholders—a Getty family trust and the J. Paul Getty Museum, which together owned 52% of Getty—but declining Pennzoil's motion for a preliminary injunction preventing acquisition of Getty by Texaco in arguable derogation of Pennzoil's rights under such agreement); *see also* Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768, 808 (Tex. Ct. App. 1987), *cert. denied,* 485 U.S. 994 (1988) ("There is also sufficient evidence that the [Getty] directors were informed on [price and] the other aspects of the transaction and exercised their business judgment in approving the Pennzoil proposal."); *id.* at 808-09 ("Once the agreement [with Pennzoil] was made, Getty could not evade it, citing fiduciary duty, just because a higher offer came along."). Pennzoil, of course, ultimately prevailed on its claim that rival suitor Texaco tortiously interfered with Pennzoil's original contract with Getty, winning a historic verdict of $10.3 billion in damages against Texaco. *See generally* Stephen J. Adler, *How to Lose the Bet-Your-Company Case*, AM. LAW., Jan./Feb. 1986, at 27; William G. Lawler, *The Auction Process: Can It Ever Be Over?*, 28 THE REV. SEC. & COMMODITIES REG. (Standard & Poor's), Dec. 20, 1995, at 227; Matthew L. Wald, *Judge Dismisses Claim by Icahn on Texaco Plan*, N.Y. TIMES, Sept. 29, 1988, at D2. After this verdict survived review by the Texas appellate courts, Texaco was forced to seek refuge under Chapter 11 of the Bankruptcy Code and ultimately settled the matter with a payment of approximately $3 billion to Pennzoil. *See id.*

105 382 N.W.2d 576 (Neb. 1986) (applying Delaware law).

intervening all-cash offer to acquire MBPXL was superior to the ConAgra merger and that they could not recommend that MBPXL stockholders vote in favor of the ConAgra merger. Cargill ultimately succeeded in acquiring MBPXL, while ConAgra sued MBPXL and Cargill, respectively, for breach of contract and tortious interference with contractual relations.

The *ConAgra* court began its analysis with the promising suggestion that a determination of the MBPXL directors' obligations turned on "a delicate interplay of principles of both contract and corporate law, neither wholly controlling the outcome."[106] That said (and immediately disregarded), the court premised its analysis exclusively on fiduciary precepts.[107] The court essentially declared that the best efforts clause "could not relieve the MBPXL directors of their duties to act in the shareholders' best interests."[108] Consequently, the MBPXL board's decision to cancel the stockholders' meeting on the ConAgra merger (in light of the superior Cargill proposal) was deemed an appropriate discharge of fiduciary responsibility to the MBPXL stockholders that could not trigger any contractual liability to ConAgra.

A strong dissent chastised the majority for "ignor[ing] basic principles of contract law" with its unduly "sweeping declaration of a board's fiduciary duties."[109] Indeed, the dissenters lamented that, as a consequence of the majority's decision, "[a] 'suitor' corporation now has no contractual rights with respect to actions by the board of a 'target' corporation, despite agreements . . . pledging . . . best efforts to promote [a] merger."[110] Citing *Great Western* and *Jewel* (both cases in which the target boards at least held fast to their commitment to convene a stockholders' meeting to vote on the original transaction), the dissenters proposed a "more balanced application of contract and corporate law."[111] In the dissenters' view, a target board faced with a competing offer

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106 *Id.* at 586.

107 The court did refer briefly to a vague fiduciary-out clause that stated "nothing herein contained shall relieve either Board of Directors of their continuing duties to their respective shareholders." *Id.* at 587. Even this language was construed as an acknowledgment of what the court perceived as the overriding primacy of fiduciary responsibility in this context. *See id.* ("[T]he parties recognized that there was a continuing fiduciary duty owed by each board of directors to its respective shareholders which could not be contracted away.").

108 *Id.* at 588; *see also id.* ("Under the circumstances in this case, the MBPXL board's fiduciary duties obligated it to withdraw its recommendation of the ConAgra proposal.").

109 *Id.* at 589, 594 (White, J., dissenting).

110 *Id.* at 589.

111 *See id.* at 589, 592-93.

should remain contractually bound to convene the stockholders' meeting on the original proposal, as promised to the first suitor, and then disclose to the stockholders the circumstances of the intervening and potentially superior offer (in keeping with the board's fiduciary obligations to its stockholders).[112]

2. A Statutory Solution to the "Best Efforts" Problem

Amendments to the DGCL adopted in 1998 should provide much needed guidance to the directors of a target company who, upon advice and in good faith, approve a merger agreement with an initial acquiror, only to find themselves faced with a potentially superior offer from a second bidder before the target stockholders have had an opportunity to vote on the initial proposal. As the above best efforts cases demonstrate, boards of directors (and the courts that have reviewed the directors' choices in such cases) have struggled in their attempts to reconcile the apparent tension between the target directors' contractual obligations to the initial acquiror and their fiduciary responsibilities to the target's stockholders.[113] As discussed below, the most recent amendments to DGCL section 251 (pertaining to mergers and consolidations) now permit the target board and the initial acquiror to agree that a stockholders' meeting to vote on the transaction will be held, irrespective of whether "subsequent events" persuade the target board to recommend against the transaction.

DGCL section 251(b) continues the target board's gatekeeping role for approving a merger agreement, but adds the requirement that the directors also "declare[] its advisability."[114] Section 251(c), which mandates a stockholder vote on the merger agreement, now includes a provision which permits—but does not

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112 *See id.* at 592-93. Two prominent corporate practitioners recently called attention to the *ConAgra* dissenters' approach as an example of what they regard as an appropriate reconciliation of contractual and fiduciary principles in this context. *See* Gregory V. Varallo & Rod J. Howard, *Protecting the deal in an auction: Contract Rights vs. Corporate Control*, BUS. L. TODAY 42, 44-45 (1999).

113 The target's contractual promises to the initial acquiror typically may include a "best efforts" undertaking to convene a stockholders' meeting to vote on the transaction, and a promise by the target board to recommend that stockholders vote in favor of the acquisition. The board's "primary" fiduciary obligation in the change of control setting is, of course, "[t]he realization of the best value reasonably available to the stockholders." Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994).

114 DEL. CODE ANN. tit. 8, § 251(b) (1998). "The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation *and declaring its advisability*." *Id.* (emphasis added).

require—the potential merger partners to agree that the target's stockholder vote on the merger will occur irrespective of whether intervening events persuade the target board to recommend against the transaction: "The terms of the agreement may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it."[115]

This new statutory language, cast in terms that allow potential merger partners to bargain for a stockholder vote on the transaction irrespective of intervening developments, appears to reconcile contractual and fiduciary concerns in the manner suggested by the dissenters in *ConAgra*.[116] Interestingly, the statute—by inference from what is not addressed in the amendments—suggests that fiduciary constraints preclude a target board from committing to continue recommending a merger to its stockholders irrespective of intervening developments, or from failing to disclose to stockholders the circumstances of any competing offer.[117]

Although plainly helpful to the problems encountered with intervening developments in best efforts cases, the amendments to section 251 do not speak to the fundamental problem addressed in this Article: the tension between a bidder's contractual expectations and a target board's fiduciary responsibilities when the target directors breach their fiduciary duties upon approving an initial agreement for a change of control transaction and persist in attempting to consummate the transaction contemplated by that agreement. It is in such cases, particularly where preclusive lock-ups and/or break-up fees are improperly utilized, that courts must

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115 *Id.* § 251(c). The 1998 amendments to title 8, section 251 of the Delaware Code are effective with respect to agreements of merger or consolidation made on or after July 1, 1998. *See* 71 Del. Laws 280 (1998).

116 *See supra* note 112 and accompanying text (arguing that target board's "best efforts" contractual duties required target to convene stockholders' vote on transaction while directors' fiduciary obligations mandated disclosure to stockholders of a potentially superior competing offer).

117 Indeed, the synopsis accompanying the senate bill proposing the 1998 amendments implies that fiduciary constraints, depending on the circumstances, may affect the propriety of a target board's decision to agree in the first instance to a provision obligating the target company to submit the initial merger agreement to a stockholder vote irrespective of intervening developments. *See* Sen. Bill No. 311, 139th Gen. Assembly (Del. 1998), Synopsis §§ 43-44 ("The amendments are not intended to address the question whether such a submission requirement is appropriate in any particular set of factual circumstances.").

confront the contractual expectations of the ostensibly innocent acquiror.

C. *Summary of Lock-Ups and the Corporate/Contractual Problem*

The lock-up cases, arising in the extraordinary context of a change of control transaction, reflect an appropriate judicial urgency for upholding and protecting the integrity of the fiduciary relationship between the selling corporation's directors and its stockholders. The primacy of this concern may well justify frustrating an innocent third- party bidder's contractual expectations as a matter public policy, especially when: (1) the directors have failed in their fiduciary obligations at such a profound and critical juncture in the director-stockholder relationship (particularly when the directors have breached their fiduciary duties upon entering into the agreement in the first instance); and (2) the court has the opportunity to intervene, as on a motion for a preliminary injunction, before the acquisition or exercise of any lock-up option is consummated.[118] Nevertheless, the courts' treatment of the third-party bidder's contractual interests has, to date, been both muted and unsatisfactory. The *Paramount* decision represents a tentative, yet important and—as will be seen—instinctively correct step toward justifying, in a meaningful way, the primacy of fiduciary precepts over contractual expectations in this context. Developing a more thoroughly contractual explanation of this priority first requires an examination of the important role of contract law in our market economy and the limitations which contract law imposes on the enforceability of promises.

II. THE LAW OF CONTRACT AND THE EXPECTATION INTEREST

Contract law exists to protect the individual parties' liberty interests in securing a mutually advantageous exchange and benefits society at large by enforcing productive wealth-producing transactions.[119] Such enforcement usually requires the party who breaches the contract to compensate his or her disappointed

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118 *See infra* Part II.B.

119 *See* MURRAY, *supra* note 2, § 5 ("A complex industrial society cannot operate on the basis of barter. Sophisticated economic planning requires a comprehensive system of future exchange. The institution of contract brings persons and resources together as a necessary condition to the operation of the market system because the institute of contract facilitates future exchanges.").

counterpart in terms that will economically fulfill the injured party's contractual expectations.[120] After exploring these foundational principles of contract law, this section will examine established limitations on the enforceability of contractual promises in a variety of settings for insight into how to resolve the collision of interests in the corporate governance context.

A. *Foundational Principles of Contract Law*

The principal purpose of contract law is to protect the justified expectations that arise from promises underlying bargains.[121] Contract law also "further[s] the general good by encouraging parties to enter into . . . productive transactions."[122] The parties' contractual expectations are protected by awarding "benefit of the bargain" or "expectation" damages as the usual remedy for breach.[123] Such damages place the injured party in the

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120 *See infra* notes 121-25 and accompanying text; *see also* RESTATEMENT (SECOND) OF CONTRACTS, Ch. 11, introductory note 309 (1979):

> Contract liability is strict liability. It is an accepted maxim that *pacta sunt servanda*, contracts are to be kept. The obligor is therefore liable in damages for breach of contract even if he is without fault and even if circumstances have made the contract more burdensome or less desirable than he had anticipated.

Id.; *see also* MURRAY, *supra* note 2, § 1.

121 *See* ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1 ("The main purpose of contract law is the realization of reasonable expectations induced by promises."); *see also* FARNSWORTH, *supra* note 1, § 1.3 (Contract law aids parties "in planning their future by protecting their expectations."); MURRAY, *supra* note 2, § 5 ("[T]he purpose of contract law [is] to ascertain the fulfillment of those expectations that have been induced in the promisee by the voluntary conduct of the promisor in making the promise."); Harry W. Jones, *The Jurisprudence of Contracts*, 44 U. CIN. L. REV. 43, 47-48 (1975) ("In a society like ours, people live not by birds in the hand but by promises . . . . The law of contract . . . has as its ultimate purpose the security of those reasonable expectations that arise from agreement between seller and buyer, borrower and depositor, stockholder and corporation, employer and organized employees.").

122 FARNSWORTH, *supra* note 1, § 1.3; *see also* Melvin A. Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 744 (1982) ("A modern free enterprise system depends heavily on exchanges over time and on private planning."); L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52, 61 (1936):

> Agreements can accomplish little, either for their makers of for society, unless they are made the basis for action. When business agreements are not only made but are also acted on, the division of labor is facilitated, goods find their way to the places where they are most needed, and economic activity is generally stimulated.

Id.

123 *See* Sullivan v. O'Connor, 296 N.E.2d 183, 186 (Mass. 1973) (referring to the "expectancy formula" as the "usual" and "standard measure of recovery for breach of contract"); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 347(a) (1979) ("[T]he injured party has a right to damages based on his expectation interest as measured by . . . the loss in value to him of the other party's performance caused by its failure or

same financial position as if the contract had been fully performed.[124] This measure of damages also may include lost profits expected from the exchange.[125] The contract law impulse to protect expectations and preserve the benefit of the bargain for an injured party to a contract is, presumably, the foundation of a third party acquiror's claim of "vested contract rights" when a court invokes corporate governance/fiduciary principles as the basis for refusing to enforce a merger or other acquisition agreement.[126]

Courts sometimes award damages based on the promisee's reliance rather than the promisee's expectations.[127] In such cases,

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deficiency . . . ."); *id.* § 347 cmt. a:

> Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed.

Id.; *see also* MURRAY, *supra* note 2, § 117:

> The usual remedy available to an aggrieved party when a breach of contract has occurred is an action for the recovery of compensation in the form of money damages to protect the expectation interest, i.e., an award that will place the injured promisee in the same position he would have been in had the contract been performed.

Id.; W. David Slawson, *The Role of Reliance in Contract Damages,* 76 CORNELL L. REV. 197, 217 (1990) ("The amount of damages is set by the expectation measure, because this is the amount required to put the injured party in as good a position as if the promise had been performed.").

124 *See Sullivan*, 296 N.E.2d at 186 (explaining that expectation damages are "intended to put the plaintiff in the position he would be in if the contract had been performed"); *see also* FARNSWORTH, *supra* note 1, § 12.1:

> Ordinarily [courts] . . . protect[] the expectation that the injured party had when making the contract by attempting to put . . . [the injured] party in as good a position as it would have been in had the contract been performed . . . . The interest measured in this way is called the *expectation interest* and is said to give the injured party the "benefit of the bargain."

Id.; *see also* CHARLES A. FRIED, CONTRACT AS PROMISE, A THEORY OF CONTRACTUAL OBLIGATION 17 (1981) ("The expectation standard gives the victim of a breach no more or less than he would have had there been no breach—in other words, he gets the benefit of his bargain.").

125 *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. b (1979):

> Where the injured party's expected advantage consists largely or exclusively of the realization of profit, it may be possible to express this loss in value in terms of money with some assurance. In other situations, however, this is not possible and compensation for lost value may be precluded by the limitation of certainty.

Id.

126 In *Paramount Communications v. QVC Network*, third-party acquiror Viacom asserted that it had acquired "vested contract rights" under agreements it lawfully negotiated with Paramount irrespective of whether Paramount's directors breached their fiduciary duties to the Paramount shareholders in acceding to Viacom's demands in such negotiations. *See* 637 A.2d 34, 50-51 (Del. 1994).

127 *See* RESTATEMENT (SECOND) OF CONTRACTS § 349 (1979) ("As an alternative to the measure of damages stated in § 347, the injured party has a right to damages based on

the courts attempt "to put the injured party back in the position in which that party would have been had the contract not been made."[128] A court may opt to award such reliance damages—which typically are smaller than an expectation-based recovery[129]—where "a promisee's expectation profit may not be provable,"[130] or where awarding expectation damages might impose undue hardship.[131]

Reliance damages usually include compensation to the injured party for "essential reliance," which consists of the "preparation for performance or actual performance of the contract."[132] Sometimes courts also award "incidental" reliance damages to compensate for the injured party's costs in preparing for collateral transactions that are premised on the assumption that the main contract will be performed.[133] Significantly, courts have generally not awarded reliance damages based on the injured party's opportunity costs—that is, the injured party's reliance in "foregoing opportunities to make other contracts."[134]

Lastly, courts sometimes award damages based on the injured party's restitution interest. The objective in such cases is not the enforcement of a promise but, rather, the avoidance of unjust enrichment.[135] A restitution recovery requires the party in breach

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his reliance interest, including expenditures made in preparation for performance or in performance . . . ."); *see also* FARNSWORTH, *supra* note 1, § 12.1.

128 FARNSWORTH, *supra* note 1, § 12.1; *see also Sullivan*, 296 N.E.2d at 187 (The "reliance measure" for contract damages endeavors "to put the plaintiff back in the position he occupied just before the parties entered upon the agreement, to compensate him for the detriments he suffered in reliance upon the agreement.").

129 *See* FARNSWORTH, *supra* note 1, § 12.1.

130 MURRAY, *supra* note 2, § 117; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 349 cmt. a (1979) ("[T]he injured party may . . . recover as damages his expenditures in reliance . . . if he cannot prove his profit with reasonable certainty."); *id.* § 352 ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.").

131 *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 351(3) cmt. f (1979); L. L. Fuller & William R. Perdue Jr., *The Reliance Interest in Contract Damages: 2*, 46 YALE L.J. 373, 377-79 (1937). In one case, a court suggested reliance damages would be proper so as to ensure "moderation as to the breadth of the recovery that should be permitted" in an action based on an alleged promise by a plastic surgeon to accomplish a specific result, a contract theory which the court regarded as "somewhat suspect" but ultimately within the bounds of public policy. *Sullivan*, 296 N.E.2d at 187.

132 RESTATEMENT (SECOND) OF CONTRACTS § 349 cmt. a (1979).

133 *See id.*

134 FARNSWORTH, *supra* note 1, § 12.1. *But see* Fuller & Perdue, *supra* note 122, at 60-61 (suggesting that the rule requiring the victim of a breach to mitigate damages as a prerequisite to recovering expectation damages reveals a "hidden" contract law concern for compensating for lost opportunity costs).

135 *See* FARNSWORTH, *supra* note 1, § 12.1; MURRAY, *supra* note 2, § 117; *see also*

to return to the injured party the benefit of any money or services that the injured party has conferred upon it.[136] In the corporate takeover setting, the third party acquiror will rarely have conferred substantial benefits on the target company prior to an injunction preventing consummation of their merger agreement. On the other hand, the third party acquiror will typically have both substantial reliance costs (essential and incidental reliance as well as opportunity costs) and expectation interests that a court should consider in assessing the acquiror's contractual claims. Consequently, this Article focuses on the latter two concerns—the acquiror's reliance and expectations—in suggesting a contractual analysis for corporate takeover cases.[137] Before addressing these concerns in the corporate governance context, this Article first explores more well-established limitations on the enforceability of contracts in a variety of settings for guidance in solving to the corporate/contractual problem.

B. *Established Limitations on the Expectation Interest—A Contract Law Sampler*

The expectation realization principle of contract law, a principle of first importance in this area, is far from absolute. In a variety of well-recognized settings, contract law prioritizes other important policy concerns over the concerns for facilitating commerce and protecting parties' contractual expectations. As discussed below, these policies entail overriding concerns for fairness in a variety of contexts and include, among other things, concerns based on the status of the parties (with regard to their basic capacity or competency), the behavior of the parties during the bargaining process (fraud, misrepresentation, duress, and undue influence), and, more rarely, the substantive fairness of the bargain itself (unconscionability). Moreover, courts will, on occasion, excuse a promisor's non-performance when his or her promise is premised on a mistake about a basic assumption underlying the bargain, either as to facts in existence when the contract was made (unilateral and mutual mistake) or as to facts which were expected to exist at the time of performance (frustration and impracticability).

Each of these doctrines responds to fairness concerns arising

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Fuller & Perdue, *supra* note 122, at 53-55.

136 *See* FARNSWORTH, *supra* note 1, § 12.1; *see also* MURRAY, *supra* note 2, § 117.

137 *See infra* Part V.

directly out of the relationship between the contracting parties. This Article, of course, is concerned principally with the fiduciary relationship between directors and stockholders of a target corporation and the implications of that relationship in terms of a third party acquiror's contractual interests with the target corporation. Nevertheless, under classic contract law doctrine, a review of these expectation-impairing principles is instructive generally with regard to the legitimacy of policing agreements against unfairness, even at the risk of frustrating a party's contractual expectations.[138] Moreover, the manner in which contract law mediates the conflict between protecting expectations and policing against unfairness in a variety of settings offers insight into resolving the collision of interests between a corporate acquiror and the target's stockholders. Following a review and distillation of these expectation-impairing contract law principles, this Article traces the application of these principles in more directly related contexts: disputes involving contracts negotiated by representatives (i.e., trustees and agents), and contracts that are subject to challenge on public policy grounds.[139]

1. Status-Based Concerns for Fairness: Capacity

Contract law's concern with fairness regarding the status of the parties—that is, their capacity—responds to two basic types of defects that impair a party's power to contract: immaturity and mental infirmity.[140] Although parties to a contract are presumed to have the power to bind themselves to a bargain, this power to contract, in the extreme case,[141] will be regarded as "impaired because of an inability to participate meaningfully in the bargaining process."[142] In short, the liberty interest inherent in freedom of contract presumes minimal competency to exercise

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138 Professor Farnsworth thoughtfully summarizes the competing policy concerns in this area as follows:

> [C]ourts 'police' agreements against unfairness by placing limits on their enforceability. Such an interference in the bargaining process requires courts to consider competing policies. On one side, that of enforcing the bargain as made, stands the policy favoring the stability or security of transactions and the protection of the parties' expectations. On the other side stands the policy favoring the prevention of unfairness and the protection of the parties from overreaching.

FARNSWORTH, *supra* note 1, § 4.1.

139 *See infra* Part III.

140 *See* FARNSWORTH, *supra* note 1, § 4.3.

141 *See* MURRAY, *supra* note 2, § 23.

142 FARNSWORTH *supra* note 1, § 4.2.

that freedom. In the exceptional case where this threshold competency is wanting, the fundamental policy favoring protection of a party's expectation interest is subordinated to the larger concern of protecting the party who lacks capacity.[143]

For example, a minor can incur only voidable obligations.[144] This voidability principle affords a minor the power to disaffirm contracts for the purpose of "protecti[ng] . . . minors against their own improvidence."[145] It presumes minors to be "incapable of protecting themselves."[146] Interestingly, the minor's ability to avoid a contract exists irrespective of whether the other party to the contract was aware that he or she was dealing with a minor.[147] The unimportance of notice here may reflect the strength of the policy favoring protection of minors and, perhaps, a practical appreciation for the fact that age (as opposed to a condition like mental infirmity, as discussed below) is readily ascertainable.[148] Certainly, the strength of this policy of protection can be seen in the rule that permits a minor to disaffirm a contract long after it has been fully performed on both sides.[149] Finally, a disaffirming minor traditionally has no obligation to make restitution to the

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143 *See id.* ("One whose power [to contract] is so impaired is said to lack capacity to contract and is subject to special rules that allow one to avoid the contract that one makes in order to give protection from one's own improvident acts and from imposition by others.").

144 *See* RESTATEMENT (SECOND) OF CONTRACTS § 14 (1979).

145 Davis v. Clelland, 92 N.E.2d 827, 829 (Ohio Ct. App. 1950); *see also* Porter v. Wilson, 209 A.2d 730, 731 (N.H. 1965) ("[T]he common- law conception that a minor does not possess the discretion and experience of adults and therefore must be protected from his own contractual follies generally holds sway today."); Kiefer v. Fred Howe Motors, Inc., 158 N.W.2d 288, 291 (Wis. 1968) ("Minors require some protection from the pitfalls of the marketplace.").

146 *Davis*, 92 N.E.2d at 829. This presumption of youthful incompetency is both arbitrary and irrebuttable, "ignoring the obvious differences in maturity among individuals of the same age." FARNSWORTH, *supra* note 1, § 4.2; *see also* MURRAY, *supra* note 2, § 23 ("The costs and uncertainties of distinguishing the capacities of minors . . . preclude any rule except an arbitrary one. The law, therefore, indulges what amounts to a conclusive presumption concerning the capacity of minors.").

147 Some jurisdictions invoke estoppel to disallow the infancy incapacity defense where the minor has misrepresented his or her age. *See, e.g.*, Johnson v. McAdory, 88 So.2d 106, 107 (Miss. 1956); Brinkmann v. Dorsey Motors, 1 A.2d 473 (N.J. 1938). But others allow recovery against the minor in tort for misrepresentation. *See* Mestetzko v. Elf Motor Co., 165 N.E.2d 93 (Ohio 1929).

148 *See* FARNSWORTH, *supra* note 1, § 4.8 ("[T]he test of mental infirmity gives rise to more uncertainty than does that of immaturity.").

149 *See id.* § 4.4 ("The minor may avoid the contract even if it has been fully performed on both sides, as where the minor has received and paid for goods."); *see also* MURRAY, *supra* note 2, § 23 ("If the contract has been completely performed (executed) and the infant has received a benefit that he has retained after reaching majority, he will have to be prompt in disaffirming.").

other party for the value of goods or services received; the minor has only a limited duty of restoration—that is, a rather modest obligation to return what remains in hand, whatever its condition, without obligation to account for use, depreciation or damage.[150]

Persons lacking contractual capacity due to mental illness or defect are also protected from incurring enforceable obligations.[151] Like the minor, a person with a sufficiently serious mental disability incurs only voidable contractual duties.[152] The traditional test for determining a mental incapacity to contract is "the *cognitive* test, i.e., did the party understand the nature and consequences of the transaction?"[153] The *Restatement (Second) of Contracts* ("*Restatement of Contracts*") endorses the traditional cognitive test as well as a separate "motivational," or volitional, test of mental illness, so as to protect the person who understands the transaction but is unable to control his or her actions in relation to that transaction.[154] In formulating rules for avoiding contract liability in this context, the law reflects a compromise between the policies of "protecting reasonable expectations" and affording mentally ill persons "protect[ion] against [their] own improvidence."[155] Under the *Restatement of Contracts*, for

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150 *See* FARNSWORTH, *supra* note 1, § 4.5 ("A minor who has used services is not accountable for anything. A minor who has smashed an automobile or house trailer need only return the wreck."). The court's poignant observation in *Davis v. Clelland* requires no embellishment:

> We recognize what seems to be an injustice to the defendant to permit the minor-plaintiff to possess and enjoy the use of the automobile for almost a year, drive it into a telephone pole and wreck it, then haul it into a yard and elect to rescind the whole transaction. However, this is not an equitable proceeding and is controlled entirely by legal principles under which a minor has the right as to contracts made during minority to affirm or disaffirm his contracts other than those for necessaries.

Davis, 92 N.E.2d at 829. One exception to this rule involves "necessaries" whereby a minor is obligated—based on quasi-contract rather than the actual contract price—for the reasonable value of such life-sustaining basics as food, clothing and shelter. *See* FARNSWORTH, *supra* note 1, § 4.5; *see also* MURRAY, *supra* note 2, § 24.

