FIDUCIARY DUTIES AND FIDUCIARY OUTS

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INTRODUCTION

At the intersection of contract law and fiduciary duties in corporate law lies the fiduciary out. Generally speaking, a fiduciary out is a provision in an acquisition agreement which allows the target company's board of directors not to comply with some, or all, of the directors' obligations under the agreement if it is necessary for them to avoid a breach of fiduciary duties.[1] Despite its ubiquity in acquisition agreements, the fiduciary out is almost unheard of in any other context because it is a problematic provision.[2]

The fiduciary out creates a dilemma with significant stakes on both sides. On the one hand, there is the interest of a third party—the acquirer—who has negotiated a contract with the target's board of directors. Not surprisingly, the acquirer expects compliance with the terms of the contract. On the other hand, there is the interest of the shareholders who rely on directors to pursue their interests. The sale of a company can be in the interests of its shareholders, but only if they receive adequate consideration. Presumably, directors will assure themselves of this fact before they approve the transaction. However, skepticism is appropriate "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[3] Moreover, because there is a delay between the signing of the acquisition agreement and the closing of the transaction, a superior offer often will present itself. The question then arises—

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[1] *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 945 (Del. 2003) (Veasey, C.J., dissenting) ("What is the practical import of a 'fiduciary out?' It is a contractual provision, articulated in a manner to be negotiated, that would permit the board of the corporation being acquired to exit without breaching the merger agreement in the event of a superior offer."); *see also* William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 653 (2000) ("Fiduciary outs are anomalous contract provisions that generally provide an escape hatch to a target corporation from performing some contractual undertaking meant to advance the closing of an acquisition agreement.").

[2] *Omnicare*, 818 A.2d at 939 n.88 ("Other contracts do not require a fiduciary out clause because they involve business judgments that are within the *exclusive* province of the board of directors' power to manage the affairs of the corporation.").

[3] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

whose interest shall prevail? The acquirer's expectation interest in the contract requires that the transaction proceed as planned, notwithstanding the emergence of a superior offer. The shareholders' reliance interest in fiduciary duties requires that directors pursue the best value reasonably available, which would be the superior offer. In this zero-sum game, both interests cannot prevail.

The dilemma is complicated and under-theorized in the scholarly literature. This Article considers the issue in depth. It argues that the fiduciary out is a deeply problematic device because, although the intent is that it should be exercised only when absolutely necessary, it inevitably operates as a discretionary option on the part of target directors. Nevertheless, the Article concludes that fiduciary outs are viable in the unique context of acquisition agreements but should not be extended to other contexts.

Part I explores the purpose of fiduciary duties in corporate law to set the stage for an understanding of fiduciary outs. It argues that fiduciary duties exist solely to protect the beneficiaries (i.e., the shareholders) from abuse at the hands of the fiduciaries (i.e., the directors)—and not to protect them against third parties or bad outcomes. Part II analyzes the concept of the fiduciary out in this light. It argues that fiduciary outs are essentially contractual proxies for fiduciary duties, and as such also exist to protect shareholders from director misconduct rather than to ensure good substantive outcomes. Part III uses this understanding to explore the interpretation of fiduciary out clauses. It argues that fiduciary outs almost necessarily transform acquisition agreements into options at the hands of the target directors, with the effect of protecting shareholders from bad outcomes at the expense of the acquirer. Such provisions are therefore deeply problematic. Part IV analyzes fiduciary outs in the unique context of acquisition agreements. It argues that, notwithstanding the general concerns, fiduciary outs are appropriate in acquisition agreements because they protect the shareholders in the exercise of their right to vote against a transaction from abuse at the hands of directors who might try to force the transaction upon shareholders. In addition, this Part explains how the much-pilloried case of *Omnicare, Inc. v. NCS Healthcare, Inc.*[4] can be justified in this light. Finally, Part V explores fiduciary outs in other contexts. It argues that they are not appropriate outside of the acquisition agreement context because there is no similar need to protect shareholders from directors. This Part also explains how the case of *CA, Inc. v. AFSCME Employees Pension Plan*[5] seriously erred in trying to import fiduciary outs into an analysis of corporate bylaws.

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4 818 A.2d 914 (Del. 2003).

5 953 A.2d 227 (Del. 2008).

I. THE PURPOSE OF FIDUCIARY DUTIES

What is a fiduciary duty? It is not so much a special type of duty as it is a duty imposed in a special kind of relationship.[6] A fiduciary relationship is a legally recognized relationship in which one is given power over the interests of another, who thereby becomes vulnerable to abuse. Although such relationships are risky, they can also be very beneficial. In order to encourage and police such relationships, the law imposes a duty on the first party—the fiduciary—to act in the interests of the second party—the beneficiary (who is often, but not always, the entrustor, or the party who granted the power to the first[7]). Thus, the raison d'être of fiduciary duties, and of the designation of relationships as fiduciary, is the protection of the beneficiary from abuse at the hands of the fiduciary.[8]

Section A reviews the general principles of fiduciary law to establish the nature of fiduciary relationships. It shows that there is a general consensus that fiduciary duties exist for the protection of the beneficiary from the fiduciary. Section B looks at the nature of fiduciary duties in corporate law specifically. It describes the specific implementation of fiduciary law principles that are embodied in corporate law fiduciary duties.

