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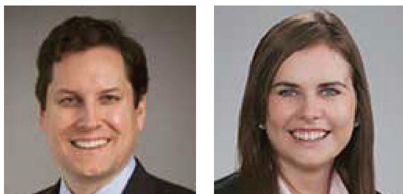
How Would Delaware Courts Treat Fiduciary-Out Provisions?



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An agreement to effect a merger in which the target is a public company usually requires the target's board of directors to recommend that stockholders vote in favor of the merger. Exceptions to this recommendation requirement, known as "fiduciary outs," seek to reconcile the target board's fiduciary duty to obtain the best deal for its stockholders with the buyer's need for assurance that the deal will proceed to closing.

Despite fierce negotiations surrounding fiduciary outs, the resulting provisions generally fall within a range of known parameters. Traditionally, merger agreements contain either a narrow fiduciary-out limited to the target's receipt of a superior proposal or a broad fiduciary-out exercisable for any reason determined by the board in the discharge of its fiduciary duties. However, as analyzed in a Gibson, Dunn & Crutcher study of large public-company merger agreements in 2012, "No-Shops and Fiduciary Outs: A Survey of 2012 Public Merger Agreements," parties have been negotiating "intervening event" fiduciary-out provisions in merger agreements with increasing frequency (34 of the 59 agreements surveyed included an "intervening event" provision). These provisions permit the target's board to change its recommendation if the target encounters an "intervening event" during the period between the deal's signing and closing. The definition of "intervening event" varies depending on the deal, but most require that the circumstance or event be material and unknown to the target's board on the date of the agreement. Other common definitional qualifiers include that the event or circumstance not be reasonably foreseeable and that it first arise after the date the merger agreement was signed. The intervening event fiduciary-out thus may present an appealing compromise that allows buyers to gain some certainty regarding the target board's backing of the deal while also giving the target board meaningful flexibility to alter its recommendation in response to unforeseen events that arise during the post-signing period.

It is uncertain whether a Delaware court would uphold an intervening event fiduciary-out in a merger agreement — or any restriction on the target board's ability to change its recommendation in the exercise of its fiduciary duties. Perhaps surprisingly, Delaware courts have yet to address squarely the validity of contractual restrictions on the board's ability to change its recommendation. This absence of guidance has created uncertainty regarding whether an intervening event fiduciary-out constitutes an acceptable fiduciary construct or whether a target board must be able to change its recommendation for any reason if required to do so in the exercise of its fiduciary duties. For example, in the context of a merger agreement that permits a target board to change its recommendation due to an intervening event (as typically defined) or receipt of a superior proposal, what happens if an event occurs between

signing and closing that was reasonably foreseeable at signing, but nevertheless leads the target board to believe that the deal is no longer in the target's or its stockholders' best interest? If the event does not qualify as either an intervening event or a superior proposal, the board would be contractually prohibited from changing its recommendation. At a panel discussion with Rob Spatt of Simpson Thacher & Bartlett at the Tulane Corporate Law Institute in 2009 during which such contractual limits were discussed, "Vice Chancellor [Leo E.] Strine [Jr.] was openly skeptical of whether [such provisions] would be consistent with Delaware law," according to a New York Times report.

Yet instead of forswearing all limitations on the target board's ability to change its recommendation, perhaps courts confronted with an intervening-event provision or other restrictions on the board's ability to change its recommendation should consider whether inclusion of the provision was the result of the target board's proper exercise of its fiduciary duties to negotiate the most favorable terms for the target's stockholders. Specifically, a provision requiring the board to recommend the merger in the absence of an intervening event or superior proposal (each as typically defined) could be seen as part of the package of negotiated points that were part of a deal that, as a whole, was in the best interests of the company and its stockholders. The target board could argue that, as a result of a thorough presigning examination of the interests of the company and its stockholders and potential changes that could necessitate a post-signing change of recommendation, the board determined that a narrowing of fiduciary outs was appropriate to achieve the ultimate goal of delivering the highest value reasonably available for the stockholders. In the give-and-take of agreement negotiations, the target's "give" of increased certainty through the inclusion of limited fiduciary-outs may well enable the target board to gain an advantage in other hotly negotiated areas such as price or size of the breakup fee. Stockholders entrust boards with the task of serving their best interests, and the stockholders' best interests may be served by agreeing to a more limited fiduciary-out provision in order to secure the highest value. To help ensure that the target's agreement to intervening event and superior proposal limitations on its board's ability to change its recommendation is consistent with the proper exercise of the board's fiduciary duties, the target board should be advised specifically about the inclusion of such provisions in the merger agreement, and the board should weigh the risks of agreeing to such provisions against (a) the likelihood of the occurrence of an event or circumstance between signing and closing that would necessitate a change in recommendation but that would not constitute an intervening event or a superior proposal and (b) the benefits obtained through other aspects of the deal, and the record should reflect these deliberations.

For Delaware courts, the considerations surrounding fiduciary outs are multifold. Not only do intervening-event provisions and other limitations on the board's ability to change its recommendation involve the target board's fiduciary duty to make an appropriate recommendation to stockholders after the agreement is signed, they also implicate the board's fiduciary duties to obtain the best overall deal for the target's stockholders before signing. A comprehensive approach to evaluating these provisions, properly balancing the considerations described above, likely should justify their inclusion in merger agreements as consistent with a board's proper exercise of its fiduciary duties.

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