151 *See* RESTATEMENT (SECOND) OF CONTRACTS § 15 (1979).

152 *See* FARNSWORTH, *supra* note 1, § 4.6.

153 MURRAY, *supra* note 2, § 25; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(a) (1979) (stating that a person incurs only voidable contractual duties where "he is unable to understand in a reasonable manner the nature and consequences of the transaction"); FARNSWORTH, *supra* note 1, § 4.6.

154 *See* RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(b) (1979) (stating that mental illness or defect includes a condition in which a person "is unable to act in a reasonable manner in relation to the transaction"); *see also* FARNSWORTH, *supra* note 1, § 4.6; MURRAY, *supra* note 2, § 25.

155 MURRAY, *supra* note 2, § 25; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 15 cmt. a (1979) ("A contract made by a person who is mentally incompetent requires the

example, a cognitively impaired person may avoid her contract regardless of whether the competent party was aware of her condition.[156] On the other hand, a volitionally impaired person—one who understands but cannot control himself with regard to the transaction—may avoid his contract only if the "the other party has reason to know of his condition."[157]

In addition to notice, the *Restatement of Contracts* incorporates a timing principle as a factor in reconciling the expectations-versus-protection conflict in contracts involving mentally impaired persons. Provided that the contract is fair and the competent party is unaware of the other party's mental infirmity, the power of avoidance afforded to the incompetent party may terminate if the contract has been performed and it would be inequitable to grant the remedy of avoidance.[158] Moreover, where the court grants the remedy of avoidance, the mentally impaired person usually has an obligation to make restitution, measured by the value of any benefit received, even if such benefit is "dissipated or squandered."[159] One eminent contract law scholar has suggested that the duty of full restitution in this context (as compared to the more limited duty of restoration imposed on minors) reflects the fact that a party to a contract with a mentally ill person is disadvantaged by the more uncertain test for mental illness rather than the bright-line age test for immaturity.[160] On the other hand, courts do not require full restitution where the party contracting with a mentally ill person has "acted unfairly and with full knowledge of the

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reconciliation of two conflicting policies: the protection of justifiable expectations and of the security of transactions, and the protection of persons unable to protect themselves against imposition.").

156 *See* RESTATEMENT (SECOND) OF CONTRACTS § 15(1)(a) (1979).

157 *Id.* § 15(1)(b). *See, e.g.*, Ortelere v. Teachers' Retirement Bd., 250 N.E.2d 460, 465 (N.Y. 1969) (requiring a volitionally impaired person to show that the competent party "knew or was put on notice as to the contractor's mental illness" in order to balance the policy favoring "stability in contractual relations and protection of the expectations of parties who bargain in good faith" with the countervailing interest in protecting "persons who may understand the . . . transaction but who, due to mental illness, cannot control their conduct").

158 Section 15(2) of the RESTATEMENT OF CONTRACTS thus provides:

> Where the contract is made on fair terms and the other party is without knowledge of the mental illness or defect, the power of avoidance . . . terminates to the extent that the contract has been so performed in whole or in part or the circumstances have so changed that avoidance would be unjust. In such a case a court may grant relief as justice requires.

RESTATEMENT (SECOND) OF CONTRACTS § 15(2); *see also id.* § 15 cmt. f.

159 FARNSWORTH, *supra* note 1, § 4.8.

160 *See id.*

incompetency."[161]

Intoxication presents a similar capacity issue, although, because intoxication is usually voluntary, courts are often hostile toward a party who attempts to escape contract liability on this basis.[162] A court will grant relief in this context only where the intoxicated person is unable to understand the nature and consequences of the transaction (i.e., is cognitively impaired) and the other partly has reason to know of this inability.[163] Here, the judicial impulse to protect the voluntarily impaired person is markedly weaker than in the case of the mentally disabled person.[164] As long as the competent party had no reason to know of the intoxicated person's condition (admittedly a rare occurrence given the degree of intoxication required for contract avoidance), the court will likely enforce the contract, even if the contract remains wholly executory.[165] Where a contract is avoided on the basis of intoxication, the avoiding party has a duty only to restore any value received, but not to make full restitution for any value that has been "squandered or dissipated during the period of drunkenness."[166]

Given that avoidance for intoxication is only available where the other party has reason to know of the intoxicated person's condition, the more limited obligation of restoration in this context resembles the more sparing recovery afforded to persons who knowingly taking advantage of mentally incompetent persons.[167]

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161 *Id.*; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 15 cmt. f (1979) ("Where the other party, though acting in good faith, had reason to know of the incompetency at the time of contracting or performance, or where the equities can be partially adjusted by the decree, the court may grant or deny relief as the situation requires."); MURRAY, *supra* note 2, § 25 ("[A]ny value received by the incompetent that he has dissipated need not be restored [if] the competent party knows or reasonably should know of the other's incompetency at the time of contracting or takes unfair advantage of the incompetent.").

162 *See* RESTATEMENT (SECOND) OF CONTRACTS § 16 (1979); *see also* FARNSWORTH, *supra* note 1, at § 4.6; MURRAY, *supra* note 2, § 26.

163 *See* RESTATEMENT (SECOND) OF CONTRACTS § 16; *see also* FARNSWORTH, *supra* note 1, § 4.6.

164 A person suffering from compulsive alcoholism or drug addiction that constitutes a type of mental illness presumably should qualify for the more solicitous avoidance test for mental illness or defect under RESTATEMENT (SECOND) OF CONTRACTS § 15. *See, e.g.*, MURRAY, *supra* note 2, § 26.

165 *See id.*

166 *Id.*; *see* RESTATEMENT (SECOND) OF CONTRACTS § 16 cmt. c (1979).

167 *See supra* note 161 and accompanying text.

2. Fairness Concerns Arising from Abuses in the Bargaining Process

A party who is competent may nevertheless avoid contractual liability where there has been an abuse of the bargaining process that produced the agreement.[168] Such abuse occurs when one party misleads (through fraud or material misrepresentation)[169] or improperly pressures (through duress[170] or undue influence)[171] the other. Freedom of contract presumes a fundamentally undistorted exercise of that freedom. When the behavior of one party improperly undermines the process by which this freedom is exercised, courts elevate the policy concerns for fairness and integrity in the bargaining process above the usual judicial instinct of protecting contractual expectations.[172]

In the case of fraud or material misrepresentation, the concern is that "a system of contract law based on supposedly informed consent" is undermined by misleading conduct on the part of one of the parties to the agreement.[173] Consequently, courts will allow the victim of such misrepresentation "to undo the transaction by avoiding it."[174] Although the avoidance remedy "plainly threatens the security of transactions," the courts' primary

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168 *See generally* MURRAY, *supra* note 2, § 92.

169 *See* RESTATEMENT (SECOND) OF CONTRACTS § 164 (1979).

170 *See id.* § 175.

171 *See id.* § 177.

172 As Professor Rosett thoughtfully explains:

> Contract is intimately tied to ideas of private autonomy: the sense that people should be free to order their own affairs by agreement .... Some statements that appear promissory nonetheless are enforceable because they fail to satisfy the definition of a promise as an assurance of future conduct or event that is voluntarily and intelligently made. Promissory language uttered by someone without capacity, executed through duress, induced by fraud, or produced by essential mistake are [sic] not deserving of respect or enforcement.

ARTHUR ROSETT, CONTRACT LAW AND ITS APPLICATION 117 (5th ed. 1994); *see also* FARNSWORTH, *supra* note 1, § 4.9.

173 FARNSWORTH, *supra* note 1, § 4.9.

174 *Id.* In the typical misrepresentation case, one party misleads the other about a fact touching on the transaction, such as the quality of goods being sold, and this misrepresentation is the "inducement" for the transaction. *See id.* Such contracts are "voidable" at the behest of the party who has been misled. *See id.* § 4.12. More rarely, the misrepresentation relates to the very character or terms of the proposed contract (where, for example, one person induces another to sign a document by misrepresenting that it is something other than a contract, *see id.* § 4.11), in which event no contract is ever formed. *See* RESTATEMENT (SECOND) OF CONTRACTS § 163 (1979) (explaining that conduct constituting an "apparent manifestation of assent" by one who is misled "as to the character or essential terms of a proposed contract" is not effective as a manifestation). Courts sometimes describe such documents as a "void" contract. *See* FARNSWORTH, *supra* note 1, § 4.10.

focus in such cases is on "the unfairness to the recipient of the misrepresentation."[175] Concern for unfairness also includes protection for the recipient of a material misrepresentation in cases where the misrepresentation is innocently made by the other party.[176] Moreover, courts will rescind wholly executed transactions, irrespective of whether the misrepresentation was fraudulently or innocently made.[177] When courts grant the remedy of avoidance (i.e., rescission), they seek to restore the parties to their pre-contractual positions.[178] In such cases, the parties are required to make restitution to one another for the value of any benefits conferred in connection with their rescinded agreement.[179]

For cases involving fraudulent, or material, misrepresentations by a third party (that is, by one who is not a party to the transaction), the *Restatement of Contracts* employs a constructive notice/reliance test as the mechanism for balancing the parties' expectations and guarding against unfairly distorted bargaining. Thus, one who enters a contract based on a third party's misrepresentation can potentially obtain rescission of the transaction. However, this is not the case where the other party to the transaction (against whom the remedy of rescission is sought) has acted "in good faith and without reason to know of the misrepresentation" and has "give[n] value or relie[d] materially on the transaction."[180] Thus, a party to a contract who makes no misrepresentation, but is on notice of facts suggesting the presence of significantly distorting influences on his or her contracting

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175 *Id.*; *see also id.* § 4.12 ("Surely the policy favoring the security of transactions gives feeble support to the maker of the fraudulent misrepresentation.").

176 *See id.* § 4.12 ("Even if the misrepresentation is not fraudulent, the contract is voidable if the misrepresentation is material."); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 163 (stating that a contract is voidable by recipient of "either a fraudulent *or* a material misrepresentation") (emphasis added). The test for materiality asks whether the misrepresentation would have been likely to have induced a reasonable person to make the contract. *See id.* § 162(2); FARNSWORTH, *supra* note 1, § 4.12. Thus, a contract induced by a fraudulent but immaterial misrepresentation is likewise voidable, although such cases are understandably rare, given the broad test of materiality in this context and the high likelihood that almost all fraudulent misrepresentations will also be material. *See id.* § 4.12.

177 *See* FARNSWORTH, *supra* note 1, § 4.15. At one time, for policy reasons favoring the security of transactions, courts would only rescind an executed transaction where fraud, as opposed to an innocent misrepresentation, was shown. *See id.*

178 *See id.* §§ 4.9, 4.15.

179 *See* RESTATEMENT (SECOND) OF CONTRACTS § 175 (1979).

180 *Id.* § 164. The *Restatement of Contracts*'s test in this regard is derived from, among other things, the familiar Uniform Commercial Code ("U.C.C.") standards governing innocent purchasers of commercial paper (i.e., holders in due course). *See id.* cmt. e (citing U.C.C. § 3-305 (1998)).

counterpart, can lay no claim to protection of his or her contractual expectations.

In addition to notice, there is a potentially important timing principle inherent in this *Restatement of Contracts* test. Despite good faith, a wholly innocent party who has not yet "give[n] value or relie[d] materially on the transaction" will nevertheless see his or her expectations frustrated in the interest of fairness and undistorted bargaining.[181] This timing principle inherent in the *Restatement of Contracts*'s constructive notice/reliance standard for subordinating an innocent party's contractual expectations offers promising insight for forging a meaningful response to the third party acquiror's contractual expectation claim in the corporate setting.[182]

The doctrine of duress responds to the bargaining distortion problem, in which a competent and accurately informed party is pressured into a contract by the use of an improper threat that leaves the victim with no reasonable alternative.[183] In such circumstances, the societal concern for fairness permits the victim to avoid the transaction and rescind the contract.[184] This interest in assuring some minimal—albeit hard to define—standard of fairness in the bargaining process necessarily has an adverse impact on the stability of transactions and contractual

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181 *Id.* § 164.

182 *See infra* Part V.A.2. The significance of the *Restatement of Contracts*'s timing principle for cases involving misrepresentations by a third party arguably loses significance in light of the broad meaning given to the term "value" as including any consideration sufficient to support a contract, including a mere promise to pay. *See* RESTATEMENT (SECOND) OF CONTRACTS § 164 cmt. e (1979) (explaining that *Restatement of Contracts*'s constructive notice/reliance test for third party misrepresentation cases is derived from, among other things, the U.C.C. provisions governing commercial paper and holders in due course). The *Restatement of Contracts* rejects the more restrictive definition of "value" that the U.C.C. requires for achieving the protected status of holder in due course. *See* U.C.C. § 3-303(a)(1) ("Value" given for holder in due course status includes a "promise of performance" but only "to the extent the promise has been performed."). Instead, the *Restatement of Contracts* favors the more expansive general definition of "value" in U.C.C. section 1-201(44)(d) (stating that "value" includes "any consideration sufficient to support a simple contract"). *See* RESTATEMENT (SECOND) OF CONTRACTS § 164 cmt. e, illus. 4 (1979).

183 *See* RESTATEMENT (SECOND) OF CONTRACTS § 175 (1979). As with rescission based on misrepresentation, parties to a contract rescinded on the grounds of duress will be required to make restitution to each other for any benefit conferred. *See* FARNSWORTH, *supra* note 1, § 4.19; *see also* MURRAY, *supra* note 2, § 93.

184 *See* RESTATEMENT (SECOND) OF CONTRACTS § 175(1) ("[T]he contract is voidable by the victim."); *see also* FARNSWORTH, *supra* note 1, § 4.19. If a party is physically compelled to sign a document, no contract is formed at all. *See* RESTATEMENT (SECOND) OF CONTRACTS § 174 (1979). In contrast, "duress by threats makes a contract voidable." EDWARD J. MURPHY ET AL., STUDIES IN CONTRACT LAW 508 (5th ed. 1997).

expectations, particularly "[a]s courts have continued to expand the concept of duress far beyond its origins."[185] Moreover, in mediating the conflict between one party who is victimized by an improper threat from a third party (that is, a non-contracting party) and the other party to the contract (who is innocent of any improper bargaining and therefore seeks the realization of his or her expectations), the *Restatement of Contracts* employs the identical constructive notice/reliance test that is used for third party misrepresentation cases.[186] Thus, a party who is innocent of any improper threat will nevertheless have his or her expectations frustrated unless he or she acted in "good faith," was "without reason to know of the duress," and has "give[n] value or relie[d] materially on the transaction."[187]

Lastly, the doctrine of undue influence addresses the unfairness that results when someone enters into a contract as a result of "unfair persuasion" by the other party.[188] The remedy of avoidance available under the doctrine of undue influence (frequently involving a contract between parties who occupy a special relationship of trust and confidence) offers protection for those who are vulnerable to improper persuasion by the other party.[189] As with other doctrines affording relief from contractual liability because of an abuse of the bargaining process, the doctrine

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185 FARNSWORTH, *supra* note 1, § 4.17 (observing that the courts' continued expansion of the doctrine of duress has made it "increasingly difficult to define with precision the proper limits of bargaining." The *Restatement of Contracts* divides threats into two types. The "more traditional kinds of improper threats" are so shocking that courts grant relief without inquiring into the fairness of the transaction, including, for example, the threat of tortious or criminal behavior. *Id.*; RESTATEMENT (SECOND) OF CONTRACTS § 176(1) (1979). In the second category of behavior, the impropriety of the threat is dependent on a finding that the resulting exchange is not on fair terms, including, for example, "the use of power for illegitimate ends." *Id.* § 176(2)(c); *see also* FARNSWORTH, *supra* note 1, § 4.17; MURRAY, *supra* note 2, § 93. Conversely:

> [T]here appears to be general acknowledgment that duress is not shown because one party to the contract has driven a hard bargain or that market or other conditions now make the contract more difficult to perform by one of the parties or that financial circumstances may have caused one party to make *concessions*.

Machinery Hauling, Inc. v. Steel of W. Va., 384 S.E.2d 139, 144 (W. Va. 1989) (emphasis added).

186 *See* RESTATEMENT (SECOND) OF CONTRACTS § 175(2) (1979); *see also supra* note 180 and accompanying text.

187 RESTATEMENT (SECOND) OF CONTRACTS § 175(2) (1979).

188 *See id.* § 177.

189 *See id.* § 177(1); *see also* FARNSWORTH, *supra* note 1, § 4.20; MURRAY, *supra* note 2, § 94. Protection is also available under this doctrine in the absence of a relationship of trust and confidence if, for whatever reason, one party "is under the domination of the person exercising the persuasion." RESTATEMENT (SECOND) OF CONTRACTS § 177(1) (1979); *see also* FARNSWORTH, *supra* note 1, § 4.20.

of undue influence renders voidable those contracts that are "produced by means that seriously impair[] the free and competent exercise of judgment."[190] Likewise, the *Restatement of Contracts* permits avoidance by a party who assents to an agreement as a result of a third party's undue influence—despite the obvious frustration of expectations for the other party to the contract—unless that other party meets the same constructive notice/reliance test involved in third party duress and misrepresentation situations.[191]

3. Substantive Fairness and the Doctrine of Unconscionability

Courts have traditionally been reluctant to police agreements for substantive unfairness.[192] Nevertheless, courts refuse to enforce agreements which, in whole or in part, are found to be unconscionable.[193] Neither the Uniform Commercial Code ("U.C.C.") nor the *Restatement of Contracts* defines "unconscionability," prompting one eminent commentator to remark that the U.C.C.'s section on unconscionability is nothing more than an "emotionally satisfying incantation."[194] One enduring definition from a leading case in this area provides that unconscionability involves the "absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."[195] However

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190 FARNSWORTH, *supra* note 1, § 4.20.

191 *See* RESTATEMENT (SECOND) OF CONTRACTS § 177(3) (1979) (stating that a contract remains voidable when undue influence is exercised by third party unless "other party to the transaction in good faith and without reason to know of the undue influence either gives value or relies materially on the transaction").

192 *See* FARNSWORTH, *supra* note 1, § 4.1.

193 Section 2-302 of the U.C.C., regulating contracts for the sale of goods, provides:

> If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

U.C.C. § 2-302(1) (1998). The *Restatement of Contracts* likewise "contains a section on unconscionability that is patterned after" U.C.C. section 2-302 which is "applicable to contracts generally." FARNSWORTH, *supra* note 1, § 4.28; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979).

194 Arthur A. Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 558 (1967).

195 Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965). The "absence of meaningful choice" formulation is known as "procedural unconscionability" (relating to problems with the bargaining process) while the test for "unreasonably favorable" terms has been dubbed "substantive unconscionability." FARNSWORTH, *supra* note 1, § 4.28 (quoting Leff, *supra* note 194, at 487); *see also* Epstein, *supra* note 1, at 294-

defined, the doctrine has obvious implications for the security of transactions. Where the bargaining process appears to have malfunctioned and/or the underlying exchange appears far too "one-sided,"[196] courts will invoke the doctrine in refusing to enforce the transaction.[197] In such cases, courts again elevate the policy of ensuring essential minimal standards of fairness above the usual contractual instinct of protecting expectations.

4. Fairness for Bargains Built on Erroneous Assumptions: Mistake, Impracticability, and Frustration

Another situation where fairness takes precedence over expectations and the security of transactions involves the contract that is egregiously one-sided not because of any abuse of the bargaining process but, rather, because the contract is based on fundamental assumptions by one or both of the parties that prove to be mistaken.[198] The doctrine of mistake (mutual and unilateral) addresses mistaken assumptions about facts in existence when the contract is made.[199]

The doctrine of mutual mistake renders a contract voidable where: (1) "a mistake of both parties at the time [the] contract was made" goes to "a basic assumption on which the contract was made"; and (2) the mistake has "a material effect on the agreed exchange of performances."[200] The *Restatement of Contracts*'s "basic assumption" standard limits relief to cases involving "a

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95 ("The doctrine [of unconscionability] should not . . . allow courts to act as roving commissions to set aside those agreements whose substantive terms they find objectionable. Instead, it should be used only to allow courts to police the process whereby private agreements are formed . . . .").

196 *See* U.C.C. § 2-302 cmt. 1 (1998).

197 The remedy for unconscionability typically consists of the court withholding relief by refusing to enforce the contract in whole or part. *See* U.C.C. § 2-303(1) (1998); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979); FARNSWORTH, *supra* note 1, § 4.28. Consequently, "there is no inherent requirement that the claimant make restitution." *Id.*

198 *See* MURPHY ET AL., *supra* note 184, at 445-46 ("Failure of the parties to possess sufficient or accurate information about a 'basic assumption on which the contract was made' undermines our confidence that the bargaining process will produce an equitable or efficient outcome.").

199 *See generally* FARNSWORTH, *supra* note 1, § 9.2. Mistaken assumptions about facts that are expected to exist when the time for performance falls due are covered by the doctrines of impracticability and frustration. *See id.*

200 RESTATEMENT (SECOND) OF CONTRACTS § 152(1) (1979). The *Restatement of Contracts* contains the additional requirement that the party seeking rescission of the contract has not assumed the risk of the mistake, either expressly in the agreement or by implication based on the circumstances of the transaction. *See id.*; *see also id.* § 154 (outlining when a party bears the risk of a mistake).

mistake at the formation stage [which] must be foundational to the contract."[201] The materiality test for the disparity of the bargain likewise ensures that courts will only disturb those transactions in which "the resulting imbalance in the agreed exchange is so severe that [the adversely affected party] can not fairly be required to carry it out."[202]

In cases of mutual mistake, the court is confronted with "two equally innocent parties" and must, "in the exercise of [its] equitable powers . . . determine which blameless party should assume the loss resulting from the misapprehension they shared."[203] If a court grants the remedy of avoidance by rescinding the transaction, either party can obtain restitution for any benefits conferred.[204] Moreover, the *Restatement of Contracts* proposes the discretionary award of reliance damages "as justice requires" in any particular case.[205] The doctrine of mutual mistake thus allows for the disturbance of expectations in the interest of fundamental fairness where neither party was aware of its mistake when the contract was made.[206]

Even more analogous to the third party acquiror's contractual claim in the takeover setting is the contract law doctrine of unilateral mistake. This doctrine permits one party to a contract to obtain rescission of the transaction when that party, at the time the contract is made, is mistaken "as to a basic assumption on which he [has] made the contract" and this mistake has a "material effect on the agreed exchange of performances that is adverse to him."[207] Courts are understandably "reluctant to allow a party to

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201 MURRAY, *supra* note 2, § 91. The *Restatement of Contracts*'s "basic assumption" language is drawn from the U.C.C.' s section on impracticability. *See* U.C.C. § 2-615(a) (1998); *see also* FARNSWORTH, *supra* note 1, § 9.3.

202 RESTATEMENT (SECOND) OF CONTRACTS § 152 cmt. c (1979).

203 Lenawee County Bd. of Health v. Messerly, 331 N.W.2d 203, 210 (Mich. 1982).

204 *See* RESTATEMENT (SECOND) OF CONTRACTS § 158 (1979); *see also* FARNSWORTH, *supra* note 1, § 9.4.

205 *See* RESTATEMENT (SECOND) OF CONTRACTS § 158(2) (1979) ("[T]he court may grant relief on such terms as justice requires including protection of the parties' reliance interest.").

206 It could be argued that the doctrine does not frustrate expectations as they existed when the contract was made. It is only the unexpected windfall, discovered after the fact, that the party opposing rescission seeks to protect under the rubric of contractual expectations. *See* RESTATEMENT (SECOND) OF CONTRACTS § 152(2) (1979) (authorizing court to reform contract when possible to rectify mistake as alternative to rescinding transaction); *see also* FARNSWORTH, *supra* note 1, § 9.3.

207 RESTATEMENT (SECOND) OF CONTRACTS § 153 (1979). As with the doctrine of mutual mistake, the party seeking avoidance on the grounds of unilateral mistake must not have assumed the risk of the mistake. *See id.*

avoid a contract for a mistake that was not shared by the other party." [208] Indeed, the policy favoring the stability of transactions invariably prevails when the non-mistaken party is innocent and unaware of the other's mistake.[209] On the other hand, a court will grant rescission if the other party had constructive notice—that is, it "had reason to know of" the mistake.[210] As in the case of rescission due to mutual mistake, parties in this context are entitled to restitution for the value of any benefits conferred[211] and the court, according to the *Restatement of Contracts* formulation of the doctrine, may award reliance damages on a discretionary basis.[212]

The constructive notice component of unilateral mistake jurisprudence finds a sensible point of equilibrium for accommodating the competing concerns of protecting expectations and ensuring essential fairness. When only one of the parties to a contract is mistaken, and the "other party is innocent[ly] . . . unaware" of the mistake,[213] it makes sense to prioritize the value of protecting expectations by enforcing the contract. The security of transactions is reinforced for the benefit of truly "innocent" parties, while others in the marketplace are given appropriate incentive to investigate their pre-contractual assumptions. On the

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208 FARNSWORTH, *supra* note 1, § 9.4; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 153 cmt. a (1979).

209 *See* MURRAY, *supra* note 2, § 91. As Professor Murray explains:

> There is a significant problem in permitting a contract to be avoided on the ground of unilateral as contrasted with mutual mistake. If only one party is mistaken, the other party is innocent, i.e., if the other is unaware of the mistake of the first party . . . she is entirely without fault and has a great claim to the protection of her expectations under the contract.

Id.; *see also* Hanby v. Alymont Fire Co. No. 1, 528 A.2d 1196, 1198 (Del. 1987) (granting relief where "there was a mutual mistake, or a *unilateral mistake coupled with knowing silence*") (emphasis added).

210 *See* RESTATEMENT (SECOND) OF CONTRACTS § 153(b) (1979) (stating that a contract is voidable for unilateral mistake where "the other party had reason to know of the mistake or his fault caused the mistake"); *see also* FARNSWORTH, *supra* note 1, § 9.4. As a safety valve for ensuring basic fairness, the *Restatement of Contracts* also would allow rescission for unilateral mistake when the other party was without reason to know of the mistake if "the effect of the mistake is such that enforcement of the contract would be unconscionable." RESTATEMENT (SECOND) OF CONTRACTS § 153(a) (1979).

211 *See* RESTATEMENT (SECOND) OF CONTRACTS § 158 cmt. b (1979); *see also* FARNSWORTH, *supra* note 1, § 9.4.

212 *See* RESTATEMENT (SECOND) OF CONTRACTS § 158(2) (1979) ("[T]he court may grant relief on such terms as justice requires including protection of the parties' reliance interest."); *see also id.* cmt. b; MURRAY, *supra* note 2, § 91 (stating that a court granting rescission "may protect the reliance interest where avoidance of the contract fails to protect that interest sufficiently").

213 MURRAY, *supra* note 2, § 91.

other hand, when a non-mistaken party is aware[214] or has reason to know of the other party's mistake, it likewise makes sense to prioritize the value of essential fairness ahead of expectations and transaction stability. The party seeking to enforce a one-sided bargain in such circumstances is not wholly "innocent," and whatever expectations he or she may claim under the contract cannot fairly be called "justified" or "reasonable."[215]

The doctrines of impracticability and frustration reveal yet another contract law policy preference (albeit in the exceptional case) for ensuring essential fairness over protecting expectations. Under the guise of impracticability, a court may excuse a party's performance when the surrounding circumstances change so markedly during the life of the contract that the party's performance becomes impossible or, because of abnormal and unexpected circumstances, extremely burdensome or unprofitable (i.e., "impracticable").[216] Similarly, a party's contractual duties may be discharged not because of any impediment to performance, but because "a change in circumstances makes one party's performance virtually worthless to the other, frustrating his

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214 When the other party "actually knows of the mistake," his or her knowing silence may also constitute a misrepresentation. *See* RESTATEMENT (SECOND) OF CONTRACTS § 153 cmt. e (1979) (citing *id.* §161).

215 *See supra* notes 121-26 and accompanying text (discussing primary purpose of contract law as protection of reasonable expectations); *see also* Tyra v. Cheney, 152 N.W. 835, 835 (Minn. 1915) ("One cannot snap up an offer or bid knowing that it was made in mistake."); Howell v. Waters, 347 S.E.2d 65, 69 (N.C. Ct. App. 1986); FARNSWORTH, *supra* note 1, § 9.4 ("Under the modern view, the contract is voidable if the other party had reason to know of the mistake or caused it.").

216 *See* MURRAY, *supra* note 2, § 112; *see also* FARNSWORTH, *supra* note 1, § 9.6 (stating that "the focus is on the increased burden on the party that is to perform"). The U.C.C. section on impracticability, entitled "Excuse by Failure of Presupposed Conditions," emphasizes the impact of supervening events on a "basic assumption" of the contract as the key to excusing nonperformance:

> Except so far as a seller may have assumed a greater obligation . . . [a] delay in delivery or non-deliver in whole or in part by a seller . . . is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made.

U.C.C. § 2-615(a) (1998); *see also id.* cmt. 1 ("This section excuses a seller from timely delivery of goods contracted for, where his performance has become commercially impracticable because of unforeseen supervening circumstances not within the contemplation of the parties at the time of contracting."). The *Restatement of Contracts* imports the U.C.C.' s impracticability formulation nearly verbatim, thereby ensuring the application of this principle beyond contracts involving the sale of goods. *See* RESTATEMENT (SECOND) OF CONTRACTS § 261 (1979); *see also id.* cmt. d; MURRAY, *supra* note 2, § 112.

purpose in making the contract."[217] The doctrines of impracticability and frustration permit the discharge of contractual duties on the basis of some finely drawn lines involving "unreasonable difficulty" and "substantial" frustration.[218] In the case of "existing" impracticability and frustration—that is, when the event impeding a party's performance or frustrating his or her contractual purpose already exists at the time the contract is made—relief from contractual hardship remains available, but only if the adversely affected party had "no reason to know" of the adverse facts at the time the contract was made.[219] When a party is discharged on grounds of impracticability or frustration (whether existing or supervening), remedial options include relief in the form of restitution and, "as justice requires," damages for "protection of the parties' reliance interests."[220]

5. Summary: Derived Principles for Reconciling Expectation and Fairness Concerns

The foregoing review of various obligation avoidance doctrines offers helpful insight into the mechanisms by which contract law mediates the tension between protecting expectations and stability of transactions on one hand, and ensuring essential fairness (principally by policing agreements that are the product of a fundamentally distorted bargaining process) on the other. These reconciliation mechanisms, summarized below, substantially inform the analysis suggested in Part V of this Article as a means

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217 RESTATEMENT (SECOND) OF CONTRACTS § 265 cmt. a (1979). The U.C.C. does not explicitly adopt the doctrine of frustration, but it is commonly understood that the doctrine applies to contracts for the sale of goods. *See* FARNSWORTH, *supra* note 1, § 9.7; *see also* U.C.C. § 1-103 (1998) ("Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions.").

218 The *Restatement of Contracts* excuses nonperformance as impracticable based on "extreme and unreasonable difficulty" as opposed to "[a] mere change in the degree of difficulty or expense." RESTATEMENT (SECOND) OF CONTRACTS § 261 cmt. d (1979). In the case of frustration, relief is available when the frustration is "substantial" and "severe," but not when the event that frustrates the party's purpose in entering into the transaction will simply render the contract "less profitable for the affected party or even [cause that party to] sustain a loss." *Id.* § 265 cmt. a; *see also* RESTATEMENT (SECOND) OF CONTRACTS ch. 11, introductory note (1979) ("[T]he court must determine whether justice requires a departure from the general rule that the obligor bear the risk that the contract may become more burdensome or less desirable . . . . In recent years court have shown increasing liberality in discharging obligors on the basis of such extraordinary circumstances.").

219 *See* RESTATEMENT (SECOND) OF CONTRACTS § 266 (1979); *see also* U.C.C. § 2-613 cmt. 2 (1998) ("This section applies whether the goods were already destroyed at the time of contracting without the knowledge of either party.").

220 RESTATEMENT (SECOND) OF CONTRACTS § 272 (1979).

of resolving the third party acquiror's assertion of protectable contractual interests in the takeover context.[221]

a. *Direct responsibility for distortions*

Not surprisingly, behavior constituting an abuse of the bargaining process by the party seeking to enforce the contract will result in non-enforcement of the bargain. Thus, any purported expectations claimed by one who is responsible for fraud or material misrepresentation, duress, or undue influence upon the other party in procuring their contract cannot be considered reasonable or justifiable.[222] The disappointment of such expectations is minor compared to the unfairness and injustice of enforcing a bargain that is built upon such purposeful distortions. A fitting corporate law analogy would be a case in which the third party acquiror knowingly assisted (i.e., aided and abetted) the target board's breach of fiduciary duty.[223] Any acquiror claim of vested contract rights in such circumstances would be frivolous. Of more interest to an analysis of the "innocent" corporate acquiror's contractual assertions are those contract law avoidance doctrines that turn on whether the party seeking enforcement of the contract was unaware of, yet had "reason to know," that the other party to the contract bargained under the impediment of some form of distortion.

b. *"Reason to know" of distortions from other sources*

In a variety of interesting settings, contract law repeatedly calls on a "reason to know" constructive notice test in deciding whether to give primacy to the value of protecting expectations (by enforcing the bargain) or the value of essential fairness (by requiring some minimal level of undistorted bargaining as a

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221 *See infra* Part V.A.

222 Arguably appropriate for inclusion in this category are contracts that are denied enforcement in whole or part as unconscionable. An egregiously one-sided bargain may itself be regarded as circumstantial evidence of a defective bargaining process. *See, e.g.*, Jones v. Star Credit Corp., 298 N.Y.S.2d 264, 267 (Sup. Ct. 1969) ("[T]he value disparity itself leads to the felt conclusion that knowing advantage was taken of the plaintiffs."); RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. c (1979):

> Inadequacy of consideration does not of itself invalidate a bargain, but gross disparity in the values exchanged may be an important factor in a determination that a contract is unconscionable and may be sufficient ground, without more, for denying specific performance. Such a disparity may also corroborate indications of defects in the bargaining process.

Id. (citations omitted).

223 *See infra* note 438 and accompanying text.

precondition to enforcement). In each instance, the party seeking enforcement of the contract is "innocent" of any bargaining misbehavior, while the other party claims the presence of some fundamentally distorting influence upon himself or herself that warrants avoidance of the contract. Whether expectations or fairness prevails in such cases (i.e., whether there is enforcement or avoidance of the contract) often turns on whether the party seeking enforcement had reason to know of the other party's problems. Thus, for example, courts will disappoint the contractual expectations of a party who had reason to know that the other party with whom he or she bargained was mentally incompetent (in the volitional sense)[224] or intoxicated.[225]

This reason to know test is also used to resolve cases where an outside party distorts the bargaining process for one of the contracting parties by misrepresentation (either fraudulent or material), duress, or undue influence. In each instance, a court may avoid the contract, and thereby frustrate the expectations of the other party (who is innocent), when that party did not actually know, but had reason to know, of the presence of such outside distortions on his or her contracting counterpart.[226] Likewise, in the case of unilateral mistake, the contract is rendered voidable when the non-mistaken party had reason to know of the other party's mistake.[227] Finally, in the case of existing, as opposed to supervening, impracticability or frustration, the reason to know test is used to deny relief from contract liability for the burdened or frustrated party who had reason to know of the adverse facts in existence at the time the contract was made.[228]

The reason to know test supplies a fair point of balance for accommodating the competing values of expectations and fairness in cases where one contracting party's participation in the bargaining process has been undermined by the presence of serious distortions for which the other party to the contract is not responsible. When the party unaffected by the distortions had reason to know of such disruptions, the value of fairness rightly takes precedence. On the other hand, when the unaffected party bargained in good faith and without reason to know of the other party's impairment, the value of protecting expectations ascends.

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224 *See supra* note 157 and accompanying text.
225 *See supra* notes 162-63 and accompanying text.
226 *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 164(2), 175(2), 177(2) (1979).
227 *See id.* § 153(b).
228 *See id.* § 266.

Absent the presence of some strong additional policy concern, the contract would likely be enforced in such circumstances, notwithstanding the resulting hardship to the party affected by the distortions.

The *Restatement of Contracts*'s reason to know test also charges persons of superior intelligence with having reason to know of a fact that a person of lesser intelligence might fail to appreciate.[229] Under the *Restatement of Contracts*, facts having a "substantial chance of existence" fall within the realm of information about which a person has reason to know.[230] These principles have interesting implications for the corporate law contract/fiduciary problem.

In the corporate takeover setting, a collision of interests occurs between the acquiror and the target's stockholders when "distortions" to the bargaining process are present in the form of the target board's breach of fiduciary duty. In such circumstances, the reason to know test may contribute to a principled resolution of the acquiror–target stockholder conflict. Thus, if an acquiror were subjectively unaware of any actual breach of fiduciary duty by the target board, but had reason to know of potential problems in this regard, that acquiror's claim to protection of its contractual expectations should be significantly weakened. In determining whether an acquiror had reason to know of a target board's fiduciary problems, the court should—in keeping with the *Restatement of Contracts*'s adjustment for "superior intelligence"[231]—evaluate the acquiror's position from the perspective of its own sophistication. Notably, in *Paramount* both the Delaware Chancery Court and Delaware Supreme Court instinctively—albeit indirectly—reached for contract law's reason to know conflict resolution mechanism in disappointing third party acquiror Viacom's contractual expectations by refusing, on fiduciary grounds, to enforce Viacom's no-shop and stock option agreements with target Paramount.[232]

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229 *See id.* ("A person of superior intelligence has reason to know a fact if he has information from which a person of his intelligence would draw the inference.").

230 *Id.* ("There is also reason to know if the inference would be that there is such a substantial chance of the existence of the fact that, if exercising reasonable care with reference to the matter in question, the person would predicate his action upon the assumption of its possible existence.").

231 *See id.* § 19 cmt. b.

232 *See* QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245, 1245 (Del. Ch. 1993); *see also id.* at 1271-72 (referring to the improper "uncapped" stock option agreement as: (1) "foreseeably" rewarding Viacom for a low initial bid; (2) "foreseeably"

c. *Timing considerations*

Timing is also an important factor by which contract law calibrates the tension between protecting expectations and ensuring fairness. The foregoing principles suggest that the sooner one party to a contract seeks avoidance on the ground of some distortion to the bargaining process, the better will be its prospects for winning relief. Given the value favoring the stability of transactions, courts are understandably reluctant to disturb agreements which have been fully performed by both sides (absent the presence of some compelling fairness principle suggesting otherwise).

Thus, for example, in the case of distortions caused by someone who is not a party to the contract (as in the case of misrepresentation, duress, or undue influence), the remedy of avoidance is lost for the adversely affected party if the other party to the contract has acted "in good faith and without reason to know" of the distortion and "either give[n] value or relie[d] materially on the transaction."[233] Likewise, in the case of mental illness or defect, the otherwise appropriate remedy of avoidance may be lost once the contract has been performed if "the circumstances have so changed that avoidance would be unjust."[234]

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imposing "stratospheric" costs on any competing bidder; and (3) "foreseeabl[y]" reducing Viacom's incentive to raise its offer later, given the significant profit available to it by allowing a competing bidder to prevail with a higher offer and simply exercising the option). In dismissively rejecting Viacom's assertions of protectable contractual interests, Vice Chancellor Jacobs admittedly did not rely directly on this "foreseeability" principle (which otherwise would suggest that Viacom had "reason to know" of a potential fiduciary problem and thus was not wholly innocent). Instead, he employed what appeared to be a conventional public policy analysis, in which he concluded that "the need to protect the interest of [Paramount] stockholders outweighs any injury to Viacom." *Id.* at 1272 n.49; *see also* Grimes v. Donald, 1995 Del. Ch. LEXIS 3, at *30 n.8 (Del. Ch. Jan. 11, 1995) (noting, in dictum, the potential significance of the "foreseeability" of a contract's adverse effects in resolving "a clash between a [party's] contract rights and the board's fiduciary duty"); *infra* Part III.C. (discussing public policy limitations on the enforceability of agreements). The Delaware Supreme Court, in affirming the chancery court's rejection of Viacom's claim of contract rights under the stock option agreement in *Paramount*, referred somewhat more directly to criteria—including acquiror Viacom's sophistication and its reliance on professional advisors—that would appropriately be considered in a contract law "reason to know" analysis for a party with "superior intelligence." *See Paramount*, 637 A.2d at 51 ("Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable features of the Stock Option Agreement.").

233 RESTATEMENT (SECOND) OF CONTRACTS §§ 164(2), 175(2), 177(3) (1979).

234 *Id.* § 15(2); *see also id.* cmt. e ("*Effect of performance.* Where the contract has been performed in whole or part, avoidance is permitted only on equitable terms.") (emphasis in original).

Conversely, a prompt request for relief by the adversely affected party in such circumstances, made prior to a material change of position by the other party, plainly enhances the prospects for obtaining the remedy of avoidance. This timing principle also assumes significance for resolving the acquiror–target shareholder dispute, particularly where the "avoidance" remedy is sought by the target's shareholders in the context of "transactional justification" (as in the case of a motion for a preliminary injunction to prevent a proposed, but not yet consummated, change of control transaction).[235] Likewise, it explains why a consummated change of control transaction that is the product of a breach of fiduciary by the target board remains lawful and valid and unlikely to be set aside,[236] while pending takeover transactions that are attacked at the preliminary injunction stage are more vulnerable to judicial interference.[237]

d. *Strong fairness policy*

Although the timing principle, which upholds the policy favoring the stability of transactions, is an important factor in mediating the expectations—fairness conflict, it nevertheless may be trumped by the presence of an especially strong competing policy. Thus, minors still may disaffirm a contract long after it has been performed by both sides[238]—a circumstance presumably attributable to the comparatively strong policy reference for protecting minors against their own improvidence.[239] Conversely, a person who entered into a transaction while intoxicated may not avoid even a wholly executory contract (so long as the other party was without reason to know of his or her condition),[240] reflecting contract law's relatively weak policy of protecting persons from the consequences of voluntary intoxication.[241]

The reason to know constructive notice test summarized

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235 *See infra* Part V.A.2.; *see also infra* notes 349-56 and accompanying text.

236 *See infra* note 356 and accompanying text.

237 *See, e.g.*, *Paramount*, 637 A.2d at 34; Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989); *In re* Holly Farms Corp. Shareholders Litig., Civ. No. 10350, 1988 WL 143010 (Del. Ch. Dec. 30, 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

238 *See* FARNSWORTH, *supra* note 1, § 4.4; *see also* MURRAY, *supra* note 2, § 23.

239 *See supra* notes 144-50 and accompanying text.

240 *See supra* note 165 and accompanying text.

241 *See supra* note 162 and accompanying text.

earlier[242] may also be supplanted by an especially strong policy concern. Thus, the strong policies favoring the protection of minors and cognitively (but not volitionally) impaired persons permit such persons to avoid their contracts based on lack of capacity, despite the fact that the other parties to such contracts were innocent and without reason to know of the incapacity.[243] The strength of the policy favoring protection of minors is also seen in the law of negotiable instruments, in which infancy constitutes a "real" defense and, thus, is effective to defeat the claims of a holder in due course of any negotiable instrument signed by a minor.[244]

A similarly strong corporate law policy concern is that of protecting the integrity of the fiduciary relationship between directors and shareholders. Moreover, in the special context of a "bet the company" board decision to approve a change of control transaction (effectively presenting the purest form of "ownership issue"),[245] this important policy concern finds perhaps its strongest point of emphasis in all of corporate law.[246]

e. *Reliance damages and the lurking fault principle*

In granting the remedy of avoidance to a party adversely affected by the presence of bargain undermining distortions, the degree to which a court may also protect the undistorted party's reliance interest depends on whether that undistorted party was wholly innocent[247] with regard to the circumstances that form the basis for avoiding the contract. As shown below, reliance damages

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242 *See supra* Part II.B.5.b.

243 *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 14, 15(1) (1979).

244 *See* U.C.C. § 3-305(a)(1) (1998). The official comment to this provision makes plain the policy choice favoring the protection of minors ahead of expectations in this instance:

> Subsection (a)(1)(i) allows assertion of the defense of infancy against a holder in due course, even though the effect of the defense is to render the instrument voidable but not void. *The policy is one of protection of the infant even at the expense of occasional loss to an innocent purchaser.*

Id. cmt. 1 (emphasis added).

245 *See infra* Part IV.B.

246 *See id.*

247 The term "wholly innocent" is used here to describe the person against whom the remedy of avoidance is granted when that person neither knew nor had reason to know of the distortions affecting their contracting counterpart. Merely "innocent" persons are described in this Article as those who bargain in good faith and without any subjective (i.e., actual) awareness of distortions affecting the other party but who have reason to know of such distortions. Persons in this latter category (i.e., "innocent" but not "wholly innocent" persons) unsurprisingly receive less protection under contract law than "wholly innocent" persons. *See supra* Part II.B.5.b. (discussing the "reason to know" test).

are not ordinarily available to a party whose contractual expectations are disappointed by the remedy of avoidance when that party was innocent, but not wholly innocent, concerning the adversely affected party's distortions, as that party had reason to know of such distortions at the time of contracting.

The *Restatement of Contracts* expressly acknowledges the discretionary power of the court, when avoiding a contract on the ground of mistake, to award relief both by way of restitution and "on such terms as justice requires including protection of the parties' reliance interests."[248] Identical language acknowledging the court's authority to award reliance damages also exists in connection with a decree of discharge based on supervening impracticability or frustration.[249] Generally speaking, the fairness principle underlying these hardship avoidance doctrines (mistake, impracticability, and frustration) involves a concern for severely one-sided exchanges that result from a failure of basic assumptions underlying the bargain of which neither party to the contract was aware.[250] When the party against whom the remedy of avoidance or discharge is granted was without reason to know of the other party's misapprehension at the time of contracting, the former party is understandably more deserving of protection of its reliance interest—"as justice requires"[251] in an appropriate case—than someone who is chargeable with notice of the other party's flawed assumptions.

The *Restatement of Contracts*'s treatment of reliance damages in unilateral mistake cases reveals, in particular, a contract law tendency against awarding reliance damages to merely innocent, as opposed to wholly innocent, persons.[252] Specifically, the comments to the *Restatement of Contracts*'s section on unilateral mistake suggest a fault-based inquiry for determining the availability of reliance damages when the remedy of avoidance is granted in this context. For example, comment (d) to section 153 explicitly allows

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248 RESTATEMENT (SECOND) OF CONTRACTS § 158(2) (1979).

249 *See id.* § 272.

250 *See supra* Part II.B.4. As discussed below, the doctrine of unilateral mistake can involve the circumstance where one of the contracting parties had reason to know of the other's mistake. *See* RESTATEMENT (SECOND) OF CONTRACTS § 153(b) (1979).

251 RESTATEMENT (SECOND) OF CONTRACTS §§ 158(2), 272(2) (1979).

252 *See id.* § 153. Under the *Restatement of Contracts*'s formulation of the doctrine of unilateral mistake, a party can avoid a contract based on its own mistake about a basic assumption underlying their bargain if: (1) enforcement of the contract would be unconscionable; or (2) irrespective of unconscionability, the other party had "reason to know of the mistake or his fault caused the mistake." *Id.*

for reliance damages pursuant to section 158(2) when the remedy of avoidance is granted on the grounds of unconscionability.[253] On the other hand, comment (e) to section 153, which speaks to the circumstance in which the contract is avoided because the other party had reason to know of the mistake (or was solely at fault in causing it), conspicuously omits reference to awarding reliance damages to the party against whom the remedy of avoidance is granted.[254]

The fault principle driving the availability of reliance damages for voidable contracts undoubtedly accounts for the absence of any provisions comparable to sections 158 and 272 among the *Restatement of Contracts* sections on the doctrines of misrepresentation, duress, and undue influence.[255] An essential element of an adversely affected party's claim for avoidance under each of these doctrines is that the other party to the contract abusively disrupts the bargaining process or has "reason to know" that such disruptions from other sources exist.[256] By definition, therefore, the remedy of avoidance is only granted under these doctrines against a party who is not wholly innocent and therefore is undeserving of any potential discretionary award of reliance damages.[257]

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253 *See id.* § 153 cmt. d ("If . . . the other party has relied on the contract in some substantial way, avoidance may leave that reliance uncompensated. . . . If, however, the court can adequately protect the other party by compensating him for his reliance under the rules stated in § 158, avoidance is not then precluded on this ground."). The illustrations accompanying the comments to section 153 similarly reinforce the distinction between allowing reliance damages when avoidance is based solely on unconscionability and disallowing such relief when the non-mistaken party "[h]ad reason to know of or caused the mistake." *Id.* cmt. d, illus. 8 (allowing reliance damages); *see id.* § 153 cmt. 3; *id.* § 153 cmt. 3, illus. 9, 10 (providing examples of voidable contracts but omitting any reference to the availability of reliance damages).

254 *See id.* § 153 cmt. e. This comment does allow for the discretionary award of reliance damages pursuant to section 158(2), but only where *both* parties were at fault in causing the mistake. *See id.* ("If the mistake was the fault of both parties, it was not caused by the other party within the meaning of this Section and the court may exercise its discretion under the rule stated in § 158(2)."); *see also id.* § 158 cmt. c ("The Court may also exercise its discretion [in awarding reliance damages] under Subsection (2) where both parties have been responsible for the mistake."). The fair import of these comments is that reliance damages should not be awarded to a non-mistaken party when rescinding a contract if the non-mistaken party is less than wholly innocent, either because it had reason to know of the other party's mistake or it was solely at fault in causing that party's mistake.

255 *See id.* Ch. 7.

256 *See id.* §§ 164, 175, 177.

257 *See id.* Persons in this setting receive only modest protection of their reliance interest—i.e., in cases where the distortion to the bargaining process is caused by someone other than a party to the contract and the contracting party against whom the remedy of

These fault-based principles for awarding reliance damages—based on an objective reason to know fault standard—offer potentially promising applications to corporation law. A third party acquiror may act in good faith and without actual knowledge that the target company's directors have breached their fiduciary duties, and nevertheless be at fault within the meaning of settled contract law principles.[258] Where an acquiror acts in good faith and is without actual knowledge, but has reason to know of potential fiduciary problems with the directors of its contracting corporate counterpart, that acquiror is vulnerable not only to the remedy of avoidance,[259] but also to the disallowance of any discretionary award of reliance damages.[260]

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avoidance is sought has, in "good faith and without reason to know" of the distortion, "relie[d] materially on the transaction." *Id.* §§ 164(2), 175(2), 177(2). Under the formulation of these provisions, however, material reliance and good faith on the part of the unaffected party will not defeat a claim for avoidance if that party acted unaware, but with "reason to know," of the distortions. *See id.*

258 For this reason, acquiror Viacom's contract law argument to the chancery court in *Paramount*—"that plaintiffs ... failed to adduce that it aided or abetted any fiduciary violation by Paramount directors" and thus "the Court [could] not (or, alternatively, should not) grant relief that would deprive Viacom of its bargained-for contractual rights"—was both misleading and flawed. *See* QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245, 1264 n.39 (Del. Ch. 1993). It was misleading because the almost impossibly difficult subjective "knowing" standard required for establishing aiding and abetting a fiduciary violation is a corporate law fiduciary principle (not a contract law precept) that speaks to a fundamentally different question that was not presented in *Paramount*: the *liability* of a third party to another corporation's shareholders. *See infra* note 438. It was also flawed because the altogether different question that was presented in *Paramount*—i.e., whether an acquiror's merger agreement with a target corporation warrants any protection under contract law—turns in part, under established contract principles, not on Viacom's subjective knowledge or good faith (these are essential but not sufficient to contractual protection), but on whether Viacom had "reason to know" of the Paramount directors' breach of fiduciary duty.

259 *See supra* Part II.B.5.

260 As a practical matter, it is difficult to imagine a "hard" case in the context of "transactional justification" (i.e., on a motion for a preliminary injunction brought before consummation of a change of control transaction where it is established that the target's directors have breached their fiduciary duties) in which the court would refuse to enjoin the transaction solely because the acquiror was "wholly innocent" and thus both subjectively unaware and without "reason to know" of the directors' breach of duty. *See RJR Nabisco*, Civ. No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989); *see also supra* note 19 and accompanying text. Moreover, there are sound reasons under contract law principles for refusing to enforce the contract under such circumstances despite the acquiror being wholly innocent. *See supra* Part II.B.5. (discussing independently dispositive significance of timing and strength of competing policy concern). Consequently, whether the acquiror had reason to know of the target director's difficulties would only have significance, on a practical level, in determining whether to award the acquiror any reliance damages in conjunction with the remedy of avoidance.

C. *Summary of the Law of Contracts and Expectation Interest*

In a variety of contexts, contract law mediates the tension between the competing values of protecting expectations and ensuring essential fairness. Although subject to exceptions in each instance, the following general principles of conflict resolution emerge. First, when the party who seeks enforcement of a contract knowingly takes advantage of abuses in the bargaining process, or is at least chargeable with knowledge that its contracting counterpart's bargaining effectiveness was compromised by the presence of some significant distortion, courts tend to elevate the fairness principle above that of protecting expectations. Second, timing is also an important variable in resolving the expectations–fairness conflict. Given the courts' understandable reluctance to disturb settled transactions, there is greater transaction jeopardy for executory contracts—when the remedy of avoidance is sought before the performances contemplated by the contract are exchanged—than in cases involving completed transactions. Third, the strength of the particular fairness policy involved may be independently dispositive. Thus, an especially strong fairness concern may independently override the preceding principles, while lesser fairness concerns may be subordinated in favor of protecting expectations. Finally, the availability of reliance damages may contribute to a more principled decree of avoidance in cases where the party whose expectations are disappointed is wholly innocent of any wrongdoing.

III. EXPECTATIONS ARISING FROM AGREEMENTS NEGOTIATED BY REPRESENTATIVES

The general principles employed in contract law to resolve disputes involving the competing concerns of protecting contractual expectations, while ensuring some minimal standard of fairness in the bargaining process, were previously discussed. This section traces the application of these potentially expectation-impairing principles in contexts more closely analogous to the acquiror corporation–target shareholder conflict. Specifically, this section examines the application of these general contract law principles in disputes involving contracts: (1) negotiated between third parties and authorized representatives (i.e., trustees or agents); and (2) subject to challenge on public policy grounds. As demonstrated below, courts rely on various forms of these same general principles to resolve the expectations–fairness conflict

between innocent claimants in each of these important contexts.

In the corporate takeover setting, when an innocent third party acquiror seeks enforcement of its contractual expectations and the target's stockholders seek protection from an alleged breach of fiduciary duty by their board of directors, these same general contract law principles should be applied. The contractual expectation interest of a third party corporate acquiror, while legitimate and deserving of protection in an appropriate case, is sharply circumscribed by: (1) the representative capacity in which the target's board of directors negotiates with the acquiror; (2) the competing interests of the shareholders of the target corporation; and (3) the extraordinary change of control context in which those interests arise. The court's enhanced role in monitoring the fiduciary relationship between the directors and shareholders of the target corporation in this significant context has legitimacy not only as a corporate governance matter, but also as a contractual matter, given: (1) the well-established limitations upon the enforceability of agreements with representatives; and (2) the important public policy of protecting the integrity of the fiduciary relationship. In contract law terms, the principles of freedom of contract and the protection of reasonable expectations derived from lawful bargaining can be outweighed by the competing societal value placed on upholding the integrity of the corporate fiduciary relationship. This potential for corporate relational concerns to dislodge contractual expectations is particularly strong where the contract implicates the most "profound" and sensitive "ownership" issue that the corporate fiduciary relationship can raise: a sale or change of control.[261]

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[261] *See, e.g.,* Loudon v. Archer-Daniels-Midland, 700 A.2d 135 (Del. 1997):

> There is an analytical distinction between "ownership claim issues" and "enterprise issues" facing a board of directors. "Enterprise issues" are usually those involving management decisions affecting the enterprise and do not go to the heart of the individual stockholder's personal property interests. "*Ownership claim issues" involve board decisions that have an immediate and profound impact on stockholders' rights.*

Id. at 147 n.47 (emphasis added); *see also* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW 1, 5-6 (1985) (arguing that courts are most deferential toward transactions involving "enterprise" issues and more vigorous in their review of transactions involving "ownership" issues); Paul L. Regan, *The Unimportance of Being Earnest:* Paramount *Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers,* 46 HASTINGS L.J. 125, 195-99 (1994) (tracing the recent emergence of the "enterprise versus ownership issue" in Delaware jurisprudence and the Delaware courts' increasingly intensive review of ownership issue cases in which a change of corporate control is contemplated); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997) ("Ownership issues raise

A. *Trust Law and the Bona Fide Purchaser Doctrine*

Trust law, by analogy to corporate fiduciary precepts, is examined first in this section. Thereafter, the elements of trust law's bona fide purchaser doctrine are explored. These elements are compared favorably to the contract law conflict resolution principles developed earlier.[262]

1. The Case for Comparison

Though fiduciaries, corporate directors are not literally "trustees."[263] Nevertheless, courts and commentators frequently refer to the analogy between trust law and corporate law in describing the relationship between directors and shareholders.[264]

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questions such as: should we merge . . . [or] fend off unwanted suitors who wish to take control by a tender offer to the stockholders? It is ownership issues which usually put corporate governance sternly to the test.").

262 *See supra* Part II.B.

263 *See* RESTATEMENT (SECOND) OF TRUSTS § 16A cmt. a (1959) ("The officers and directors of a corporation do not hold the title to the property of the corporation and therefore are not trustees.").

264 *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1148-50 (Del. Ch. 1994), *aff'd on other grounds*, 663 A.2d 1156 (Del. 1995) (borrowing from trust law principles and comparing corporate directors to trustees in determining that shareholders whose shares were acquired for cash in an arm's length merger transaction would not be entitled to recover rescissory damages from directors who negotiated transaction on their behalf); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("'Corporate officers and directors are not permitted to use their positions of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders.'") (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)); Lofland v. Cahall, 118 A. 1, 8 (Del. 1922) ("[A] director will be held as a trustee for the corporation he has undertaken to represent . . . ."); Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (arguing that the exercise of lawful power by the management of a corporation must be separately tested "by equitable rules somewhat analogous to those which apply in favor of a *cestui que trust* to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary."); Michael P. Dooley, *Two Models of Corporate Governance,* 47 BUS. LAW. 461, 487-88 (1992) (suggesting that courts may have relied too heavily on the analogy between corporate law and trust law in some early cases that declared voidable any contract or transaction between a director and the corporation); John H. Langbein, *The Contractarian Basis of the Law of Trusts,* 105 YALE L.J. 625, 641 n.75 (1995) ("As in trusts, so in corporations, expanded fiduciary duty law was the alternate safeguard that replaced restrictions on powers."); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 285 (Winter 1998) ("[C]orporate law usually has identified common shareholders as the beneficiaries . . . of managerial action."); *cf. In re USACafes,* 600 A.2d 43, 48 (Del. 1991) (analogizing corporate law to trust law in concluding that a director of a corporation that is a general partner in a limited partnership owes fiduciary duties to the partnership and its limited partners, because fiduciary duties attach to "one who controls property of another").

Similarly, the constraints of fiduciary responsibility attending the dominion over the property of others was emphasized in *Van Gorkom*:

And with good reason. The wealth of the shareholders is effectively entrusted to the directors, and the directors manage this property under a fairly open-ended arrangement in order to maximize the value of the shareholders' investment. Indeed, the legal analysis of almost every significant corporate governance opinion of the Delaware Supreme Court begins with a reminder of: (1) the broad managerial power that the DGCL affords to directors; and (2) the fiduciary constraints that attend the exercise of such open-ended authority.[265]

The analogy, of course, is not perfect. A board of directors is expected to take entrepreneurial risks in managing the firm;[266] a trustee, by contrast, is expected to perform more of a caretaking function by protecting the assets under his control and avoiding the risks inherent in entrepreneurial endeavors.[267] This difference might suggest that the contractual expectations of a third party who negotiates a transaction with a "risk-taking" board of directors are necessarily higher than those of a third party who deals with a "care-taking" trustee. After all, if corporate directors are supposed to be risk-takers (whose decisions usually are

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> Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts for others . . . . Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

265 *See, e.g.*, Paramount Communications Inc. v. QVC Network Inc, 637 A.2d 34, 41-42 (Del. 1994); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150, 1154 (Del. 1990); *Macmillan,* 559 A.2d at 1280; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179-80 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953-55 (Del. 1985); *Van Gorkom*, 488 A.2d at 872; Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984).

266 *See infra* Part IV.A.

267 *See, e.g.*, Wilmington Trust Co. v. Coulter, 200 A.2d 441, 448 (Del. 1964) ("[T]he Trustee is bound always to the primary objective of assuring the safety of the trust assets. He may take no risk which endangers the integrity of the trust corpus.").

Chancellor Allen thoughtfully summarized these differences in *Cinerama*:

> Corporate directors are responsible for often complex and demanding decisions relating to the operations of business institutions. The nature of business competition insures that these directors will often be required to take risks with the assets they manage. Indeed, an unwillingness to take risks prudently is inconsistent with the role of a diligent director. The trustee's role is, classically, quite different. The role of the trustee is prudently to manage assets placed in trust, within the parameters set down in the trust instrument. *The classic trusteeship is not essentially a risk taking enterprise, but a caretaking one.* Hence, while trustees may be surcharged for negligence, a corporate director is only considered to have breached his duty of care in instances of gross negligence.

663 A.2d at 1148.

protected by the business judgment rule), a third party who transacts with those directors should assume a high probability of realizing its contractual expectations. By comparison, one who does business with a trustee is, in theory, on notice of the more limited universe of less risky choices that a trustee may lawfully pursue and, consequently, of the arguably greater risk of judicial interference in the transaction.

But to suggest that these notable differences between directors and trustees render the law of trusts irrelevant to the corporate–contractual question examined in this Article is to overreact to such differences.[268] In each instance there is a tension between protecting the contractual expectations of third parties, on one hand, and protecting the integrity of the fiduciary relationship on the other. In each setting there exists the possibility of a collision of interests between two innocent claimants: (1) a third party who has negotiated in good faith with the fiduciary; and (2) the beneficiaries (or stockholders) who claim the transaction is the product of a failure of fiduciary responsibility. In searching for a corporate solution to this problem, it is worthwhile to explore how a more fully developed body of trust law reconciles this nearly identical problem. Moreover, because the corporate–contractual question examined in this Article arises in the extraordinary setting of a change of control transaction—a context in which the risk of judicial interference is perhaps greater than in any other corporate setting not involving a conventional conflict of interest[269]—any meaningful difference in trust and corporate principles arguably falls away.

2. The Bona Fide Purchaser Doctrine

For centuries, trust law has used the bona fide purchaser doctrine to mediate the claims of equally innocent claimants to trust property.[270] As expressed in the modern *Restatement*

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268 *See, e.g.*, B. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 876-79 (1996) (emphasizing differences between roles of directors and trustees).

269 *See infra* Part IV.B.

270 One eminent treatise traces the origin of the doctrine to the work of the English chancellors in the fifteenth century. *See* AUSTIN WAKMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUST § 284 (4th ed. 1989); *see also* James B. Ames, *Purchase for Value Without Notice*, 1 HARV. L. REV. 1, 3 (1887). The *Restatement of Restitution* also incorporates a bona fide purchaser rule that largely parallels trust law's expression of the doctrine. *See* Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954); *see also* RESTATEMENT OF RESTITUTION §§ 13, 172(1) (1937).

(Second) of Trusts ("*Restatement of Trusts*"), the bona fide purchaser doctrine cautiously establishes the narrow circumstances under which the claim of a third party purchaser of trust property will take precedence over the assertions of the trust's beneficiaries that the transaction is the result of a breach of trust by the trustee.[271] As in other areas of contract law involving the avoidance of consensual obligations, the doctrine balances competing policies: (1) the "securing of transactions" for good faith purchasers; and (2) protecting the integrity of the trustee–beneficiary relationship.[272]

Careful examination of the elements of the bona fide purchaser doctrine reveals a strong parallel to the general contract avoidance principles discussed earlier.[273] On reflection, this is not surprising. In each of these remarkably diverse settings, the law's common endeavor is to reconcile the competing interests of innocent claimants in a principled and just manner. Such cases invariably are reduced to a choice between protecting contractual expectations or ensuring essential fairness by affording protection to the party adversely affected by the bargain. Commonly shared notions for resolving conflicts between such innocent claimants revolve, in one form or another, around what for this age has been called "the Watergate question," but which in fact has for

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271 Section 284(1) of the *Restatement of Trusts*, entitled "Bona Fide Purchaser," thus provides:

> If the trustee in breach of trust transfers property to, or creates a legal interest in the subject matter of the trust in, a person who takes for value and without notice of the breach of trust, and who is not knowingly taking part in an illegal transaction, the latter holds the interest so transferred or created free of the trust, and is under no liability to the beneficiary.

RESTATEMENT (SECOND) of TRUSTS § 284(1); *see also id.* § 284(2) ("In the Restatement of the Subject such a transferee is called a 'bona fide purchaser.'").

272 SCOTT & FRATCHER, *supra* note 270, at § 286 ("A court of equity will not assist a purchaser to acquire a right of property if in so assisting him the court would have to compel the vendor to commit a breach of trust of breach of any other specifically enforceable duty."). As explained further in the foregoing treatise, trust law balances these competing concerns based on notions of good faith and timing considerations:

> The policy underlying the doctrine of bona fide purchaser is the securing of transactions, the protection of persons who have purchased property in good faith. If the purchase is complete before the purchaser receives notice, he is entitled to know that he will not be deprived of the property that he has bought because someone has an equitable claim to the property. . . . But if he pays the purchase before he receives title to the property, he is not entitled to rely on acquiring an enforceable claim to the property, and runs the risk that someone else may have a prior claim that is enforceable.

Id. at 54-55.

273 *See supra* Part II.B.

centuries been a core principle of fairness and accountability, namely: "What did they know and when did they know it?"[274]

a. *Knowledge and notice*

Similar to contract avoidance doctrine, trust law's bona fide purchaser rule relies heavily on the factors of knowledge and notice in determining whether a party who transacts business with a trustee will acquire trust property free of competing claims by trust beneficiaries. Thus, only the "bona fide" purchaser who acquires trust property "without notice of the breach of trust" is afforded transactional protection.[275] A third person has "notice" of a breach of trust, and thus inferior rights as against trust beneficiaries, when that person "knows or should know of the breach of trust."[276] Consequently, it is of no moment that a third person acted in subjective good faith and without actual knowledge of the trustee's breach, if that party nevertheless "should [have] know[n]" of the breach.[277] In either case, the third party's prior knowledge—actual or constructive—of the trustee's breach is deemed sufficient to justify disappointing the third

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274 Scott Shephard, *Watergate Taught D.C. Big Lesson: Don't Turn Your Back on Scandal*, ATLANTA J. & CONST., July 31, 1994, at A5 ("'The classic question emerges: What did the president know, and when did he know it?'") (quoting Senator Alfonse D'Amato); *see also* Langbein, *supra* note 264, at 641, ("The traditional [bona fide purchaser] rule, still codified in the *Restatement (Second) of Trusts*, turns on notice: The purchaser who 'has notice that the trustee is committing a breach of trust in making the transfer' is unprotected against the beneficiaries' claim to recover the trust assets or its proceeds.") (quoting RESTATEMENT (SECOND) of TRUSTS §296 (1959)) (footnote omitted); William Scheider, *Disillusionment Began Pre-Watergate*, CNN News Broadcast, April 23, 1994, Transcript #311-6 ("Any hint of scandal—Iran-Contra, Whitewater—and the press and Congress go into Watergate mode, asking the famous question, 'What did the president know, and when did he know it?'").

For thousands of years, the degree to which a party has had prior notice of facts has informed dispute resolution principles:

> If a man's bull injures the bull of another and it dies, they are to sell the live one and divide both the money and the dead animal. However, if it was known that the bull had the habit of goring, yet the owner did not keep it penned up, the owner must pay, animal for animal, and the dead animal will be his.

Exodus 21:35-36; *see also* CLARENCE MORRIS & C. ROBERT MORRIS, JR., MORRIS ON TORTS § 2, at 226 (2d ed. 1980) ("Once masters have knowledge ('scienter') that their domestic animals have especially vicious dispositions, they are responsible for attacks regardless of the care they take to prevent them. It is sometimes said that every dog has one bite and every bull one gore."); W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS § 79, at 560-61 (5th ed. 1984).

275 RESTATEMENT (SECOND) OF TRUSTS § 284(1) (1959).

276 *Id.* § 297(a); *see also id.* cmt. a ("A third person has notice of a breach of trust not only when he knows of the breach, but also when he should know of it . . . .").

277 *Id.*

party's contractual expectations in favor of protecting the beneficiaries.

Because of the significance of notice to the bona fide purchaser inquiry, it is profitable to explore the factors that inform a determination of whether a third party has notice of a trustee's breach. Under the *Restatement of Trusts*, a person has notice of a breach: (1) when that person is aware of facts that would lead a "reasonably intelligent and diligent person to inquire" as to whether a breach is being committed; and (2) "if such inquiry when pursued with reasonable intelligence and diligence would give him knowledge or *reason to know* that the trustee is committing a breach of trust."[278] Many important circumstances influence an evaluation of whether a third person ought to have inquired into the possibility of a breach of trust (and thus, ultimately, whether the third party was on notice of a breach). Some of these translate directly to the acquiror corporation's position in negotiating for aggressive lock-ups or other auction-impeding devices:

> Among the circumstances which are or may be of importance are the following: (1) whether he knows that the person with whom he is dealing is in fact a trustee; . . . (4) whether the transaction is one in the ordinary course of the business of the trustee; [and] (5) whether the trustee is disposing of the property for much less that its real value. . . .[279]

Nor is the notice with which the *Restatement of Trusts* is concerned limited to actions by the trustee that are beyond its powers, as the rights of a purchaser can also be extinguished when the purchaser is on notice that the trustee is abusing his discretion.[280]

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278 *Id.* (emphasis added).

279 *Id.*; *see also* SCOTT & FRATCHER, supra note 270, § 268.4 (noting "number of cases [in which] the disparity [in value of exchange between third party and trustee] has been found by the court to be a sufficient indication in itself that the transferee must have had notice of the breach of trust").

280 The comment to *Restatement of Trusts* section 297 thus provides:

> If by the terms of the trust the trustee is authorized to sell trust property if in his discretion he deems it wise, the purchaser is not bound to inquire whether the trustee is properly exercising his discretion. *If, however, the purchaser knows or should know that the trustee is abusing his discretion and therefore is committing a breach of trust in making the sale, he takes subject to the trust.*

RESTATEMENT (SECOND) of TRUSTS § 297 cmt. 1 (1959) (emphasis added); *see also* Jerome J. Curtis, Jr., *The Transmogrification of the American Trust*, 31 REAL PROP. PROB. & TR. J. 251, 296 (1996) ("[E]ven if a trustee possessed the power to enter into the agreement but exercised that power wrongfully, other parties to the agreement should not be able to reach trust assets if they knew or should have known of the trustee's misfeasance . . . .")

Finally, the notice principle is so significant that it trumps the timing factor. When a third party completes an acquisition while "on notice" of a breach of trust, the rights of the beneficiaries take precedence.[281] Therefore, any trust property so acquired by the third party is held in "constructive trust for the beneficiary of the trust."[282]

b. *Timing*

Timing is also crucial to resolving the third party purchaser–trust beneficiary conflict. Assuming a purchaser of trust property qualifies as a person who bargained without notice of a trustee's breach of trust, that purchaser must also satisfy the timing requirements of the bona fide purchaser rule to defeat the trust beneficiaries' claims. Thus, to receive the protection of the rule, the purchaser must "take" the property "for value" before the trust beneficiaries assert a claim for breach of trust.[283] Both of these concepts—obtaining possession of the property and giving value—separately underscore a critical timing principle inherent in the bona fide purchaser doctrine.

One who otherwise satisfies every element of the bona fide purchaser rule will nevertheless fail to defeat a beneficiary's claim if that person has not yet obtained title to the property at the time his claims are asserted. The equitable interests of the trust beneficiaries will take precedence in those circumstances, regardless of whether the third party had otherwise signed a contract with the trustee to purchase trust property, or was formerly without notice of the breach of trust and/or paid the full purchase price to the trustee.[284] The transfer of title is emphasized

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281 *See* RESTATEMENT (SECOND) OF TRUSTS § 288 (1959):

> The interest of the beneficiary in the trust property is not cut off by a transfer by the trustee in breach of trust to a third person who at the time of the transfer has notice that the transfer is in breach of trust, although he paid value for the transfer; and the beneficiary can in equity compel the third person to restore the property to the trust.

Id. cmt a.

282 *Id.*

283 *See* RESTATEMENT (SECOND) OF TRUSTS § 284(1) (1959); *see also* SCOTT & FRATCHER, *supra* note 270, § 298.5 ("The whole policy of the doctrine of bona fide purchase [sic] is to protect one who enters into a commercial transaction, provided that the transaction is completed before there is any notice of any equity.").

284 Section 310 of the *Restatement of Trusts*, entitled "Contract to Transfer Trust Property," provides as follows:

> [I]f the trustee in breach of trust makes a contract to sell, mortgage or otherwise dispose of trust property to a third person, the third person cannot compel specific performance of the contract, even though he had no notice of the trust at

because "[a] court of equity will not compel a trustee to commit or complete the commission of a breach of trust."[285] Moreover, one who would otherwise qualify as a bona fide purchaser (having bargained in good faith and without notice of a breach of trust, and having given value) nevertheless acquires the property "subject to the trust" if that person "at any time prior to the transfer . . . [has] notice that the trustee is committing a breach of trust in making the transfer."[286]

Further, a third party purchaser likewise cannot obtain transaction protection under the bona fide purchaser rule if, before the third party has given "value" for the trust property transferred to it, the beneficiaries' claims are asserted or the third person is otherwise put on notice that the trustee is committing a breach of trust.[287] Moreover, the mere promise by the third party to make payment for the transferred property in the future, though sufficient as consideration for a contract, is generally insufficient to qualify as "value" under the bona fide purchaser rule.[288] On the

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> the time when the contract was made and paid value before receiving such notice.

RESTATEMENT (SECOND) OF TRUSTS § 310 (1959). The third party in such circumstances will be able to recover the purchase price such person has paid, either from the trustee personally, or from the trust estate if the purchase money is in the trust estate. *See* SCOTT & FRATCHER, *supra* note 270, at 310.

285 RESTATEMENT (SECOND) OF TRUSTS § 310 cmt. a; *see also id* § 286 cmt. a:

> [A]lthough a court of equity will not deprive a person of an interest which he has acquired for value and without notice that it was acquired through a breach of trust, yet a court of equity will not assist a person to acquire an interest if in so assisting him it would thereby compel a trustee to commit or complete the commission of a breach of trust.

Id.; *see also id.* § 272 cmt. c ("[T]he third person cannot maintain a suit for specific enforcement of the contract, although the trustee had a power of sale, if the contract to sell was for a price so inadequate or otherwise on such terms that the sale would be a breach of trust.").

286 *Id.* § 311; *see also id.* cmt. a ("[A] person who has paid value without notice of the breach of trust cannot after receiving such notice improve his position by obtaining a transfer [of the property].").

287 *See id.* § 301. ("A transferee of trust property takes subject to the trust if prior to the payment of value he has notice that the trustee is committing a breach of trust in making the transfer, although he receives the transfer before he has such notice.").

288 *See id.* § 302(1). This more stringent requirement of "value" is consistent with the U.C.C.'s definition of value for holder in due course status. *See* UCC § 3-303(a) (1998). This requirement may be contrasted with the less rigorous "consideration" definition of value that is applied in contract law to determine whether a party to a contract loses the right to seek avoidance of the agreement based on misrepresentation by a third party outside the contract. *See* RESTATEMENT (SECOND) OF TRUSTS § 164 cmt. e (1959); *see also supra* note 180 and accompanying text.

Similarly, partial payment by the third party for a promise of future payment fails to qualify as "value" under the bona fide purchaser rule. *See* RESTATEMENT (SECOND) OF

other hand, when a third party has paid the full purchase price ("value") and taken title to the property, all without notice of a breach of trust, then the policy favoring the security of transactions ascends and the rights of the trust beneficiaries are cut off.[289]

c. *Strength of competing policy*

The bona fide purchaser rule does not set forth as a separate analytical component the issue of whether the policy in tension with the purchaser's contractual expectations is compelling or otherwise especially strong. Implicit in the many requirements of the rule, however, is an obvious and powerful concern with protecting beneficiaries from a trustee's breach of trust. Only the third party purchaser who satisfies all of the rule's various requirements will receive protection of its contractual expectations over the claims of the trust beneficiaries.[290]

The strength of this policy favoring protection of trust beneficiaries from breaches of trust can also be seen in, among other things, the use of a constructive notice test (as opposed to requiring actual notice). This constructive notice test thus permits beneficiaries to recover property sold in breach of trust to a third person who, though innocent of any wrongdoing, "should [have] know[n]" of the breach of trust.[291] Also indicative of the law's

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TRUSTS § 303 (1959). A purchaser who without notice of a breach of trust takes title to trust property, makes partial payment for the property, and thereafter "receives notice" of the breach of trust cannot qualify as a bona fide purchaser. *See id.* That purchaser takes subject to the trust but s/he is entitled to a lien on the trust property for recovery of that part of the purchase price which was paid before notice of the breach of trust. *See id.*

289 *See* RESTATEMENT (SECOND) OF TRUSTS § 298 (1959). Indeed, the policy favoring the security of transactions attaches upon completion of the transaction and a court will not undo it "although the trustee still holds the purchase price so that it could be restored to the transferee, or the beneficiary is able and willing to repay the amount of the purchase price to the transferee." *Id.* cmt. j. "He is entitled to the benefit of his purchase and not merely protected against the loss of what he has paid." *Id.* Furthermore:

> To carry out this policy [of protecting one who enters into a commercial transaction] to its full extent, it is not enough that a purchaser in good faith and for value should be saved from a loss of the consideration that he gave; he is entitled to the benefit of the bargain he has made.

SCOTT & FRATCHER, *supra* note 270, § 298.5.

290 These requirements include the following: (1) the third party purchaser acted in good faith and without actual or constructive notice of the breach of trust; (2) the third party completed the transaction by acquiring title to the property from the trustee; (3) the third party gave value by paying the full purchase price to the trustee for the property; and (4) the third party did not subsequently receive constructive notice of the breach of trust at any time before all of the foregoing requirements were satisfied. *See* RESTATEMENT (SECOND) OF TRUSTS § 284 (1959).

291 *See id.* §§ 284, 297.

strong concern for the integrity of the trustee–beneficiary relationship is the fact that a completed transfer of trust property will be set aside, including transfers of property to persons without any notice of a breach of trust, if the purchase price remains unpaid or was paid after the purchaser acquired notice of the breach.[292]

Finally, the fact that a purchaser's contractual promise to pay for the already transferred property does not qualify as "value" given under the bona fide purchaser rule (though qualifying as consideration for an enforceable obligation under contract law) is also revealing. In contrast to general contract law avoidance principles for arm's length transactions between principals with whom no trust is involved,[293] trust law seems to create an opportunity at every conceivable juncture to ensure protection of beneficiaries from the consequences of a breach of trust. Consequently, beneficiaries can recover property transferred in breach of trust to a third party purchaser who: (1) has no notice of the breach of trust; (2) has taken title to the property; (3) has tendered an otherwise enforceable promise to make future payment for the property; but (4) has not yet made such payment to the trustee.[294] That trust law affords so many opportunities for the claims of beneficiaries to take precedence over the contractual expectations of third parties reveals a compelling policy concern for protecting the integrity of the trustee–beneficiary relationship. Promoting this policy ahead of the stability of commercial transactions in this sensitive context frequently results in the

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[292] *See id.* §§ 301-303; *see also id.* § 302 cmt. e ("If the transferee of trust property receives notice that the transfer was in breach of trust before he has paid any part of the purchase price, he holds the property subject to the trust, even though he thereafter pays the full amount of the purchase price.").

[293] Contract law permits a party to a contract to avoid his agreement, though his contracting counterpart is innocent of any bargaining abuses, provided the party seeking avoidance can demonstrate that he was the victim of misrepresentation, duress, or undue influence by another who is not a party to the contract. *See id.* §§ 164(2), 175(2), 177(3). In each instance, however, the remedy of avoidance is cut off once the other party to the contract, acting in good faith and without reason to know of the bargaining defect, "gives value." *Id.* The definition of "gives value" is easily satisfied in this context—it includes any consideration sufficient to support a simple contract. *See id.* § 164 cmt. e, illus. 4. Obviously, this definition gives greater protection to contracting parties than trust law affords to third party purchasers. A fair implication from these differences is that the policy favoring protection of beneficiaries from breaches of trust is stronger than that of protecting persons from the consequences of bargaining distortions caused by those who are not parties to the contract. In the former instance (breach of trust), fiduciary precepts take precedence over transaction stability, while in the latter circumstance, protecting contractual expectations is given greater priority.

[294] *See id.* §§ 284(1), 302(1).

frustration of a third party's contractual expectations.

d. *Protecting the purchaser's reliance interest*

The bona fide purchaser doctrine explicitly protects the third party's reliance and expectation interests by refusing to disturb completed transactions, despite a trustee's breach of trust, provided the third party satisfies all the doctrine's many requirements. Therefore, the third party must pay the purchase price for the trust property in full before acquiring notice of the breach of trust.[295] Moreover, the purchaser's reliance interest is further protected under an exception to the otherwise rigorous definition of "value" that must be satisfied for him to qualify as a bona fide purchaser:[296] a purchaser's mere promise to make future payment for transferred trust property does not ordinarily constitute a "transfer for value" within the meaning of the doctrine.[297] However, when the promise-making purchaser has undergone "such a change of position . . . that it would be inequitable to deprive him of the property[,]" that promise will be deemed a "transfer for value."[298] In this latter circumstance, the law's concern for protecting the beneficiaries is outweighed by a greater concern for the injury that a more rigorous application of the doctrine would otherwise unjustly visit upon the third party.

Trust law has less concern for the purchaser's reliance when all of the elements of the bona fide purchaser doctrine are not satisfied and the property must be reconveyed to the trustee. Unlike the *Restatement of Contracts* provisions addressing the avoidance of contract on grounds of mistake, impracticability, and frustration,[299] the many *Restatement of Trusts* provisions governing trust law's bona fide purchaser doctrine contain no section explicitly authorizing the discretionary award of reliance damages to the party whose contractual expectations are disappointed by the remedy of avoidance.[300] It is unclear why trust law's bona fide

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295 *See id.* §§ 284, 300-303.

296 *See supra* note 288 and accompanying text.

297 RESTATEMENT (SECOND) OF TRUSTS § 302(1) (1959).

298 *Id.* § 302(3); *see also id.* cmt. l ("[T]he transferee cannot be compelled to surrender the property if he has so changed his position that it would be inequitable to compel him to do so even though he were discharged from his liability upon the promise."); SCOTT & FRATCHER, *supra* note 270, § 302.6, at 162.

299 *See* RESTATEMENT (SECOND) OF TRUSTS §§ 158(2), 272(2) (1959).

300 Section 303 only protects the third party purchaser's restitution interest, by creating a lien on transferred trust property in favor of the purchaser for that part of the purchase price that was paid before the purchaser had notice of the breach of trust:

If the trust property has been transferred and the transferee has paid part of the

purchaser doctrine does not explicitly call for the discretionary award of reliance damages to disappointed purchasers, "as justice requires,"[301] when completed transfers of trust property are to be set aside in favor of the trust beneficiaries. One explanation is that one who deals with a trustee is on notice from the outset that any transaction involving trust property is subject to a greater risk of judicial interference than a transaction between two principals where no trust is involved.[302]

3. Summary

The analogy between trust law and corporate law is sufficiently close to warrant examination of trust law precepts for resolving contractual claims of innocent corporate acquirors. Like many of the contract law avoidance doctrines discussed earlier,[303] trust law's bona fide purchaser doctrine offers a promising application for the corporate/contractual conflict examined in this Article.

Under the bona fide purchaser doctrine, a strong concern for the integrity of the fiduciary relationship between trustees and beneficiaries requires that a purchaser of trust property must satisfy all elements of the doctrine before that purchaser can acquire the property free of the beneficiaries' claims of breach of trust. Significantly, subjective good faith by the purchaser is necessary, but not sufficient. To receive protection under the doctrine, the purchaser must also have been without notice (i.e., constructive notice) of the trustee's breach of trust. Timing is also an independently crucial factor. A purchaser who enters into a contract with a trustee without notice of any breach of trust will nevertheless find its contractual expectations defeated if the beneficiaries assert timely claims of breach of trust, or the purchaser otherwise receives notice of the breach, either before the trust property is transferred to the purchaser or before the purchaser pays the full purchase price. Because of the strength of

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> purchase price before he has notice that the transfer is in breach of trust, he cannot be compelled to surrender the property unless and until he is reimbursed for the part of the purchase price so paid.

Id. § 303 cmt. a.

301 RESTATEMENT (SECOND) OF CONTRACTS §§ 158(2), 272(2) (1979).

302 In this regard, it is worth recalling that one of the various factors to consider in determining whether a purchaser was on notice of a breach of trust includes "[w]hether [the purchaser] knows that the person with whom he is dealing is in fact a trustee." RESTATEMENT (SECOND) OF TRUSTS §297 cmt. a (1959).

303 *See supra* Part II.B.

the policy favoring protection of the trust relationship, only a fully completed transaction involving a wholly innocent purchaser[304] will withstand a challenge by beneficiaries on breach of trust grounds.

B. *Agency Law and Apparent Authority*

1. Directors as "Agents"

As with the law governing the trustee–beneficiary relationship, there is a meaningful comparison between the law of agency and the role of corporate directors under corporate governance principles. "Agency" is defined as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."[305] Given the broad statutory power afforded to boards of directors,[306] and the stockholders' consent that the directors act on their behalf, it is unsurprising that directors are frequently referred to, if only loosely, as "agents" of the corporation and/or its stockholders.[307]

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304 The term "wholly innocent" is used in this Article to describe a third party that neither knew nor was on notice of a breach of fiduciary duty or other bargaining failure on the part of its contracting counterpart.

305 RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).

306 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1998) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."); REVISED MODEL BUS. CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the discretion of, its board of directors.").

307 *See, e.g.*, Thorpe v. CERBCO, Inc., 676 A.2d 436, 445 (Del. 1996) (invoking agency law principle that "agent must account for value received from third parties in connection with services on behalf of principal" as basis for imposing personal liability on directors (who were also majority stockholders) for breach of fiduciary duty of loyalty) (citing RESTATEMENT (SECOND) OF AGENCY § 388 (1959)); Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997) (analogizing to agency law principles in assessing effect of stockholder vote ratifying issuance of stock options to directors); Bovay v. H. M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944) ("The courts, state and federal, at different times, and under varying circumstances, have held officers and directors of corporations to be at one time agents or mandatories, and at another time, trustees, and have defined their liability accordingly."); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."); *In re* Shoe-Town Inc. Stockholders Litig., Consol. C.A. No. 9483, 1990 Del. LEXIS 14, at ** 20-21 (Del. Ch. Feb. 20, 1990) ("Directors and other governing members of a corporation who are imbued with fiduciary responsibility can be characterized as agents or quasi trustees.") (citing inter alia 3 FLETCHER CYCLOPEDIA CORPORATIONS § 841 (Per. Ed.)); Blasius Indus. v. Atlas Corp., 564 A.2d 651, 663 (Del. Ch. 1988) ("The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters."); Carpenter v. Griffith Mortgage Corp.,

Of course, just as directors are not literally trustees,[308] neither are they literally "agents." Crucially absent from the relationship between directors and stockholders is the element of control. Although directors serve as the "duly elected and authorized representatives of the stockholders,"[309] directors are not under the control of the stockholders in managing the firm. Nevertheless, given that directors "represent[] . . . the financial interests of others"[310] in transacting corporate business with third parties, it is useful to consider agency law's mechanisms for mediating the conflict between a third party's claim to an enforceable contract and the principal's assertion that the agreement exceeds the scope of the agent's authority. As discussed below, these agency principles include concepts of authority and apparent authority.

2. Directors and Apparent Authority

"Authority" consists of the power of an agent to bind the principal to transactions with third parties when done "in accordance with the principal's manifestations of consent to [the agent]."[311] "Apparent authority" expands the zone of potential liability of a principal to third parties based on the acts of an agent, or professed agent, when transacted in accordance with the principal's "manifestations to such third persons."[312] Thus, a principal will be subject to contractual liability to a third person for a transaction into which its agent was either authorized or apparently authorized to enter.[313] As a transaction- validating

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172 A. 447 (Del. Ch. 1934) (referring to "the directors, whom [the] stockholders selected as their managing agents"); RESTATEMENT (SECOND) OF AGENCY § 14C cmt. a (1959) ("Members of the board resemble agents in that they act on behalf of others and are fiduciaries owing duties of loyalty and care."); *cf.* Debra A. DeMott, *Agency and the Unincorporated Firm: Reflections on Design on the Same Plane of Interest*, 54 WASH. & LEE L. REV. 595 (1997) ("The law of agency provides a set of doctrines that underlie the mechanisms of firm governance."); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 137 (1998) (discussing role of agency principles in literature on the theory of the firm and noting that "the investors are viewed as principals and the managers as agents in an agency relationship").

308 *See supra* note 263.

309 Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 41-42 (Del. 1994); *see also* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150, 1154 (Del. 1990).

310 Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

311 RESTATEMENT (SECOND) OF AGENCY 307 § 7 (1957).

312 *Id.* § 8.

313 *See id.* § 140. A principal also may be subject to liability to third persons for transactions conducted by its agent pursuant to the agent's "inherent agency power," a power that is "derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a

device, the doctrine of apparent authority obviously serves to protect the commercial expectations of third parties who reasonably rely on the agent's authority in negotiating a transaction involving the business of the principal.[314]

A corporate acquiror could well argue, by analogy to agency's apparent authority doctrine, that its contract with a target company merits enforcement irrespective of any breach of fiduciary duty by the target's directors. Adding fuel to this argument is the intriguing idea that apparent authority can be created positionally. That is, a sufficient manifestation from the principal for purposes of creating apparent authority can be found in the simple appointment of a person to a position that "carries with it generally recognized duties."[315] Stockholders, it could be asserted, clothe the board of directors with both actual and apparent authority to negotiate a binding merger agreement by the simple but significant act of electing (i.e., appointing) the directors at the annual meeting. In this regard, a board's actions in negotiating a merger agreement indisputably constitute one of a corporate board's "generally recognized duties."[316]

There is evidence that the Delaware courts would not be intrinsically hostile to such an argument as a doctrinal matter. In *Citron v. Fairchild Camera & Instrument Corp.*,[317] a case involving a change of control transaction, the Delaware Supreme Court observed that the business judgment rule's protective presumption of propriety "attaches to a director-approved transaction within a board's conferred or *apparent authority*."[318] *Citron* did not

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servant or other agent." *Id.* § 8A.

314 *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 49 cmt. i (1957) ("[T]he phrase 'apparent authority' has frequently been used by the courts to indicate any situation in which it is desirable to subject the principal to liability for unauthorized transactions by an agent.").

315 RESTATEMENT (SECOND) OF AGENCY §27 cmt. a (1957); *see also* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 11 (7th ed. unabridged 1995) (noting "special type of apparent authority" arising from the "*power of position*").

316 RESTATEMENT (SECOND) OF AGENCY § 27 cmt. a (1957); *see also, e.g.*, DEL. CODE ANN. tit. 8, § 251(b) (1998) (mandating board approval of merger agreement before stockholder vote on transaction); REVISED MODEL BUS. CORP. ACT § 11.03(b) (1984) (mandating same board approval of merger agreement before stockholder vote on transaction except in cases where board has grounds for making no recommendation); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (noting board's obligation to act "in an informed and deliberate manner in determining whether to approve an agreement of merger *before* submitting the proposal to the stockholders") (emphasis added).

317 569 A.2d 53 (Del. 1989).

318 *Id.* at 64 (emphasis added).

elaborate further upon this reference, but the opinion has been quoted with approval in at least two instances—one a Delaware Supreme Court decision involving another change of control transaction,[319] and the second a Delaware Court of Chancery opinion concerning a parent–subsidiary going private merger.[320] Thus, while any notion that directors are literally agents is untenable,[321] these various (albeit cryptic) references to apparent authority, particularly in the context of the transaction-validating doctrine of the business judgment rule, suggest an openness on the part of Delaware courts to protecting the contractual expectations of an acquiror on this basis.

3. The Acquiror's Constructive Notice and Other Pertinent Factors

Assuming the concept of apparent authority transfers by analogy to the corporate context, such that the corporation can become liable to third parties upon merger agreements that are the product of a breach of fiduciary duty by the target board, the question remains as to what circumstances will trigger the application of apparent authority in this extraordinary context. The provisions of the *Restatement (Second) of Agency* ("*Restatement of Agency*") pertaining to the creation of apparent authority largely confirm the "reason to know" and "notice" concepts used, respectively, for the avoidance of contracts[322] and trust law's bona fide purchaser doctrine.[323] For example, section 27 of the *Restatement of Agency* makes plain that transaction protection will only be afforded to those third persons who form a *reasonable* belief in the existence of the agent's authority.[324] Presumably, an acquiror that bargains aggressively for preclusive lock-ups will be met with the argument that its belief as to the board's apparent authority to make such concessions, if sincerely held, was nevertheless unreasonable and therefore an unprotected

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319 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993).

320 *See* Citron v. E.I. DuPont de Nemours & Co., 584 A.2d 490, 499 (Del. Ch. 1990).

321 *See* Arnold v. Society for Sav. Bancorp., Inc., 678 A.2d 533, 539-40 (Del. 1996).

322 *See supra* Part II.B.

323 *See supra* Part III.A.2.a.

324 Section 27 thus provides in pertinent part:

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

RESTATEMENT (SECOND) OF AGENCY § 27 (1957) (emphasis added).

belief.

Restatement of Agency section 34, entitled "Circumstances Considered in Interpreting 'Authority,'" enumerates various factors to consider in the apparent authority analysis which reinforces this point.[325] Among the variables to which section 34 calls attention are: (1) "the general usages of business"; and (2) "the nature of the subject matter," including "the legality or illegality of the act."[326] It could be argued with some force in reliance on these provisions that "general usages of business" include reasonable, but not preclusive, lock-ups when doing business in the market for corporate control. Moreover, the law is sufficiently developed in this arena[327] so that aggressive acquirors and their advisors should sense when they are near the boundary of illegitimacy.[328] An acquiror that attempts to impede a fair auction process by seeking overcompensation of its transaction costs (both out of pocket transaction costs and opportunity costs) runs the substantial risk of seeing its contractual expectations declared unreasonable[329] and unenforceable.[330]

The potential "illegality" of a transaction involving preclusive lock-ups also undermines the favored acquiror's "reasonable belief" claim for apparent authority purposes.[331] This factor renders suspect those agreements contemplating criminal acts, as well as those agreements that simply offend public policy. For example, an agreement with a fiduciary that induces a violation of

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325 *See id.* § 34. The factors enumerated in section 34, applicable generally to actual authority situations, are also made applicable to an apparent authority inquiry by section 49, with certain exceptions. *See id.* § 49 ("The rules applicable to the interpretation of authority are applicable to the interpretation of apparent authority.").

326 *Id.* § 34(a), (d).

327 *See generally supra* Part I.A.

328 A package of lock-ups and break-up fees promising payments to the bidder in an aggregate amount comprising 2% of the transaction value is considered a de facto safe harbor under Delaware decisional law. *See, e.g.*, Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997) (upholding as reasonable termination fee representing 2% of merger partner's market capitalization); *In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770 (Del. Ch. 1988) (upholding "topping fee" compensation commitment to favored bidder approximating 2% of transaction value); Hamermesh, *supra* note 77, at 959; Martin Lipton & Theodore Mirvis, *10 Questions and Answers Raised by Delaware* 'Paramount *Decision,'* N.Y. L.J., Feb. 10, 1994, at 1.

329 *See* CORBIN, *supra* note 121 § 1 (summarizing contract law's main purpose as the "realization of *reasonable* expectations induced by promises") (emphasis added).

330 Indeed, this lesson was not lost on two prominent corporate practitioners who, in the aftermath of the *Paramount* decision, counseled acquirors to exercise moderation in negotiating for lock-ups as part of a "less is more" strategy. Lipton & Mirvis, *supra* note 328, at 1.

331 *See* RESTATEMENT (SECOND) OF AGENCY §34(d) (1957).

the latter's fiduciary duty is a prime example of a contract that is vulnerable to non-enforcement on public policy grounds.[332] Thus, a court will "not readily infer[]" the existence of authority by directors to commit the corporation to agreements that tend to prevent the stockholders of a selling corporation from realizing the highest price for their shares.[333]

Finally, *Restatement of Agency* section 49, directly applicable to apparent authority situations, also emphasizes that interpretations of any "manifestations" from the principal to the third party[334] must be considered "in light of what the [third] party knows or should know."[335] Similar to both contract avoidance doctrines[336] and trust law's bona fide purchaser rule,[337] the acquiror's subjective good faith is necessary, but not sufficient, for transaction protection. Further, an acquiror's claim to a reasonably held belief in the board's authority to grant preclusive lock-ups and break-up fees becomes increasingly suspect as the acquiror begins to overreach in demanding such concessions from the target.[338]

It could be argued that a target board's "ownership" decision to sell control of the company to an acquiror is so extraordinary as to eliminate any zone of apparent authority within which a board could breach its fiduciary responsibility and yet still contractually bind the company contractually. By way of comparison, the Uniform Partnership Act and Revised Uniform Partnership Act both codify a general partner's actual and apparent authority for matters in the "usual way" or "ordinary course" of the partnership's business;[339] both statutes state that a partner cannot bind the partnership in extraordinary matters without actual authority.[340]

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332 *See* RESTATEMENT (SECOND) OF CONTRACTS § 193 (1979); *see also infra* Part III.C.

333 *See generally supra* Part I.A.

334 In the corporate context, these "manifestations" will arise positionally by virtue of the directors' election to office. *See supra* note 316 and accompanying text.

335 RESTATEMENT (SECOND) OF CONTRACTS §49(a) (1979).

336 *See supra* Part II.B.5.

337 *See supra* Part III.A.2.

338 Harkening back to section 34's "nature of the subject matter," an extraordinary "bet the company" decision to sell corporate control ought to be seen as sharply circumscribing, but not eliminating, the zone of apparent authority applicable to the board's decision. *See* RESTATEMENT (SECOND) OF AGENCY §34(d) (1957).

339 *See* UNIF. PARTNERSHIP ACT § 9(1), 6 U.L.A. 400 (1995); REVISED UNIF. PARTNERSHIP ACT § 301(1), 6 U.L.A. 33 (1995).

340 *See* UNIF. PARTNERSHIP ACT § 9(2), 6 U.L.A. 400 (1995); REVISED UNIF. PARTNERSHIP ACT § 301(2), 6 U.L.A. 33 (1995).

One problem with this argument against the existence of apparent authority is that the Delaware Supreme Court already has suggested (in the context of cases involving change of control transactions) that the business judgment rule protects decisions within a board's apparent authority.[341] Moreover, as a policy matter, to eliminate apparent authority in this context would create unwelcome transaction instability, particularly for completed transactions. The Delaware Supreme Court declared in *Arnold v. Society for Savings Bancorp., Inc.* ("*Arnold II*")[342] that the consummation of a merger transaction in which the target board has breached its fiduciary duties[343] does not render the merger void ab initio. The transaction is statutorily valid so long as the parties comply "with all of the express statutory requirements for the merger."[344] The court further explained that equitable constraints arising from the "fiduciary duties imposed upon directors by decisional law" apply to director action "as a corollary to the statutory requirements."[345] A breach of these judicially imposed fiduciary duties may warrant injunctive relief "[i]f timely sought"[346] (i.e., if sought before—or perhaps immediately after[347]—consummation of the transaction) but such violations are not grounds to undo a completed acquisition. In short, the policy favoring the securing of transactions ascends at this point and the (former) stockholders are limited to a claim for damages against their directors.[348]

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341 *See supra* notes 317-20 and accompanying text.

342 678 A.2d 533, 536-37 (Del. 1996).

343 In *Arnold II* the directors of Society for Savings Bancorp, Inc. ("Bancorp") breached their fiduciary duty of disclosure in soliciting Bancorp stockholder approval of the merger of Bancorp with an affiliate of Bank of Boston Corporation. *See id.* at 534; *see also* Arnold v. Society for Savings Bancorp, Inc. ("*Arnold I*"), 650 A.2d 1270 (Del. 1994).

344 *Arnold II*, 678 A.2d at 536.

345 *Id.* at 537 n.9.

346 *Id.*

347 In theory, the equitable remedy of rescission remains a possibility, but the Delaware courts have shown no inclination to unwind consummated merger transactions, presumably in recognition of the strong policy favoring the security of completed transactions as well as the logistical difficulty associated with awarding such relief. *See* Gimbel v. Signal Cos, Inc., 316 A.2d 599, 603 (Del. Ch. 1974) *aff'd*, 316 A.2d 619 (Del. 1974) (granting preliminary injunctive relief preventing sale of subsidiary to third-party acquiror and noting impracticability of the remedy of rescission—like trying to 'unscramble the eggs'—if sale were permitted to proceed) (quoting Metro Goldwyn-Mayer v. Transmerica Corp., 305 F.Supp. 1344, 1348 (S.D.N.Y. 1968)).

348 *See Arnold II*, 678 A.2d at 537 n.9. If the board's violation of its fiduciary duty amounts to a breach of the duty of care (uncomplicated by any problems of loyalty or bad faith), the stockholders may be left without a remedy if the certificate of incorporation contains a provision eliminating personal liability of directors. *See* DEL. CODE ANN. tit. 8,

Arnold II does much to rationalize the interplay between judicially imposed fiduciary precepts and legislatively prescribed mechanisms for "organic change[s]" to the corporate enterprise.[349] In effect, there is a lurking timing principle, analogous to that underlying contract avoidance doctrine[350] and trust law's bona fide purchaser rule[351] that affects the degree to which the third party acquiror's contractual expectations will be realized. A target board's compliance with the literal requirements of the Delaware statute protects a completed transaction, such as a merger, from judicial interference.[352] In effect, a target board has apparent authority to accomplish such a transaction despite a breach of fiduciary duty in approving the deal. Further, the third party acquiror is protected (absent a knowing participation in the target directors' breach of fiduciary duty)[353] in relying on the target board's satisfaction of the statutory formalities.[354] Conversely, when a complaining target stockholder timely requests preliminary injunctive relief preventing consummation of the merger because of the board's breach of fiduciary duty (i.e., in the context where the issue is "transactional justification")[355] the strong policy favoring protection of the fiduciary relationship ascends. In that instance, irrespective of whether the third party held a reasonable belief as to the board's authority (i.e., was previously without notice of the board's breach of fiduciary duty), the doctrine of apparent authority will not save the transaction.[356]

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§ 102(b)(7) (1998). That was the case in *Arnold II*. *See* 678 A.2d at 541.

349 *See Arnold II*, 878 A.2d at 537 n.9.

350 *See supra* Part II.B.5.c.

351 *See supra* Part III.A.2.b.

352 *See Arnold II*, 678 A.2d at 537 n.9 ("[I]f the statutory procedure is followed, the organic change is authorized and effective.").

353 *See infra* note 438 and accompanying text (discussing liability standard for aiding and abetting a board's breach of fiduciary duty).

354 *Cf. Arnold II*, 678 A.2d at 537 ("To assure themselves that the corporation is validly existing, third parties that transact business with the surviving corporation are obliged to investigate only the specific steps required under the merger statutes.").

355 *See supra* note 25.

356 This lurking timing principle inherent in the interplay of fiduciary and statutory requirements helps to explain why the completed merger in *Van Gorkom* was "authorized and effective" despite the Trans Union directors' breach of their duty of care in approving the transaction. *See Arnold II*, 678 A.2d at 537 n.9; *see also id.* at 537 (citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)); Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1337-38, 1341 (Del. Ch. 1987) (granting preliminary injunction preventing consummation of parent–subsidiary merger based on, among other things, breach of duty of care of subsidiary's board of directors).

4. Summary

The agency law doctrine of apparent authority provides helpful insight into the formulation of a coherent analytical model for the contractual claim of the corporate acquiror. Although directors are not literally "agents" of the corporation or the stockholders, they are appointed by the stockholders through the electoral process to represent the stockholders' financial interests. A third party acquiror thus bargains with the recognition that the board negotiates in a representative capacity, raising the added transaction risk that the "agents" may have exceeded their authority. Nevertheless, the doctrine of apparent authority promotes the policy favoring the securing of transactions by protecting third parties who transact business, while harboring a reasonable belief that the "agent" (i.e., the board of directors) has the authority to cause the corporation to enter into the transaction. This belief can arise positionally, from the mere appointment of the directors to their specific positions on the board, because the "generally recognized duties"[357] of boards of directors include the authority to negotiate a change of control transaction.[358]

Established limitations on the apparent authority doctrine closely parallel the conflict reconciliation mechanisms employed by both contract law and trust law when the issue is whether to disappoint the contractual expectations of an innocent third party for the sake of some weightier policy concern. Thus, the reasonableness of the third party's belief concerning the agent's authority is measured objectively, in light of what that third party knew or should have known.[359] A timing principle also emerges in the corporate takeover context. The business judgment rule protects decisions within a board's "conferred" or "apparent" authority if the transaction complies with all express statutory requirements.[360] Under this rubric, a court will not disturb a completed merger transaction that satisfies the statutory requirements, despite a finding that the target directors breached their fiduciary duties. Conversely, when a complaining stockholder timely intervenes with a request for injunctive relief preventing consummation of the takeover—a procedural context involving what is known as "transactional justification"[361]—a

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357 RESTATEMENT (SECOND) OF AGENCY §27 cmt. a (1957); *see also id.* § 34(b).
358 *See supra* note 317-20 and accompanying text.
359 RESTATEMENT (SECOND) OF AGENCY §49(a) (1957).
360 *See supra* notes 342-44 and accompanying text.
361 *See supra* note 25 and accompanying text.

finding that the target directors have breached their fiduciary duties will ordinarily be dispositive. In that instance, the policy favoring protection of the fiduciary relationship takes precedence over the third party acquiror's contractual expectations, and a court will likely enjoin the parties from completing the transaction.

C. *Public Policy and the Expectations–Fairness Conflict*

Contract law's preeminent concern for protecting expectations also is subject to general limitations based on competing policy concerns. Freedom of contract furthers the public interest by making agreements for future exchanges legally enforceable, thereby facilitating the exchange of services and resources in our market economy.[362] Sometimes, however, the greater public interest is better served by refusing to enforce an agreement that is seen as violative of some competing public policy that calls for suppression of contract law's first impulse to ensure the realization of contractual expectations.[363] As discussed further below,[364] a target board's decision to grant a preclusive lock-up and/or unreasonable break-up fee to a favored bidder, in breach of the target directors' fiduciary duties to their stockholders, presents an example of such a competing policy concern.[365]

1. The Restatement Balancing Test

The *Restatement of Contracts* provides for a "careful balancing" of competing concerns in determining whether to deny enforcement of a contract on public policy grounds.[366] The

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362 *See supra* note 2 and accompanying text.

363 *See* FARNSWORTH, *supra* note 1, § 5.1.

364 *See infra* Part III.C.2–3. As explained by Professor Farnsworth, a court's refusal to enforce an agreement on public policy grounds may be animated by two considerations:

> A court may be moved by two considerations in refusing to enforce an agreement on grounds of public policy. First, it may see its refusal as an appropriate sanction to discourage undesirable conduct. Second, it may regard enforcement of the promise as an inappropriate use of the judicial process to uphold an unsavory agreement.

FARNSWORTH, *supra* note 1 § 5.1 (footnotes omitted). This latter consideration (refusing judicial aid for the enforcement of an "unsavory" bargain) is similar to the timing principle underlying trust law's bona fide purchaser rule whereby "[a] court of equity will not compel a trustee to commit or complete the commission of a breach of trust." RESTATEMENT (SECOND) of TRUSTS § 310 cmt. a (1957).

365 *See infra* note 374 and accompanying text.

366 RESTATEMENT (SECOND) OF CONTRACTS § 178 cmt. b (1979). This balancing of competing considerations applies to those agreements which raise a public policy concern for judicial determination, as opposed to cases in which existing legislation declares the

strength of the policy favoring the protection of contractual expectations is seen in the formulation of this balancing test, which limits non-enforcement of agreements to cases where the usually prevailing interest in enforcement "is *clearly* outweighed" by a competing public policy against enforcement.[367]

The balancing test identifies various factors to consider in weighing the interest in enforcement of an agreement against the opposing public policy interest.[368] Among the factors to consider in favor of enforcement are "the parties *justified* expectations."[369] Balanced against enforcement are such factors as "the strength of [the competing] policy as manifested by legislation or judicial decision" and "the seriousness of any misconduct involved."[370]

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agreement unenforceable ("in which instance the judicial task is simply one of statutory construction."). *Id.* Cases involving public policy issues are more common. *See id.* "Only infrequently does legislation, on grounds of public policy, provide that a term is unenforceable." *Id.* Section 178(1) thus provides: "A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms." *Id.* § 178(1).

367 *Id.* (emphasis added); *see also id.* cmt. b ("Enforcement will be denied only if the factors that argue against enforcement clearly outweigh the law's traditional interest in protecting the expectations of the parties . . . ."); FARNSWORTH, *supra* note 1 § 5.1 ("Enforcement should not be refused unless the potential benefit in deterring misconduct or avoiding the inappropriate use of the judicial process outweighs the factors favoring enforceability."). The courts' reluctance to disturb agreements on public policy grounds is captured well in the famous admonition of a nineteenth century English judge that public policy "is a very unruly horse, and when once you get astride it you never know where it will carry you." *Id.* § 5.2 (quoting Richardson v. Mellish, 2 Bing. 229, 252, 130 Eng. Rep. 294, 303 (1824) (Burrough, J.)).

368 *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 178(2), (3) (1979).

369 *Id.* §178(2)(a) (emphasis added). In full, RESTATEMENT OF CONTRACTS section 178(2) provides, "[i]n weighing the interest in the enforcement of a term, account is taken of (a) the parties' justified expectations, (b) any forfeiture that would result if enforcement were denied, and (c) any special public interest in the enforcement of the particular term." *Id.*

370 *Id.* § 178(3). In full, RESTATEMENT OF CONTRACTS section 178(3) provides as follows:

> In weighing a public policy against enforcement of a term, account is taken of
> (a) the strength of that policy as manifested by legislation or judicial decisions,
> (b) the likelihood that a refusal to enforce the term will further the policy,
> (c) the seriousness of any misconduct involved and the extent to which it was deliberate; and
> (d) the directness of the connection between that misconduct and the term.

Id.

2. The Director–Stockholder Fiduciary Relationship as a Protected Category

Section 179 of the *Restatement of Contracts* identifies various categories of public policy concerns which the courts historically have protected, even at the expense of a contracting party's expectations.[371] Among these historically protected categories are "judicial policies against" agreements that restrain trade, impair family relations, or –significant to the focus of this Article— interfere "with other protected interests."[372] This latter category of "other protected interests" explicitly includes agreements which induce a violation of fiduciary duty.[373] *Restatement of Contracts* section 193, to which section 179(b)(iiii) refers, thus articulates a strong public policy concern for protecting the integrity of the fiduciary relationship: "[A] promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy."[374] The comments to section 193 also make plain that the fiduciary relationships meriting protection under this section include the relationship between corporate directors and stockholders.[375] Moreover, the violations of fiduciary duty contemplated by this section are not limited to loyalty violations, and thus include any action by a fiduciary that is contrary to the "beneficiary's" best interests.[376]

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371 *See* RESTATEMENT (SECOND) OF CONTRACTS §179 (1979); *see also id.* cmt. a ("Historically, the public policies against enforcement of terms were developed by judges themselves on the basis of their own perception of the need to protect some aspect of the public welfare. Some of these policies are now rooted in precedents accumulated over centuries.").

372 *Id.* § 179(b).

373 *See id.* § 179(b)(iii).

374 *Id.* § 193. In an intriguing post-mortem on *Van Gorkom*, Morton Moskin argues, based on an expansive reading of *Restatement of Contracts* section 193, that the Trans Union directors: (1) remained inherently free, because of overriding fiduciary concerns, to withdraw from the merger agreement with Jay Pritzker; and (2) thus arguably satisfied their fiduciary duties by later reaffirming the transaction on a more informed basis. *See* Morton Moskin, *Trans Union: A Nailed Board*, 10 DEL. J. CORP. L. 405, 424 (1985); *see also* Jennifer J. Johnson & Mary Siegel, *supra* note 8, at 368 ("It is anomalous to suggest that target directors could recommend approval of a merger in the face of a competing bid that better served shareholders' interests, given that directors cannot lawfully contract away their fiduciary duties of care and loyalty.").

375 *See* RESTATEMENT (SECOND) OF CONTRACTS § 193 cmt. a (1979) ("Directors and other officials of a corporation act in a fiduciary capacity and are subject to the rule in this Section."). Indeed, two of the three illustrations to section 193 involve corporate matters, albeit matters touching upon stockholder voting agreements. *Id.* illus. 2, 3.

376 *See id.* § 193 cmt. a ("A fiduciary is expected to refrain from acting for his private advantage *or otherwise contrary to the interests of his beneficiary or principal in matters affecting his fiduciary relation.*") (emphasis added).

3. The Preclusive Lock-Up as a Competing Policy Concern

Applying the *Restatement of Contracts* balancing test to the corporate acquiror's contractual claim is instructive. Weighing in favor of enforcement of a merger or similar agreement is the preeminent contract law concern with protecting the expectations that arise from lawful bargaining. Potential acquirors could will be discouraged from pursuing wealth-producing takeovers if agreements in this context were too readily prone to judicial invalidation. On the other hand, considering the historic "fifth wave" of record breaking merger and acquisition activity currently in process, nearly fifteen years of experience with Delaware's relatively invasive judicial scrutiny for change of control transactions[377] appears not to have discouraged takeovers at all.[378]

The *Restatement of Contracts*'s regard for the parties' "*justified* expectations"[379] is also significant, and largely confirms the "reason to know" and constructive "notice" tests employed by other contract law avoidance doctrines,[380] trust law's bona fide purchaser rule,[381] and agency law's "reasonable belief" standard.[382] A corporate acquiror, even one acting in subjective in good faith, that presses for and obtains unreasonable concessions from the target—in the form of a preclusive lock-up or break-up fee—is effectively on "notice" of a potential fiduciary problem with the target's board, and thus cannot claim that its contractual expectations were well-justified. Moreover, the breach of a fiduciary relationship, including one between directors and stockholders, is the type of public policy concern that will displace contract law's usual inclination toward enforcement of bargains.[383]

Related to this point is the especially strong policy at stake when an issue of fiduciary responsibility arises in the context of a board's "ownership" decision to sell control.[384] The strength of the policy ensuring that a board takes reasonable measures to achieve the highest price for the stockholders has been manifested in

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377 *See infra* Part IV.B.

378 *See supra* note 16.

379 RESTATEMENT (SECOND) OF CONTRACTS §178(2)(a) (1979) (emphasis added).

380 *See supra* Part II.B.

381 *See supra* Part III.A.2.

382 *See supra* Part III.B.3.

383 *See* RESTATEMENT (SECOND) OF CONTRACTS §193 (1979).

384 *See infra* Part IV.B. The comment to section 178 emphasizes that "[t]he strength of the public policy involved is a critical factor in the balancing process." RESTATEMENT (SECOND) OF CONTRACTS §178 cmt. a (1979).

numerous judicial decisions in Delaware and elsewhere.[385] In particular, these decisions have identified preclusive lock-ups, unreasonable break-up fees, and no-shop clauses as the kinds of auction impeding devices that are vulnerable to judicial review for reasonableness.[386] An acquiror who insists on "pushing the envelope" with these devices needlessly invites substantial transaction risk; is plainly "on notice" of potential fiduciary transgressions by the target board; and thus will not qualify as a party with "justified" expectations. In that instance, the strong public policy favoring the protection of the fiduciary relationship between the target directors and their stockholders should, and usually does, take precedence.

D. *Summary*

A strong parallel exists between the analyses governing contract law's general principles for the avoidance of contractual obligations and the limitations upon the enforceability of agreements negotiated with representatives who occupy a fiduciary relationship. In each of these contexts, courts are confronted with a difficult choice between competing claims of presumably innocent parties to a contract: (1) protecting legitimately bargained for expectations; or (2) protecting an adversely affected party from the consequences of some fundamental distortion to the bargaining process. Given the importance of transaction stability to our market economy, it is unsurprising that contract law's first impulse is to enforce the bargain. Nevertheless, the gravity of the case for fairness or protection of the adversely affected party may pull the court toward avoiding a transaction if the circumstances are sufficiently compelling.

Courts employ remarkably similar principles in identifying the sufficiently compelling case for avoidance, despite the diverse contexts in which a claim for contract avoidance may arise. The similarity of these principles reveals that, whatever the context, claims for contract avoidance raise questions that are more alike than different–such as deciding when it is fair to disappoint the expectations of an arguably innocent party to a contract for the sake of ensuring some minimal standard of fairness in the

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385 *See id.* § 178(3)(a) (identifying as a factor weighing against enforcement "the strength of [the public] policy as manifested by legislation or judicial decisions").

386 *See supra* Part I.A.

bargaining process.

An examination of these conflict resolution principles in the contexts of trust law, agency relationships, and general public policy concerns reaffirms insights gained from examining general contract law avoidance doctrine.[387] Specifically, whether a third party's agreement with a trustee, agent, or corporate fiduciary will remain enforceable against the "principal" (i.e., against the trust, the principal, or the corporation), despite the representative's breach of fiduciary duty, will depend on: (1) whether the third party knew or should have known of the representative party's breach; (2) the timing of the discovery of the breach in relation to whether the performances contemplated by the agreement have been exchanged; (3) the strength of the policy competing against enforcement (i.e., the strong policy toward protecting "beneficiaries" from a breach of fiduciary duty); and (4) the degree to which the third party changed position in reliance on the agreement.

As further discussed below, this Article proposes that these core expectations–fairness conflict resolution principles should be applied in the takeover context when an acquiror asserts that it has protectable contractual interests in a merger agreement with the target, irrespective of any breach of fiduciary duty by the target's board in approving the transaction.[388] Appreciating fully the acquiror's contractual expectations in this takeover context first requires an examination of the uniquely corporate principles that define the relationship between the target's directors and their stockholders, particularly in the extraordinary context of a change of control transaction.

IV. CORPORATE GOVERNANCE AND THE ACQUIROR'S EXPECTATION INTEREST

In measuring a potential acquiror's claim to protectable contractual expectations, one should consider the context in which the claim is asserted. It is one thing for a third party to complain of disappointed expectations when the subject matter of its contract with another corporation is within the ordinary course of the corporation's business. It is quite another if the subject involves arguably the most extraordinary transaction possible—a "bet the company" decision by the corporation's board to undergo

387 *See supra* Part II.B.
388 *See infra* Part V.

a sale or change of control.[389] This is not to suggest that an acquiror's contractual expectations in this latter, extraordinary context are non-existent or somehow unworthy of contractual weight. Nevertheless, such expectations are inevitably tempered by the risk of transaction non-consummation that results from heightened judicial scrutiny in this context.[390]

The traditional business judgment rule affords great deference to board decisions involving ordinary business matters. A far more searching level of judicial review (enhanced judicial scrutiny) is reserved for extraordinary board decisions (i.e., "ownership" decisions)[391] such as those involving a change of control transaction. This section suggests that an acquiror who bargains for a change of control transaction has substantially diminished contractual expectations from the outset, because that acquiror enters into the merger agreement on notice that a searching judicial review into the substantive reasonableness of the proposed transaction is virtually inevitable.

A. *Traditional Rules for Enterprise Issue Cases*

It has long been a "fundamental principle" of corporate law that the business and affairs of a corporation come under the managerial authority of the board of directors.[392] The business judgment rule, an "extension" of this foundational organizational

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389 *See* Veasey, *supra* note 261, at 403 ("Someday, the directors may well face a big ownership issue or a 'bet the company' deal or litigation.").

390 Chief Justice Veasey of the Delaware Supreme Court captures this distinction well in his article addressing the relationship between board authority and judicial review in the scheme of corporate governance:

> Corporate governance issues often divide among "enterprise" and "ownership" issues in corporate decision-making, and "oversight" issues in the board's non-decision-making monitoring role. This is an oversimplification, of course, but I have found it to be a helpful analytical tool. . . Ownership issues raise questions such as: should we merge . . . [or] fend off unwanted suitors who wish to take control by tender an offer to the stockholders? *It is ownership issues which usually put corporate governance to the test.*

Veasey, *supra* note 261, at 394 (footnotes omitted) (emphasis added).

391 *See infra* Part IV.B.

392 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("Our starting point is the fundamental principle of Delaware law that the business and affairs of a corporation are managed by or under the direction of its board of directors."); *see also* Spiegel v. Buntrock, 571 A.2d 767, 772-73 (Del. 1990) ("[D]irectors, rather than shareholders, manage the business and affairs of the corporation."); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) ("The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors.").

principle,[393] protects the board's managerial authority by erecting obstacles to shareholder lawsuits attacking the directors' decisions.[394] These judicially created obstacles, inherent in the deference afforded director action under the business judgment rule, promote "the value of centralized decisionmaking"[395]

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393 *See Cede*, 634 A.2d at 360.

394 *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("[T]he business judgment rule is the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors."); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)."); Daniel J. Morrisey, *Defensive Tactics in Tender Offers–Does Anything Go?*, 53 TENN. L. REV. 103, 120 (1985) ("[T]he business judgment rule has been aptly justified as an acknowledgment of the board's managerial prerogatives.").

395 Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation*, 44 BUS. LAW. 503, 522 (1989). In addition to the value of centralized decisionmaking, the business judgment rule responds to many other public policy concerns. For example, some commentators (including this author) and courts maintain that the rule benefits stockholders, and society at large, by encouraging entrepreneurial risk-taking by directors who otherwise would lean timidly toward safe, if only modestly rewarding, business strategies were they vulnerable to personal liability simply because their decisions turn out badly. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("[T]he business judgment rule exists to protect and promote the full and free exercise of managerial power granted to . . . directors."); Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Shareholders don't want (or shouldn't rationally want) directors to be risk adverse."); Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984) ("The business judgment rule gives managers the freedom to err, and thus it facilitates risk-taking."); Lawrence A. Hamermesh, *Calling off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1145-46 (1996) ("The fiduciary duty of care, as thus refined by the 'business judgment rule,' reflects a balance of regulation that reduces the costs of monitoring the behavior of corporate manages, avoids undue discouragement of entrepreneurial risk-taking, and thereby enhances stockholder wealth."); Bayless Manning, *The Business Judgment Rule and the Directors' Duty of Attention*, 39 BUS. LAW. 1477, 1491 (1984) ("Sophisticated modern courts further explicitly recognize that the private sector entrepreneurial process cannot operate unless managers are given the latitude to be innovative and experimental and, therefore, to make mistakes."); Regan, *supra* note 261, at 133-36; AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 135 (1994) ("The basic policy underpinning of the business judgment rule is that corporate law should encourage, and . . . stimulate risk taking, innovation, and other creative entrepreneurial activities."); REVISED MODEL BUS. CORP. ACT § 8.30, Official Comment (3d ed. 1993) ("[T]he courts recognize that boards of directors and corporate managers continuously make decisions that involve the balancing of risks and benefits for the enterprise.").

Other explanations for the business judgment rule include a professed concern for the courts' lack of competency to assess business decisions. *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1378 n.14 (Del. 1993); Solash v. Telex Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,608, at 97,727 (Del. Ch. Jan. 19, 1988); Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 490 (1990). Others have suggested that the liability-shielding effect of the rule may also be designed to encourage competent managers to serve as directors. *See* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment*

underlying our board-managed corporate regime by precluding shareholders, through the vehicle of the court system, from interfering unreasonably with the board's decisionmaking power.[396]

A shareholder seeking to challenge a board's decision as a breach of fiduciary duty must first overcome a standing evidentiary presumption "that in making a business decision, the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[397] A shareholder plaintiff can overcome this presumption, but only by demonstrating that the directors, in reaching their decision, breached "one of the *triads* of their fiduciary duty–good faith, loyalty or due care."[398] If the shareholder plaintiff fails to overcome this evidentiary obstacle, then "the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they made."[399]

Rule, 48 BUS. LAW. 1337, 1342 (1993) ("More persuasive reasons for the rule are its role in encouraging qualified men and women to serve as directors and motivating them to be willing to take entrepreneurial risks.").

396 *See id.* Specifically:

> The power to hold to account is the power to interfere and, ultimately, the power to decide. If stockholders are given too easy access to courts, the effect is to transfer decision-making power from the board to the stockholders or, more realistically, to one of a few stockholders whose interests may not coincide with those of the larger body of stockholders.

Id.

397 Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

398 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d at 361; *see also Citron*, 569 A.2d at 64 ("The burden falls upon the proponent of a claim to rebut the presumption by introducing evidence either of director self-interest, if not self dealing, or that the directors lacked good faith or failed to exercise due care."). If a shareholder plaintiff demonstrates that the directors breached one or more of their fiduciary duties, any utility otherwise resulting from judicial deference for board choices is presumptively lost thus, the burden then shifts to the directors to demonstrate the entire fairness of the challenged transaction in the crucible of strict judicial scrutiny. *See Cede*, 634 A.2d at 361; Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983); *see also* William D. Araiza et al., *The Jurisprudence of Yogi Berra*, 46 EMORY L.J. 697, 743 (1997) (using Yogi Berra's remark after New York Yankees's 1960 World Series loss to Pittsburgh Pirates—"We made too many wrong mistakes"—as capturing essence of business judgment rule's protection of directors for decisions that simply turn out badly (i.e., legitimate or "right" mistakes) and lack of protection for decisions which were grossly negligent (i.e., "wrong mistakes")); Regan, *supra* note 261, at 138-45 (summarizing business judgment rule jurisprudence).

399 *Citron*, 569 A.2d at 64; *see also* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 n.17 (Del. 1994) (stating that when a shareholder plaintiff fails to overcome the evidentiary presumption of propriety afforded to the directors, the court will give "great deference to the substance of the directors' decision and will not invalidate the decision . . . [and] will not examine its reasonableness . . . ."); Dennis J. Block et al., *The Duty of Loyalty and the Evolution and Scope of Judicial Review*, 59 BROOK. L. REV. 65, 67 (1993) ("[C]ourts will not interfere with a business decision if it is made in good

The business judgment rule's implications for contractual expectations in matters involving ordinary "enterprise"[400] decisions are self-evident. The risk of judicial interference at the behest of a complaining stockholder in such a transaction is so negligible as to be entirely disregarded entirely by the party contracting with the corporation. Absent bargaining defects or other circumstances suggesting the potential applicability of contract avoidance doctrines, a party to a contract with a corporation involving an ordinary operational or enterprise matter, should: (1) legitimately anticipate the realization of its contractual expectations; and (2) discount the risk of any judicial interference in the bargain based on corporate fiduciary precepts.

B. *Enhanced Judicial Scrutiny for Ownership Issue Cases*

Enhanced judicial scrutiny of board decisions made in the context of a potential takeover first appeared explicitly in the landmark case of *Unocal Corp. v. Mesa Petroleum Co.*[401] in 1985, which has been referred to as "the watershed year . . . in Delaware jurisprudence."[402] Although this "watershed" reference alludes to a familiar trilogy of "ownership" issue cases—*Unocal*, *Moran v. Household International, Inc.*, and *Revlon*[403]—the Delaware Supreme Court effectively laid the foundation for enhanced

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faith by disinterested directors after reasonable investigation and does not constitute an abuse of discretion."); Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 470 (1992) ("[T]he [business judgment] rule precludes judicial review of board decisions that are honest and carefully thought out, but just plain wrong from the standpoint of advancing the shareholders' interests."); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the* Unocal/Revlon *Gap,* 35 ARIZ. L. REV. 989, 999 n.10 (1993) ("Under the business judgment rule, the board prevails whenever it can articulate a rational, unselfish business purpose for its actions.").

400 *See, e.g.*, Loudon v. Archer-Daniels-Midland, 700 A.2d 135, 147 n.47 (Del. 1997) ("'Enterprise issues' are usually those involving management decisions affecting the enterprise and do not go to the heart of the individual stockholder's personal property interests."); E. Norman Veasey, *The Defining Tension in Corporate Governance in America,* 52 BUS. LAW. 393, 394 (1997) ("Enterprise issues raise questions such as: should we manufacture cars or widgets, and should the plant be in Perth or Pittsburgh? . . . There is little or no court interference in enterprise issues.").

401 493 A.2d 946 (Del. 1985).

402 E. Norman Veasey, *The Business Judgment Rule*, 15 DEL. J. CORP. L. 573, 576 (1990) (reviewing D. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS (3d ed. 1989)) (book review).

403 *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding adoption of poison pill rights plan defense as both statutorily valid under DGCL and a reasonable exercise of board fiduciary responsibility under *Unocal*); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

judicial scrutiny earlier that same year, in the provocative *Smith v. Van Gorkom*[404] decision.

With the benefit of hindsight, one can revisit *Van Gorkom* and fit that decision more comfortably into the then–soon–to–be–announced principles of *Revlon*.[405] In the abstract, whether to brand the Trans Union directors in *Van Gorkom* as grossly negligent was an intensely debatable question, and only a narrow majority of a rarely divided Delaware Supreme Court would so conclude. But to suggest that the Trans Union directors failed to act reasonably in attempting to achieve the highest price for the stockholders (as measured by the *Revlon–Macmillan–Paramount* framework)[406] strikes one as a far more defensible proposition. In short, the duty of care language confined more appropriately to shareholder attacks on ordinary "enterprise" decisions—that the directors were not only negligent in discharging their responsibilities, but "grossly" negligent—seemed inadequate to the task of calibrating the deference–accountability tension in so important a context.

In a prophetic article published just months after the *Van Gorkom* opinion, Bayless Manning called attention to the extraordinary nature of the board decision at issue in the case as the driving force behind the finding of liability.[407] In his article, Manning coined the terms "enterprise issues" and "ownership claim issues" to differentiate between cases involving shareholder attacks on ordinary business decisions by directors and those involving an extraordinary sale of control transaction. Further, Manning accurately predicted that board decisions in this latter

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404 *See generally* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (finding board of directors of Trans Union Corporation personally liable to stockholders for breach of duty of care in deciding to sell the company).

405 *See* Lawrence A. Hamermesh, *Calling Off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1124 n.153 (1996) (noting efforts by various scholars "to reexamine the [*Van Gorkom*] case to divine some rationale more satisfactory than the 'ill-fitting' duty of care theory invoked by the court") (quoting Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1354-55 (1989)); Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127, 128 (1988) (construing *Van Gorkom* as a takeover case); *see also* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051 n.4 (Del. Ch. 1996) ("I count *Smith v. Van Gorkom*... not as a 'negligence' or due care case involving no loyalty issues, but as an early and, as of its date, not yet fully rationalized, '*Revlon*' or 'change of control' case.").

406 *See* Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); *Revlon*, 506 A.2d at 173 (Del. 1986); *see also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989).

407 *See* Manning, *supra* note 261, at 1.

category would receive greater judicial attention.[408] Subsequent case law and commentary leave no doubt that the Delaware Supreme Court has embraced Manning's classifications as a tool for identifying those cases in which board decisions will be subjected to the substantive reasonableness review of enhanced judicial scrutiny.[409]

Unocal was the first case in which a court explicitly applied an intermediate level of judicial scrutiny—later called "enhanced scrutiny"[410]—without any threshold showing by the shareholder plaintiff that the directors had breached one or more of their fiduciary duties. The *Unocal* court reasoned that the decision by a board—even a board comprised of a majority of independent, outside directors—to adopt defensive measures to thwart a hostile takeover raises the "omnipresent specter" of potential entrenchment (i.e., disloyalty).[411] Consequently, before achieving

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408 *See id.* at 5-6; *see also Gagliardi*, 683 A.2d at 1052 n.4 ("I see [*Van Gorkom*] as reflecting a concern with the Trans Union board's independence and loyalty to the company's shareholders in a *critical 'sale of the company' context.*") (emphasis added).

409 *See* Loudon v. Archers-Daniels-Midland Co., 700 A.2d 135, 147 n.47 (Del. 1997) (quoting with approval Manning, *supra* note 261, at 5-6); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (contrasting application of traditional business judgment rule to "completed [board approved] actions involving operational issues with "*Unocal*'s reasonableness and proportionality review" for defensive measures which "implicate *issues affecting stockholder rights*") (emphasis added); Veasey, *supra* note 260, at 394; *see also* Regan, *supra* note 261, at 195-99 (tracing the emergence of the enterprise/ownership analysis as post-*Van Gorkom* model for invoking enhanced scrutiny).

410 *Compare* Unocal Corp. v. Mesa Petroleum, Co., 493 A.2d 946, 954 (Del. 1985) (stating that "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred"), *with Revlon*, 506 A.2d at 184 (referring to "the enhanced scrutiny which *Unocal* requires of director conduct").

411 *Unocal,* 493 A.2d at 954. Later cases reinforced the point that *Unocal*'s enhanced scrutiny for reasonableness was triggered by the mere possibility of entrenchment-motivated decision-making when a board erects obstacles to a potential takeover. *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 251 (1989) ("The proportionality test brings a novel, objective standard to the review of defensive tactics—a reasonableness test that impliedly allows courts to identify and reject unreasonable tactics, whatever the motives of their authors."); Paul L. Regan, *Delaware Court of Chancery Invalidates Limited Duration No-Hand Poison Pill*, 21 BANK & CORP. GOVERNANCE L. REP. 900, 906 (1999) ("The refreshing beauty of *Unocal* is that a court may declare a defensive measure to be invalid as objectively unreasonable [in effect, on suspicion of disloyalty] without having to make the maddeningly difficult finding that the directors' decision was primarily [and subjectively] based on perpetuating themselves in office."); E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role,* 45 BUS. LAW. 2065, 2075 (1990) (arguing that the *Unocal* "proportionality test is not a finding that in such cases there is necessarily a violation of the duty of loyalty"); *see, e.g.*, *Revlon*, 506 A.2d at 180 (emphasizing the "potential for conflict" that obligates a

the deferential refuge of the business judgment rule, a board in such circumstances must first prove that: (1) they reasonably determined that a hostile bid posed a "threat" to the company and/or its stockholders; and (2) their defensive response was reasonable and balanced in proportion to the threat.[412] As refined more recently in *Unitrin*, this second analytical prong of *Unocal* calls for inquiry into whether a board's defensive response is preclusive or coercive (in which case the defense is unreasonable as an improperly "draconian" response) and, if not, whether the defensive strategy falls within a "range of reasonableness."[413]

Judicial review of the substantive reasonableness of directors' defensive decisions obviously creates more jeopardy for the board than the highly deferential review of a traditional business judgment rule analysis. Although this jeopardy in the anti-takeover setting to date has proved more theoretical than real,[414] certainly one's expectations that a defensively adopted transaction will in fact be consummated are inevitably tempered by the risk attending this heightened judicial review.

Revlon tentatively introduced the notion of enhanced judicial scrutiny of board decisions approving a break-up of the company or a sale or change of corporate control. Although the opinion explicitly applied enhanced scrutiny in assessing the reasonableness of Revlon's initial defensive responses, the part of the opinion in which *Revlon* invalidated the auction-ending lock-up option granted to Forstmann Little appeared to follow a

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defensively minded board to demonstrate both the reasonableness of its decision-making process and the substantive reasonableness of its choices in deploying a particular defensive measure); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (noting that *Unocal* responds to the concern that "a board *may* be acting primarily in its own interests") (emphasis in original); *id.* at 115 (observing that deployment of improperly coercive defensive measure "creates species of director interest even on the part of the outside directors").

412 *See Unocal*, 493 A.2d at 954-55. The *Revlon* court aptly summarized the two-part *Unocal* inquiry as follows:

> This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance—that the responsive action taken is reasonable in relation to the threat posed.

Revlon, 506 A.2d at 180 (citations omitted).

413 *Unitrin*, 651 A.2d at 1386-88.

414 *See* Regan, *supra* note 411, at 904 ("[D]irectors in the *Unocal* mode [as opposed to *Revlon* mode] tend to get a fairly forgiving, if not entirely free pass from the Courts . . . ."); Johnson & Siegel, *supra* note 8, at 330 (criticizing *Unocal* as a "toothless standard" that is "fairly inconsequential and far less stringent than a fairness test").

traditional business judgment rule analysis.[415] Nevertheless, the court's later decisions in *Macmillan* and *Paramount* removed any doubt that board decisions approving a sale or change of control also will be subjected to judicial review for substantive reasonableness (i.e., enhanced scrutiny) without any threshold showing by a complaining stockholder that the board breached its fiduciary responsibilities.[416] In particular, *Paramount* articulated a two-pronged test for change of control transactions which, similar to *Unocal*, entails an examination of: (1) the "adequacy of the board's decisionmaking process"; and (2) the "reasonableness of the substantive merits of a board's actions."[417]

Unlike the enhanced scrutiny that *Unocal* reserves for anti-takeover measures, a standard that commentators have disparaged as "toothless,"[418] the enhanced scrutiny of *Revlon* and its progeny has proved quite invasive and, in a number of instances, has destabilized the expectations of would-be acquirors. As discussed earlier,[419] the Delaware courts have not hesitated to invoke the extraordinary remedy of preliminary injunctive relief to prevent target boards from selling control too cheaply to a favored suitor.[420]

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415 *Compare Revlon*, 506 A.2d at 180-81 (upholding adoption of poison pill and defensive exchange offer as reasonable responses to threat of "bust-up" takeover at inadequate price), *with id.* at 182-85 (invalidating lock-up option and no-shop and termination fee commitments as product of Revlon board's breaches of fiduciary duties of care and loyalty). *But see Revlon*, 506 A.2d at 184 ("[W]hen a board ends an intense bidding contest on an insubstantial basis . . . the action cannot withstand the enhanced scrutiny which *Unocal* requires of director conduct."). In a number of cases decided after *Revlon* in which a change of control was involved, the Delaware Court of Chancery impliedly or expressly refused to apply enhanced scrutiny to claims attacking the manner in which a board had conducted an auction. *See In re* RJR Nabisco, Inc. Shareholders Litig., Civ. No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989); *In re* Holly Farms Corp. Shareholders Litig., Civ. No. 10350, 1988 WL 143010 (Del. Ch. Dec. 30, 1988). *In re* Fort Howard Corp. Shareholders Litig., Civ. No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988); *In* re J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770 (Del. Ch. 1988). The Delaware Supreme Court took the opportunity in *Macmillan* to criticize the chancery court's inappropriate use of an "ordinary business judgment rule analysis" in each of these cases. Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1988).

416 *See Macmillan*, 559 A.2d at 1287-88; Paramount Communications v. QVC Network, Inc., 637 A.2d 34, 42, 45 (Del. 1994).

417 *Paramount*, 637 A.2d at 45. As in the *Unocal* context, directors subjected to enhanced scrutiny in the change of control setting are charged with the burden of proving that they have satisfied this two-prong test—i.e., "proving that they were adequately informed and acted reasonably." *Id.*

418 *See* Johnson & Siegel, *supra* note 8, at 330; *see also id.* at 338 ("Recent Delaware Supreme Court rulings regarding defensive tactics evidence that in fighting tender offers almost anything will pass muster.").

419 *See supra* Part I.A.

420 *See generally Paramount*, 637 A.2d at 34; *Macmillan*; 559 A.2d at 1261; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); *In re Holly Farms*, Civ.

On appeal, decisions from the Delaware Chancery Court granting a preliminary injunction enjoining measures found injurious to the conduct of an auction for corporate control have been affirmed.[421] In contrast, *Unocal* and *Unitrin* both involved reversals of chancery court rulings that granted preliminary injunctive relief invalidating defensive measures.[422]

Although some commentators have suggested that *Paramount* effectively unified the *Unocal* test for both anti-takeover and change of control decisions,[423] this writer respectfully disagrees. Although the tests are linguistically similar, experience teaches that there is an intensely practical substantive difference between them. As *Paramount* emphasized repeatedly, in a change of control transaction, stockholders almost certainly will have no further opportunity to realize a control premium for their shares, so it is incumbent on the court to ensure a reasonable outcome for the stockholders.[424] In contrast, the fairly forgiving review inherent

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No. 10350, 1988 Del. Ch. LEXIS 164 (Dec. 30, 1988).

421 *See generally Paramount*, 637 A.2d at 34; *Macmillan*; 559 A.2d at 1261; *Revlon*, 506 A.2d at 173.

422 *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152-53 (Del. 1990) (criticizing *Interco* and *Pillsbury*, chancery court decisions that dismantled target's defensives under guise of *Unocal*, but with no opportunity for appellate review); Grand Metro., PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988); City Capital Assocs. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988); *see generally* Unitrim, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). A recent opportunity for supreme court review of a chancery court decision that invalidated a defensive measure under *Unocal* was lost when the supreme court invalidated a limited duration "no-hand" poison pill strictly on statutory grounds, thus avoiding the *Unocal* fiduciary inquiry. *See*, Mentor Graphics Corp. v. Quickturn Design Sys., Inc., 728 A.2d 25 (Del. Ch.), *aff'd on other grounds,* Quickturn Design Sys., Inc. v . Shapiro, 700 A.2d 1281 (Del. 1998).

423 *See, e.g.*, Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law after* QVC *and* Technicolor*: A Unified Standard (and the End of* Revlon *Duties?),* 49 BUS. LAW. 1593 (1994); Martin Lipton & Theodore N. Mirvis, *Enhanced Scrutiny and Corporate Performance: The New Frontier for Corporate Directors,* 20 DEL. J. CORP. L. 123, 125 (1995); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: The Impact of* QVC *and Its Progeny,* 32 HOUS. L. REV. 945 (1995).

424 *See, e.g.*, *Paramount*, 637 A.2d at 43 ("[T]he *Paramount–Viacom* transaction has economic consequences of considerable significance. Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium."); *id.* at 44 ("[C]onsiderations [pertinent to assessing competing offers] are important because the selection of one alternative may permanently foreclose other opportunities."); *id.* at 45 ("[A]n asset belonging to public stockholders (a control premium) is being sold and may never be available again."); *id.* at 47-48 ("There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each represents a fundamental [and perhaps irrevocable] change in the nature of the corporate enterprise from a practical standpoint."); *see also* Marcel Kahan, Paramount *or Paradox: The Delaware Supreme Court's Takeover Jurisprudence,* 19 J. CORP. L. 583, 595 (1994) ("What is important about the fact that 'control' remains in

under *Unocal* appears premised on at least two ameliorating principles: (1) the notion that a company's intrinsic value will remain for a future control premium opportunity;[425] and (2) the safety-valve mechanism that permits the stockholders to use the proxy machinery "to turn the board out."[426]

The reality and inevitability[427] of invasive judicial review of change of control transactions has important implications for the acquiror's contractual expectations ex ante. Participants in the market for corporate control are invariably sophisticated and counseled by leading financial and legal advisors. They bargain in this rarefied setting—which, in the change of control transaction, presents the purest form of "ownership issue"—on notice of the risk of judicial interference with their transaction based on broadly defined notions of reasonableness. This is especially so when the

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the hands of unaffiliated shareholders, 'in the market,' is that all these unaffiliated shareholders have virtually identical interests with respect to the company: to maximize the value the value of their shares."); Regan, *supra* note 411, at 904.

425 *See Unocal*, 493 A.2d at 956 n.11 (citing studies that demonstrated that the stock price of companies that successfully resisted hostile takeovers usually traded later "at higher market prices than the rejected offer, or were acquired after the tender offer was defeated by another company at a price higher than the offer price").

426 *Id.* at 959 ("If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."); *see also* Moran v. Household Intern, Inc., 500 A.2d 1346, 1354 (Del. 1958) (concluding that the Household "Rights Plan does not prevent stockholders from receiving tender offers" because, among other things, "[o]ne could also form a group . . . and solicit proxies for consents to remove the Board and redeem the Rights"). In view of the doctrinal significance of the proxy machinery in calibrating the takeover balance of power under Delaware law, it is not surprising that recent attempts by target directors to encroach upon this stockholder power—through such devices as "dead-hand" and limited duration "no-hand" poison pills—have failed. *See* Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998) (invalidating, on statutory grounds, limited duration "no-hand" poison pill that would have prevented newly elected board members from dismantling pill for six months following their election); Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998) (revised, July 27, 28, and Aug. 4, 1998) (denying motion to dismiss claims attacking, on statutory and fiduciary grounds, a "dead hand" poison pill that purported to deny indefinitely the power of any newly elected board to dismantle the pill).

427 As a practical mater, any proposed change of control transaction typically precipitates, sometimes within hours of its announcement, a flurry of class action lawsuits challenging the conduct of the target's board of directors on fiduciary and other grounds. Given these present-day realities, the acquiror of a publicly traded Delaware corporation must anticipate as inevitable that the transaction will be subjected to enhanced scrutiny. This is analogous to litigants bargaining for a settlement in the context of a stockholder class or derivative action. The litigants contract to resolve all claims in consideration of some benefit promised to the class or the corporation, but with the understanding that the settlement transaction is subject to the chancery court's approval as fair and reasonable. *See generally* DEL. CH. R. 23, 23.1; Prezant v. De Angelis, 636 A.2d 915 (Del. 1994); Nottingham Partners v. Dana, 564 A.2d 1089 (Del. 1989); Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989).

merger agreement, or related contract, with the target contains lock-ups, break-ups, no-shops, and/or other devices tending to impede the target's realization of the highest value reasonably attainable. Thus, a would-be acquiror who bargains aggressively for over-compensation of its otherwise legitimate transaction costs (both out-of-pocket transaction costs and opportunity costs) does so with the knowledge that unduly aggressive bargaining jeopardizes the overall transaction.[428] An acquiror's claim to disappointed contractual expectations in those circumstances must be measured against the recognition that its expectations upon entering the agreement were quite muted by the highly sensitive setting in which they were generated.

C. *Summary*

Contracting parties bargain in the corporate takeover setting with the awareness that substantive judicial review of their contracts is virtually inevitable. In particular, parties who bargain for a change of control involving a Delaware corporation do so with a substantially greater risk of judicial interference than is present in the anti-takeover context. Lock-ups and break-up fee commitments, if excessive, are especially vulnerable in this context because these devices, if abused, are precisely the means by which management-favored suitors improperly preempt an active auction. This purest form of ownership issue—whether the target board has acted reasonably to achieve the highest price for the stockholders in a change of control transaction—arises precisely in the context in which enhanced judicial scrutiny is most likely to yield preliminary injunctive relief preventing enforcement of a favored suitor's merger contract. As for the acquiring corporation's contractual expectation interest, a signed deal here translates into "all bets are off."

V. A CONTRACTUAL RESPONSE FOR THE ACQUIROR'S CONTRACTUAL CLAIM

With the acquiror's contractual claim properly understood, from the corporate perspective, as one arising in the extraordinary context of a change of control transaction, it is appropriate to

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[428] One positive incentive under that kind of regime is that an acquiror's ex ante incentives to bargain for concessions will be moderated. *See, e.g.*, Lipton & Mirvis, *supra* note 328, at 1 (advising moderation in use of lock-ups to protect transaction from judicial interference).

fashion a contractual model for reconciling the conflict between the acquiror and the target's stockholders. The acquiror understandably presses for the realization of its contractual expectations, including the value of any lock-up and/or break-up fee for which it has bargained in good faith. On the other hand, the target's stockholders insist on protection from their directors' breach of fiduciary responsibility. In a case where the target's directors have breached their fiduciary duties by committing the corporation contractually to a preclusive lock-up or similar device, the court is necessarily confronted with a choice between either: (1) adhering to contract law's first preference for enforcing bargains; or (2) subordinating this expectation realization principle in favor of protecting the fiduciary relationship between the target's stockholders and their board of directors. Courts in this arena have instinctively opted for the latter course, with either minimal or no accounting for the contractual consequences of their choice.[430]

This section sets forth this Article's recommendation, derived from experience in other contractual settings, for reconciling more meaningfully the contractual and fiduciary principles at stake in such cases.[431] Thereafter, this recommended analysis is applied to the facts of the *Paramount* decision,[432] both by way of illustration and to confirm the wisdom of the court's choice of elevating fiduciary precepts over contractual expectations in that case.[433]

A. *A Contractual Solution for the Acquiror–Target Stockholder Conflict*

This Article proposes a contractual analysis that largely validates the courts' traditional instinct for prioritizing fiduciary concerns ahead of contractual expectations in this significant context. This analysis is derived substantially from a distillation of essential principles that contract law employs, in a variety of settings, to resolve what in each instance reduces to the same tension confronting courts in the corporate takeover context: whether to protect expectations (by enforcing the bargain) or ensure some notion of essential fairness (by allowing an adversely affected party to avoid the contract). Drawing from general

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[430] *See supra* Part I.A.
[431] *See infra* Part V.A.
[432] *See* Paramount Communications Inc. v. QVC Network, 637 A.2d 34 (Del. 1994).
[433] *See infra* Part V.B.

contract law avoidance principles,[434] trust law's bona fide purchaser doctrine,[435] agency law's concept of apparent authority,[436] and contract law's public policy limitations on the enforceability of agreements,[437] this Article proposes that courts in the takeover context explicitly consider and apply four essential principles, summarized below, which inform the resolution of the expectations–fairness conflict in each of these diverse but analogous contexts.

In determining whether a corporate acquiror has protectable contractual interests under a merger or other agreement with a target corporation whose directors have breached their fiduciary duties in approving the change of control transaction, a court should consider the following: (1) whether the acquiror knew, or should have known, of the target board's breach of fiduciary duty; (2) whether the change of control transaction remains pending or is already consummated at the time that judicial intervention is sought; (3) whether the board's violation of fiduciary duty relates to policy concerns that are especially significant; and (4) whether the acquiror's reliance interest under the challenged agreement merits protection in the event a court were to declare the agreement unenforceable.

1. Knowledge and Notice

Whether an acquiror knew or should have known of a breach of fiduciary duty by the target corporation's board of directors in approving a change of control transaction is an independently critical variable which alone could justify refusing to enforce an agreement between the acquiror and target. In the admittedly rare instance in which the evidence shows that the acquiror subjectively knew and took advantage of the target board's breach of fiduciary duty, there should obviously be no contractual protection afforded to the acquiror. Indeed, such knowing participation by the acquiror could lead to a valid claim for damages by the target stockholders against the acquiror for aiding and abetting a breach of fiduciary duty.[438]

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[434] *See supra* Part II.B.
[435] *See supra* Part III.A.
[436] *See supra* Part III.B.
[437] *See supra* Part III.C.
[438] *See, e.g.*, Nebenzahl v. Miller, Civ.A. 13206, 1996 WL 494913, at *7 (Del. Ch. July 2, 1996) (corrected Aug. 29, 1996) ("A court can infer a non-fiduciary's knowing participation only if a fiduciary breaches its duty in an inherently wrongful manner, and the plaintiff alleges specific facts from which that court could reasonably infer knowledge

Corporate law's appropriately high threshold for aiding and abetting liability—that an acquiror knowingly participated in a board's breach of fiduciary duty—may have obscured a more pervasive and less exacting contract law standard for denying enforcement of agreements that are the product of a board's failure of fiduciary responsibility. Whether to impose liability on a corporate outsider for aiding and abetting presents a dramatically different question from the simple enforceability of a contract. In this latter instance, contract law relies not just on whether the party seeking enforcement actually knew of some bargaining distortion affecting its contracting counterpart, but on whether the first party, though subjectively unaware, had "reason to know" or "should have known" of such distortions.[439]

Whether measured from the perspective of trust law's constructive notice test[440]—the "knows or should know" limitation of agency law's apparent authority doctrine[441]—or general public policy concern for whether someone's expectations were "justified,"[442] the law abounds with instances in which the contractual expectations of a subjectively innocent party will nevertheless be frustrated for the sake of some overriding fairness concern. In effect, there is a lurking fault principle in contract law that justifies disappointing the expectations of a party who may not have known, but should have known, that its contracting counterpart bargained defectively. In undertaking the inquiry into what the party seeking enforcement should have known, the law appropriately considers, if applicable, the superior intelligence and sophistication of that party.[443]

Translated to the corporate setting, these principles suggest

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of the breach."); Wells Fargo & Co. v. First Interstate Bancorp., Civ. Nos. 14696, 14623, 1996 WL 32169, at *11 (Del. Ch. Jan. 18, 1996) (claiming that aiding and abetting a board's breach of fiduciary duty requires showing that third party knew target board's "actions or failure to act were a breach of fiduciary duty, and knowing that, cooperated in the course of action by which the . . . board sought to accomplish" an improper result); Weinberger v. Rio Grand Indus., Inc., 519 A.2d 116, 131 (Del. Ch. 1986) (stating that a claim for aiding and abetting a breach of fiduciary duty requires proof of "(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty and (3) a knowing participation in that breach by the defendants who are not fiduciaries"); Gilbert v. El Paso Co., 490 A.2d 1050, 1057 (Del. Ch. 1984), *aff'd*, 575 A.2d 1131 (Del. 1990) ("It is well settled that a third party who knowingly participates in the breach of a fiduciary's duty becomes liable to the beneficiaries of the trust relationship.").

[439] *See supra* Parts II.B.5, III.

[440] *See supra* Part III.A.2.a.

[441] *See supra* Part III.B.2-3.

[442] *See supra* note 369 and accompanying text.

[443] *See supra* note 229 and accompanying text.

that it is entirely appropriate to deny enforcement of a merger agreement containing preclusive lock-ups or unreasonable break-up fees solely on the grounds that the acquiror should have known that the target board had violated its fiduciary responsibilities in granting such concessions. The acquiror's sophistication as a well-financed and competently advised transaction participant should contribute to the analysis of what the acquiror should have known in this regard. Given the extraordinary attention and judicial intervention that lock-ups and break-up fees have received,[444] it is fair to assume that an acquiror's advisors are cognizant of the boundaries of legitimacy, however loosely defined, for such provisions.[445] For cases in which the acquiror neither knew nor should have known of the target board's breach of fiduciary duty, there remains the independently dispositive question of timing.

2. Timing and the Question of Transactional Justification

Whether or not the performances contemplated by a contract have been exchanged is also an independently critical and dispositive consideration when a claim for contract avoidance or non-enforcement is presented. So long as the contract remains wholly executory, and a proper case for avoidance is presented, it is of no moment that the party seeking enforcement of the contract acted in good faith and neither knew nor should have known of some bargaining failure or distortion affecting its contracting counterpart. In such circumstances, the court should frustrate the nascent expectations of a wholly innocent party for the sake of ensuring fundamentally undistorted bargaining.

This judicial tendency to afford relief from executory agreements, notwithstanding the good faith of the party seeking enforcement, can be seen in contract cases involving wrongful conduct (i.e., misrepresentation, duress, or undue influence) by one who is not a party to the contract. A court will grant the avoidance remedy to the contracting party who is the victim of

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[444] *See supra* Part I.A; *see also supra* Part IV.B. (discussing heightened judicial scrutiny, and accompanying risk of non-consummation, for change of control transactions).

[445] To borrow a phrase coined by Chancellor Allen in another context, an acquiror should be deemed on notice of the target board's breach of fiduciary duty with regard to preclusive lock-ups and the like when the acquiror presses for and obtains such concessions from the target under circumstances suggesting, in light of existing precedent, that the parties are "in the vicinity" of illegitimacy. *See* Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp., Civ. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) (stating that directors begin to owe fiduciary duties to creditors of corporation when company is in "vicinity of insolvency").

such misconduct, but only if the other party to the transaction has not yet given value or relied materially on the transaction.[446] The timing principle of trust law's bona fide purchaser rule affords even greater protection to beneficiaries adversely affected by a trustee's agreement constituting a breach of trust, no doubt because of the strong policy favoring protection of the fiduciary relationship between trustees and beneficiaries. Thus, if the transfer of trust property contemplated by a third party's agreement with the trustee has not been accomplished, the purchaser—though innocently unaware of any breach of trust—loses the status of bona fide purchaser if before transfer of the trust property: (1) the purchaser acquires constructive notice of the breach of trust; or (2) the court has the opportunity to intervene.[447] In this latter instance, a court will not enforce the transaction because, as a policy matter, "[a] court of equity will not compel a trustee to commit or complete the commission of a breach of trust."[448]

The above principles have powerful significance for the acquiror–target stockholder conflict. If the target stockholders demonstrate that a proposed, but not yet consummated, change of control transaction is the product of a breach of fiduciary duty by their directors, a court is on eminently solid ground in refusing to allow the transaction to proceed. In such cases, the question is solely one of "transactional justification"—whether the business judgment rule is available to protect the board's decision to approve the transaction.[449] The procedural posture for a

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[446] *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 164(2), 175(2), 177(2) (1979); *see also supra* notes 233-37 and accompanying text.

[447] *See supra* notes 283-89 and accompanying text.

[448] RESTATEMENT (SECOND) OF TRUSTS § 310 cmt. a (1959); *see also supra* note 285 and accompanying text.

[449] *See supra* note 25 and accompanying text. Whether the directors are liable personally for breaching their fiduciary duties typically is not presented in this context. In the context of a change of control transaction, adjudicating the fiduciary duty question at the preliminary injunction stage is sound as a policy matter. Once control is transferred, any opportunity for a value-maximizing auction or its equivalent is lost. It is far better for the court to intervene in "real time" when the stakes are irretrievably high and the fading opportunity for awarding meaningful relief still can be grasped. Moreover, from the perspective of the target's directors, it is both frustrating and embarrassing to see a transaction that has publicly been endorsed judicially declared a violation of fiduciary responsibility and therefore enjoined. Yet the consequences of post-transaction judicial review can be far more severe. For example, it can be said, with the unrealistic aid of hindsight, that perhaps two of the most improvidently refused injunctions in all of corporate governance occurred in the *Getty Oil* and *Trans Union* cases. *Compare* Pennzoil Co. v. Getty Oil Co., Civ. No. 7425, 1984 WL 19832, at *7 (Del. Ch. Dec. 18, 1984) (finding probable contract among *Pennzoil*, *Getty Oil*, and others to acquire control

transactional justification question is typically a target stockholder's motion for a preliminary injunction preventing the board from completing the transaction.[450] If the target stockholders demonstrate a breach of fiduciary duty by the target board at this stage, before control is transferred to the acquiror, it is of no moment that the acquiror previously was without knowledge, or reason to know, of the target board's failure of fiduciary responsibility. Analogous to the frustrated purchaser of trust property, the corporate acquiror in such a case loses the status of a protected purchaser, and the court of equity's overriding policy of refusing to assist in the completion of a breach of fiduciary duty properly takes precedence.

Conversely, when a completed merger transaction is challenged as a breach of the target board's fiduciary duties, the policy favoring the securing of transactions takes priority and the court, analogizing to the doctrine of apparent authority, will not set the transaction aside.[451] The target stockholders are limited in that instance to a claim against the directors personally, if permitted by the certificate of incorporation.[452]

3. A Critical Question of Fiduciary Responsibility: the "Ownership" Issue

To frustrate a party's contractual expectations for the sake of some competing policy concern is to counteract contract law's first priority of enforcing bargains to protect the expectations they generate.[453] Consequently, the policy in competition with the prevailing enforcement impulse must have fundamental significance to warrant displacement of the usual order of priority.

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of Getty Oil, but refusing Pennzoil's motion for preliminary injunction to prevent sale of Getty Oil to Texaco in arguable breach of Pennzoil agreement), *with* Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. Ct. App. 1987), *cert denied*, 485 U.S. 994 (1988) (affirming judgment awarding Pennzoil $10.3 billion in damages against Texaco for tortious interference with original Pennzoil agreement); *compare* Smith v. Van Gorkom, No. Civ. A. 6342, 1985 WL 22040, at *3 (Del. Ch. Oct. 11, 1985) (approving class action settlement and noting earlier denial of Trans Union stockholders' motion for a preliminary injunction merger transaction), *with* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding target directors personally liable to class of target stockholders for breach of duty of care).

[450] *See Pennzoil*, 1984 WL 19832 at *7. A hostile acquiror, by virtue of its modest stock ownership in the target, also has standing to press the claim that the target directors have breached their fiduciary duties. *See, e.g.*, City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 800 (Del. Ch. 1988).

[451] *See supra* Part III.B.3.

[452] *See supra* notes 347-48 and accompanying text.

[453] *See supra* Part II.A.

General contract avoidance principles are grounded in concerns for ensuring undistorted bargaining and protecting minors and cognitively impaired persons from improvident bargains.[454] In contracts negotiated by representatives, such as trustees or agents, the primary concern is for protection of the trust beneficiaries or principal from the consequences of a breach of fiduciary responsibility.[455] Indeed, the concern with the consequences of a breach of fiduciary duty is especially compelling, and will justify refusing to enforce an agreement tending to induce such a breach as against public policy.[456]

In the corporate governance context, a similar regard for the integrity of the fiduciary relationship between directors and stockholders prevails.[457] In the extraordinary context of a "bet the company" board decision to sell control—arguably the purest and most vigilantly reviewed form of "ownership" issue possible—the concern for this fiduciary relationship finds perhaps its greatest intensity.[458] A target board's decision to grant a preclusive lock-up or unreasonable break-up fee to a favored acquiror irreparably harms the stockholders at the most profound juncture in the director–stockholder relationship—the sale of the company. Absent judicial intervention in such circumstances, market forces (in the form of a viable auction or its equivalent) are artificially and irretrievably prevented from contributing to the maximization of the stockholders' wealth.[459] In contract law terms, a board's violation of fiduciary duty in this context presents a compelling case for displacing the usual priority of protecting contractual expectations.

4. The Acquiror's Reliance Interest

a. *Reliance damages as a mitigating device*

If a court applying the foregoing criteria determines that judicial intervention preventing enforcement of a preclusive lock-up or similar device is warranted (based on contractual and corporate governance concerns), the court may consider whether it is appropriate to award some measure of reliance damages to the

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[454] *See supra* Part II.B.1.
[455] *See supra* Part III.A-B.
[456] *See supra* Part III.C.
[457] *See supra* Part IV.B.
[458] *See supra* notes 418-28 and accompanying text.
[459] *See supra* note 424 and accompanying text.

disappointed acquiror. Courts in the takeover context typically have not undertaken such an inquiry.[460] Nevertheless, there may be sound policy reasons to consider such an award, at least in cases where the acquiror neither knew nor should have known of the target board's breach of fiduciary duty.

Contract law permits the discretionary award of reliance damages to an innocent party whose contractual expectations are disappointed by the remedy of avoidance based on mistake, impracticability, or frustration.[461] The lurking fault principle underlying the potential award of reliance damages in this context is that the other party to the contract, to whom such damages may be awarded, must be wholly innocent (i.e., was without knowledge or constructive notice) regarding the circumstances giving rise to the avoidance decree.[462] Trust law protects the bona fide purchaser's reliance interest only to the extent of enforcing agreements that satisfy the doctrine's numerous requirements (including the completed transfer of trust property).[463] Otherwise, there does not appear to be any trust law authority for awarding reliance damages to an arguably innocent purchaser whose expectations fail because it gains notice of a breach of trust before transfer of the trust property is possible.

Corporate law appears to follow trust law's approach in this regard. To the extent that there is protection of the acquiror's reliance interest, that protection is afforded only for completed transactions. Analogizing to the agency law concept of apparent authority, and presumably in furtherance of the policy favoring the security of transactions, the courts will not disturb a completed merger transaction—notwithstanding a breach of fiduciary duty by the target board—if the express statutory prerequisites were satisfied.[464] Otherwise, courts to date have not explicitly awarded reliance damages to an arguably innocent potential acquiror when preventing consummation of a change of control transaction because of a breach of fiduciary duty by the target's board. There is at least one intriguing corporate law analogy running contrary to this trend: the doctrine of ultra vires.[465]

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[460] *See supra* Part I.A.

[461] *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 158(2), 272(2) (1979); *see also supra* notes 247-57 and accompanying text.

[462] *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 158(2), 272(2) (1979).

[463] *See supra* note 289 and accompanying text.

[464] *See supra* Part III.B.

[465] Ultra vires refers to "[a]cts beyond the scope of the powers of a corporation, as defined by its charter or laws of state of incorporation." BLACK'S LAW DICTIONARY 1365 (5th

b. *Reliance damages and the doctrine of ultra vires*

In the earlier part of the twentieth century, when modern corporation codes were in their infancy, the law emphasized limitations on corporate powers as the principal means of protecting stockholders against managerial opportunism.[466] Under the doctrine of ultra vires, a corporation could successfully avoid an otherwise binding contract on the grounds that it was without power to enter into such an undertaking, pointing to constraints on business activity set forth in its own articles of incorporation.[467] Frustration with the unfairness often caused by the doctrine's application led to its virtual elimination by statutory pronouncement.[468] A board may no longer point to its corporation's own charter to escape an otherwise lawful contractual obligation.[469] Interestingly, however, under the remaining vestiges of the doctrine, today a stockholder may bring

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ed. 1979).

[466] *See* John H. Langbein, *The Contractarian Basis of the Law of Trusts,* 105 YALE L.J. 625, 641 n.75:

> Corporation law experienced a comparable movement from the restricted corporate powers that produced the old case law about *ultra vires* acts, to the modern statutes that grant 'corporations legal powers . . . to engage in any lawful line or lines of business.' As in trusts, so in corporations, expanded fiduciary law was the alternate safeguard that replaced restrictions on powers.

Id. (quoting ROBERT C. CLARK, CORPORATE LAW § 16.1, at 676 (1986)).

Over time, the equitable constraints of fiduciary duty as developed by decisional law came to replace the earlier emphasis on corporate powers as the primary mechanism for ensuring the integrity of the director-stockholder relationship. *See* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 453 (1998) (discussing "evolution in the conception of corporate directors from one of agents, exercising delegated power always subject to control [by] the delegating shareholders, to one of managers not subject to stockholder control except through annual elections") (quoting Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 252 (1991)).

[467] An early concern for potential unfairness to third parties that might result from an unfettered application of the doctrine of ultra vires led to some judicially imposed limitations. Foremost among these early attempts at protecting third parties was the notion that "completed transactions would not be disturbed." ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 214 (6th ed. 1998). Consequently, the doctrine remained applicable as a means of invalidating executory agreements. *See id.* This early notion that courts would not disturb an unauthorized but completed transaction strongly parallels the courts' modern reliance on apparent authority principles to leave undisturbed a completed merger transaction that meets all statutory prerequisites, but which is the product of a board's breach of its judicially imposed fiduciary duties. *See supra* notes 339-56 and accompanying text.

[468] *See* DEL. CODE ANN. tit. 8, § 124 (1998); REVISED MODEL BUS. CORP. ACT § 3.04 (1984).

[469] *See* DEL. CODE ANN. tit. 8, § 124 (1998).

an action to enjoin an unauthorized act (assuming the charter limits the firm's business activities) and the court, if it decides to enjoin the proposed transaction, may award reliance (but not expectation) damages to the third party whose expectations will be frustrated by the awarding of injunctive relief.[470] This potential award of reliance damages appears to represent a compromise between protecting the corporation's stockholders (by preventing the corporation from engaging in unauthorized business activity) and protecting innocent third parties who bargain in good faith with the corporation, only to have their expectations disappointed.

It may be useful to consider the ultra vires compromise in the context of a preclusive lock-up agreement. Granting the target stockholders injunctive relief precluding enforcement of a preclusive lock-up legitimately disappoints the third party acquiror's expectations, given the strong fiduciary policies at stake. Nevertheless, granting such relief on an "all or nothing" basis fails to account for the potential acquiror's reliance interest in pursuing the transaction (both out-of-pocket expenses and opportunity costs).

One possibility—at least in a case in which the acquiror neither knew nor should have known of the target board's breach of fiduciary duty upon entering into the agreement (an admittedly rare occurrence when the breach pertains to a preclusive lock-up)—would be to award modest reliance damages to the disappointed acquiror when refusing to enforce the lock-up. In theory, the potential availability of reliance damages in such circumstances might preserve the economic incentive for a party to make a bid, and thereby benefit stockholders.[471] Conversely, such

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[470] Section 124(1) of the DGCL provides the following:

> If the unauthorized acts or transfer sought to be enjoined are being, or are to be, performed or made pursuant to any contract to which the corporation is a party, *the court may . . . if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow . . . the other parties to the contract . . . such compensation as may be equitable for the loss or damage sustained* by any of them which may result from the action of the court in setting aside and enjoining the performance of such contract, *but anticipated profits derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.*

DEL. CODE ANN. tit. 8, § 124(1) (1998) (emphasis added). Section 3.04(c) of the MODEL ACT is similar: "In a shareholder proceeding . . . to enjoin an unauthorized corporate act, the court may enjoin or set aside the act, if equitable . . . and may award damages for loss [other than anticipated profits] suffered by the corporation or the other party because of enjoining the unauthorized act."

REVISED MODEL BUS. CORP. ACT § 3.04(c) (1984).

[471] *See* Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 178, 183 (Del. 1986)

a regime might perversely encourage bidders to overreach with regard to lock-ups or termination fees, on the assumption that a court will effectively write a more reasonable term into the contract if an injunction is issued. This undesirable incentive could be eliminated, however, by insisting on contract law's "wholly innocent" standard for granting reliance damages incident to the avoidance of agreements based on mistake, impracticability, or frustration.[472] An acquiror that bargains aggressively for an unreasonable lock-up or termination fee risks jeopardizing any opportunity for a discretionary award of reliance damages, because it would have "reason to know" of the target board's breach.[473] Only those bidders who were without reason to know of the breach should qualify for a discretionary award of reliance damages.

B. Paramount *Revisited*

Based on the analysis developed in this Article, *Paramount*[474] presented perhaps the most compelling case—short of a case involving aiding and abetting a breach of fiduciary duty—for disappointing the expectations of a third party acquiror by refusing to enforce a preclusive lock-up option. Paramount agreed to be acquired by Viacom through a merger transaction. Despite knowing about the interest of a rival suitor, QVC Network, in acquiring Paramount, the Paramount board of directors effectively destroyed any auction opportunity by: (1) granting Viacom a preclusive lock-up stock option (worth approximately $500 million to Viacom); (2) committing to pay Viacom an additional $100 million in termination fees (if the transaction were not consummated); and (3) granting Viacom a no-shop exclusive that unreasonably constrained Paramount's ability to negotiate with QVC.[475] Every aspect of the analytical model proposed in this Article confirms the soundness of the court's decision to refuse

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(identifying as beneficial to target stockholders "those lock-ups which draw bidders into the battle").

[472] *See supra* text accompanying note 461.

[473] *See* Lipton & Mirvis, *supra* note 328, at 123.

[474] 637 A.2d 34 (Del. 1994).

[475] *See id.* at 39-40. The combined $600 million value of the lock-up and termination fee represented nearly 7% of the proposed transaction's original $8.7 billion value, an astonishingly high percentage. *See* QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245, 1261 (Del. Ch. 1993) ("The lockups would also have a dilutive effect by diverting to Viacom $600 million that would otherwise flow to Paramount's shareholders.").

enforcement of the preclusive lock-up and no-shop in that case.

First, with respect to whether acquiror Viacom—a sophisticated party with expert advisors—had notice or reason to know of the Paramount board's breach of fiduciary duty, it is noteworthy that the court of chancery specifically referred to the "foreseeably" injurious effects of the uncapped lock-up option in granting injunctive relief.[476] Although the court relied on these foreseeably injurious effects in concluding that the Paramount directors breached their fiduciary duties, the same information was known to Viacom. Indeed, the Delaware Supreme Court appropriately emphasized Viacom's sophistication and knowledge with regard to the preclusive lock-up as a sound basis for refusing to enforce the agreement.[477] This evidence supports the conclusion that Viacom, though subjectively unaware, was "on notice" of the Paramount board's breach of fiduciary duty. On this basis alone, injunctive relief was warranted.

Second, even assuming Viacom was without notice of the breach of fiduciary duty by the Paramount board, Viacom's contractual expectations were properly disappointed because of the timing of the court's intervention. Analogizing to trust law, Viacom, even if wholly innocent upon entering the various agreements with Paramount, lost the protected status of bona fide purchaser because it acquired notice of the Paramount directors' breach before transfer of the property of the "beneficiaries."[478] Specifically, Viacom acquired such notice through the court's intervention—in the context of a motion for preliminary injunction presented before consummation of the acquisition—in what was purely a question of transactional justification.

Third, balanced against Viacom's interest in enforcement of the contract was the especially strong public policy concern for the integrity of the fiduciary relationship. In the context of a board decision to approve a change of control transaction, judicial regard for the importance of the director-stockholder fiduciary relationship is particularly intense. Viacom bargained with notice of the special risks attending heightened judicial scrutiny of such transactions and, given the auction-impeding concessions it

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[476] *See supra* note 232 and accompanying text.

[477] *See Paramount*, 637 A.2d at 51 ("Viacom, a sophisticated party with experienced legal and financial advisors, knew of [and in fact demanded] the unreasonable features of the Stock Option Agreement.").

[478] *See supra* note 286 and accompanying text.

successfully demanded of Paramount,[479] could not meaningfully claim that its contractual expectations were "justified" under the circumstances.[480]

Fourth, although the *Paramount* court did not consider the possibility of awarding Viacom reliance damages (in mitigation of its lost expectations under the enjoined lock-up), it is intriguing that the court of chancery declined to enjoin the $100 million termination-fee provision. The court of chancery concluded that this fee, representing about 1.2% of the value of the original Viacom–Paramount merger, "reasonably reflect[ed] the actual expenses Viacom estimated it would incur in making and defending its bid."[481] On the other hand, to refuse any award of reliance damages to Viacom (either as a discretionary matter or under the express terms of the contract's termination-fee clause) would certainly have been defensible, both under contract law's lurking fault principle[482] and under Delaware's corporate law precedent.[483]

CONCLUSION

In the extraordinary market for corporate control, contracting parties spend enormous resources bargaining for acquisitions. From the perspective of the potential acquiror, these transaction costs include substantial out-of-pocket expenses, as well as opportunity costs (including the cost of foregoing other transactions and the cost of dedicating senior management resources exclusively or substantially to acquisition, as opposed to operational, strategies). Moreover, these costs are incurred by the acquiror with the significant risk that the proposed acquisition will

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[479] In this regard, the ill-advised remarks of Viacom's Sumner Redstone upon announcement of the transaction arguably reflected a damning awareness of the preclusive and auction-impeding effects of the concessions Viacom had procured for itself. *See Paramount*, 637 A.2d at 39 (quoting Redstone's public statements that: (1) proposed merger with Paramount was a "'marriage' that would 'never be torn asunder;'" and (2) "only a 'nuclear attack' could break the deal.").

[480] *See* RESTATEMENT (SECOND) OF CONTRACTS § 178(2)(a) (1979).

[481] *QVC Network*, 635 A.2d at 1271; *see also id.* ("[T]he $100 million amount represents a fair liquidated amount to cover Viacom's expenses should the Paramount–Viacom merger not be consummated.").

[482] *See supra* notes 247-60 and accompanying text. A refusal to award Viacom any reliance recovery thus would be premised on the very supportable conclusion that Viacom had reason to know or was otherwise on notice of the Paramount board's breach of fiduciary duty.

[483] *See, e.g.*, *Paramount*, 637 A.2d at 34; Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989); Revlon, Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986).

not be consummated, in which event any hoped-for transaction gains will be unavailable to offset the costs. Consequently, an acquiror will insist on provisional compensation for its transaction costs, through stock or asset lock-up options and/or termination fees that only become exercisable or payable if the acquisition proposal should fail (if, for example, the target's stockholders vote against the transaction or a higher bidder emerges).

The dilemma for corporate law is to regulate, from a fiduciary perspective, the decision of a target board to commit the company contractually to provisional compensation of the potential acquiror's transaction costs. Delaware decisional law presumes that an auction model for implementing change of control transactions best maximizes shareholder wealth.[484] Thus, all target-promised lock-ups, termination fees, and other devices that draw bidders into the auction (by ensuring compensation for a potential acquiror's transaction costs in the event its bid is unsuccessful) are seen as beneficial to target stockholders, and thus considered a prudent exercise of fiduciary duty by the target's board.[485] Conversely, those lock-ups and break-up fees which effectively overcompensate the potential acquiror (i.e., preclusive lock-ups) can be destructive of the auction process by discouraging other bidders from participating, and thus are seen as violative of the target board's fiduciary responsibilities.[486]

In order to preserve the opportunity for a value-maximizing auction, the courts have not hesitated, on fiduciary duty grounds, to grant injunctive relief preventing enforcement of any preclusive lock-ups or other auction-impeding contractual concessions granted by the target to the acquiror.[487] The courts in such instances are understandably animated by a preeminent concern for ensuring the integrity of the fiduciary relationship between the target directors and their stockholders. This judicial emphasis upon the director–stockholder fiduciary relationship—particularly in this extraordinary context of a change of control transaction (perhaps the purest form of "ownership" issue)[488]—is instinctively correct, and yet ultimately unsatisfactory because of the courts'

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[484] *See, e.g.*, *Paramount*, 637 A.2d at 34; Barkan v. Amsted Indus., 567 A.2d 1279 (Del. 1989); *Macmillan*, 559 A.2d at 1261; *Revlon*, 506 A.2d at 173.

[485] *See, e.g.*, *Paramoun*, 637 A.2d at 49-50; *Macmillan*, 559 A.2d at 1284; *Revlon*, 506 A.2d at 183.

[486] *See, e.g.*, *Paramount*, 637 A.2d at 49-50; *Macmillan*, 559 A.2d at 1284; *Revlon*, 506 A.2d at 183.

[487] *See supra* Part I.A.

[488] *See supra* notes 389-90 and accompanying text; *see also supra* Part IV.B.

virtual disregard of the contractual interests of the disappointed (and arguably innocent) acquiror. The development of a more meaningful explanation of the appropriate priority of the fiduciary relationship over the acquiror's contractual relationship in this context is aided by an examination of the principles by which contract law accommodates the tension between protecting contractual expectations and ensuring integrity in the bargaining process.

Contract law promotes economic activity by enforcing the justified expectations that arise from the business of promise-making. On the faith of securing judicially enforceable promises, goods and services are exchanged, assets are moved to higher and better uses, and the welfare of society is enhanced. Freedom of contract, premised on the autonomous choices of presumptively rational participants, thus promotes and protects the gains realizable from private ordering, so that individual participants in the contracting process, and society at large, are benefited.

Contract law's enduring first priority of protecting the expectations of the parties to a bargain will only be displaced reluctantly, when the prevailing foundational assumption—that rational autonomous choices were made—is shown in a particular case to be unfounded. Fundamental distortions that affect one of the parties to a contract thus may justify disappointing the expectations of its contracting counterpart, even when that other party is wholly innocent of any bargaining misbehavior or opportunism. The criteria employed by contract law in any number of contexts to balance the competing concerns of protecting expectations, while insisting on some minimal level of bargaining integrity, are instructive for corporation law.

General contract law avoidance doctrine responds to the concern that some fundamental distortion has substantially impaired one of the contracting parties' bargaining effectiveness. In such instances, overriding concerns for essential fairness justify displacing the usual priority of protecting expectations. Whether such distortions arise from the adversely affected party's status (immaturity or mental infirmity), bargaining misbehavior (such as fraud, misrepresentation, or duress), or flawed fundamental assumptions underlying the bargain (mistake, frustration, or impracticability), the criteria by which contract law accommodates the competing goals of protecting expectations and ensuring

essential fairness are remarkably consistent.[489] In each of these diverse contexts, a judicial determination of whether to elevate the policy of securing transactions (by enforcing the agreement) or that of ensuring basic fairness (by granting the remedy of avoidance) turns on four basic principles: (1) whether the party seeking enforcement knew or had reason to know of the distortions adversely affecting their contracting counterpart; (2) whether the disputed agreement is executory; (3) whether the particular fairness challenge underlying the claim for avoidance arises out of an especially strong policy concern (such as protecting minors and mentally impaired persons from their own improvidence); and (4) whether reliance damages are appropriate for the wholly innocent party whose contractual expectations will be disappointed if the remedy of avoidance should be granted.

These same principles are seen at work in cases involving contracts that are more closely analogous to the acquiror–target corporation contract—namely, contracts negotiated between a third party and a representative (such as a trustee or agent) and contracts that are vulnerable to non-enforcement because of some countervailing public policy concern. Trust law's bona fide purchaser doctrine affords some measure of transaction protection for parties who purchase trust property in good faith and without notice of a trustee's breach of trust. Nevertheless, the strength of the competing policy concern for protecting the integrity of the trustee–beneficiary relationship is seen in the bona fide purchaser doctrine's many rigorous requirements, as failure to satisfy any one of these requirements results in the avoidance of the transaction for the protection of trust beneficiaries.

The various criteria by which trust law balances the concerns for transaction security and protecting beneficiaries from a breach of trust closely parallel the core principles (summarized above) in a variety of contract avoidance settings. For example, a third party who is subjectively unaware of a trustee's breach of trust cannot qualify as a bona fide purchaser if that third party was simply on notice of the breach of trust. Moreover, even a purchaser who enters into a contract with a trustee while neither aware nor on notice of the trustee's breach loses the status of bona fide purchaser if it acquires such notice before transfer of the trust

[489] In this context, one might regard the doctrine of unconscionability as a judicial safety valve allowing avoidance of egregiously one-sided bargains in a context in which the severely imbalanced exchange itself evidences otherwise unseen but suspected bargaining misbehavior. *See supra* Part II.B.3.

property. Indeed, a court of equity will refuse to enforce such a contract, if it remains executory, because the court will not assist in the completion of a breach of trust.[490]

Agency law's apparent authority doctrine similarly protects the expectations of a third party who bargains with an agent on behalf of a principal—even in cases where the agent exceeds the authority granted by the principal—provided that the third party reasonably believed the agent had authority for the transaction.[491] The transaction protection afforded to third parties is lost, despite the subjective good faith beliefs of the third party as to the agent's authority, if those genuinely held beliefs were nevertheless unreasonable. For apparent authority purposes, as in other areas of contract law avoidance doctrine, the reasonableness of a third party's beliefs are measured by the familiar inquiry into what the third party "knows or should know."[492]

Finally, contract law's public policy limitation on the enforceability of contacts turns importantly on, among other things, a balancing of the "justified expectations" of the party seeking enforcement and the strength of the countervailing policy involved.[493] These countervailing policy considerations include, in particular, an especially strong contract law presumption against enforcing agreements that "tend[] to induce" a fiduciary to violate his or her fiduciary duties.[494]

This Article proposes that courts employ contract law's core principles for resolving the expectations–fairness conflict raised by the acquiror's claim for contractual protection in the corporate setting. In a typical case, this analysis will be triggered by the court's determination that the target directors breached their fiduciary duties by promising a preclusive lock-up or unreasonable break-up fee to the potential acquiror. The question in such a case is whether, in spite of target board's breach of fiduciary duty, the apparently innocent acquiror nevertheless deserves contractual protection.

Mindful of the special risks attending change of control transactions (including enhanced judicial scrutiny and the particularly strong policy concern for the director–stockholder fiduciary relationship in this extraordinary "ownership" decision

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[490] *See supra* note 285 and accompanying text.
[491] *See supra* Part III.B.3.
[492] *See supra* note 335 and accompanying text.
[493] *See supra* Part III.C.1.
[494] *See supra* Part III.C.2.

context), this Article recommends that a court in such a case should consider the following criteria: (1) whether the acquiror knew, or should have known, of the target board's breach of fiduciary duty; (2) whether the change of control transaction remains pending or is already consummated at the time that judicial intervention is sought; (3) whether the board's violation of fiduciary duty relates to policy concerns that are especially significant; and (4) whether the acquiror's reliance interest under the challenged agreement merits protection in the event the court were to declare the agreement unenforceable.

Applied to a case like *Paramount*, in which the corporate-contractual issue arises amidst an ongoing battle for corporate control,[495] these four factors suggest a strong contractual justification for refusing to enforce a preclusive lock-up or similar device, irrespective of the disappointed acquiror's subjective good faith. First, the pertinent contractual inquiry is not the guilty knowledge requirement of corporation law's aiding and abetting liability theory,[496] but whether the acquiror should have known of the target board's breach of fiduciary duty. Given the sophistication (i.e., "superior intelligence")[497] of corporate acquirors and their professional advisors, there is a strong case for non-enforcement on the basis that an acquiror, like Viacom, should have known that it had demanded unusual concessions which, in light of established precedent, bordered on illegitimacy.

Second, irrespective of whether the acquiror should have known of the target board's breach of duty upon entering into the contract, any possibility of protected status as a "bona fide purchaser" is lost when such knowledge is obtained before transfer of corporate property. This was the case in *Paramount*, where the court found a breach of fiduciary duty by the target board in the context of a preliminary injunction motion that was decided before any change of control of Paramount could be consummated.[498]

Third, in preclusive lock-up cases, the protection of contractual expectations competes with a particularly strong policy concern of both contract and corporation law—the integrity of the

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[495] *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994). When the corporate-contractual issue arises in mid-auction, as in *Paramount*, a question of "transactional justification" is presented, and thus the only corporate law fiduciary inquiry is whether the business judgment rule protects the unconsummated merger agreement from judicial interference. *See supra* note 25 and accompanying text.

[496] *See supra* note 438 and accompanying text.

[497] *See supra* notes 229-32 and accompanying text.

[498] *See Paramount*, 637 A.2d 34; *see also supra* note 495 and accompanying text.

fiduciary relationship between directors and stockholders. Moreover, these cases involve one of the most profound aspects of this fiduciary relationship—the extraordinary "ownership" decision to undergo a change of control transaction. A preclusive lock-up agreement that induces a violation of the target board's fiduciary duties in the context of a change of control transaction thus presents one of the more compelling cases for non-enforcement, as a matter of both contract and corporate law.

Fourth, a court that refuses to enforce a preclusive lock-up or similar agreement, by application of corporate fiduciary precepts and the foregoing contract law principles, may nevertheless wish to consider whether to award some measure of reliance damages to the disappointed acquiror. Given the lurking fault principle underlying the discretionary award of reliance damages to innocent parties in other contract avoidance contexts,[499] a court should only undertake such an inquiry in the corporate setting when the acquiror was wholly innocent upon entering into agreement (i.e., the acquiror neither knew nor should have known of the target board's breach of fiduciary duty). The award of reliance damages to the wholly innocent acquiror will mitigate the frustration of that acquiror's contractual expectations and create ex ante incentives for other good faith potential acquirors to incur the substantial costs required to propose a value-maximizing change of control transaction.

In the end, contract law's countervailing concerns against enforcing agreements in a variety of contexts tend to align neatly with, not contradict, the emphasis that corporate law places on the integrity of the director–stockholder fiduciary relationship. Hopefully, the analysis proposed here will assist the courts in resolving future disputes in which an apparently innocent acquiror asserts that its contractual expectations warrant protection in spite of the target board's breach of fiduciary duty.

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[499] *See supra* notes 247-60 and accompanying text.