A. *Fiduciary Law Generally*

Fiduciary law is not generally considered to be a separate and distinct body of law in the United States. Rather, many different areas of law employ fiduciary law principles. Among the most common are agency law, trust law,

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6 *See* Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. (forthcoming 2013) (manuscript at 11), *available at* http://ssrn.com/abstract=2083855 ("The conventional position is that fiduciary duties arise upon the establishment of a fiduciary relationship.").

7 It is worth noting that I am using the term "entrustor" slightly differently than does Professor Tamar Frankel, who coined the term. *See* Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 800 n.17 (1983). As I use the term, for example, the "entrustor" would be the settlor rather than the beneficiary in trust law.

8 *See* P. D. FINN, FIDUCIARY OBLIGATIONS 3 (1977) ("[Fiduciary] duties ensure that when a decision is taken it is in fact taken by the fiduciary, that it is taken because he believes it should be taken, and that it is taken in the interests of his beneficiaries."); TAMAR FRANKEL, FIDUCIARY LAW 108 (2011) [hereinafter FRANKEL, FIDUCIARY LAW] ("The duty of loyalty supports the main purpose of fiduciary law: to prohibit fiduciaries from misappropriating or misusing entrusted property or power."); Frankel, *supra* note 7, at 824 ("[M]uch of fiduciary law is designed to prevent the fiduciary from using delegated power to further interests other than those of the entrustor."); Miller, *supra* note 6 (manuscript at 62) ("Given that fiduciary power is a means of the beneficiary, the interaction between fiduciary and beneficiary must be presumptively conducted for the sole advantage of the beneficiary."); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Law*, 55 VAND. L. REV. 1399, 1402 (2002) ("[T]he duty of loyalty that is the essence of *fiduciary* duty protects beneficiaries against opportunistic behavior by fiduciaries.").

corporate law (and the law of other business entities), the Employee Retirement Income Security Act, and professional practice. Each implements the principles of fiduciary law in different ways. Thus, it is difficult to make very many claims about fiduciary law in general.

For example, scholars do not agree on the source of fiduciary law—whether it is based on property,[9] contracts,[10] morality,[11] or some other foundation.[12] In fact, many scholars are skeptical about whether fiduciary law can be adequately defined. Some scholars, such as Professor Deborah DeMott, come to this conclusion reluctantly.[13] She acknowledges that "fiduciary obligation eludes theoretical capture"[14] and admits that "[o]ne could justifiably conclude that the law of fiduciary obligation is in significant respects atomistic."[15] Judge Frank J. Easterbrook and Professor Daniel R. Fischel, on the other hand, are much less reluctant. According to them, "[s]cholars . . . have had trouble coming up with a unifying approach to fiduciary duties because they are looking for the wrong things. They are looking for something special

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9 This is implicit in the work of Adolf Berle and Gardiner Means. *See., e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 221, 226-27 (reprt. 1933) (1932) (describing the source of fiduciary duties within corporations); A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1071-72 (1931) (discussing the fiduciary relationship between directors and shareholders); *see also* Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 212 (arguing "that default fiduciary duties should be confined to relationships that involve the contractual delegation of broad power over one's property").

10 *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426-27 (1993) ("[Fiduciary duties are] a response to the impossibility of writing contracts completely specifying the parties' obligations. . . . Instead of specific undertakings, the agent assumes a duty of loyalty in pursuit of the objective and a duty of care in performance. . . . Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.").

11 *See, e.g.*, Robert Flannigan, *The Fiduciary Obligation*, 9 OXFORD J. LEGAL STUD. 285, 310 (1989) (fiduciary duties exist "for the singular purpose of maintaining the integrity of trusting relationships"); Frankel, *supra* note 7, at 830 ("[O]nce a person becomes a fiduciary, the law places him in the role of a moral person and pressures him to behave in a selfless fashion, to think and act for others.").

12 *See, e.g.*, MATTHEW CONAGLEN, FIDUCIARY LOYALTY 4 (2010) ("[T]he fiduciary concept of 'loyalty' is a convenient encapsulation of a series of legal principles . . . [that] provide[s] a subsidiary and prophylactic form of protection for non-fiduciary duties."); Gareth Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 LAW Q. REV. 472, 472 (1968) (arguing that the source of fiduciary law is unjust enrichment); Miller, *supra* note 6 (manuscript at 42-67) (proposing a juridical justification for fiduciary duties).

13 *See* Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 925, 934-36 (2006) (illustrating that the applications of fiduciary duties are "too varied" to extrapolate one distinct definition).

14 Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligations*, 1988 DUKE L.J. 879, 908 (1988).

15 *Id.* at 915.

about fiduciary relations. There is nothing special to find."[16] Other scholars have expressed variations on these sentiments.[17]

Nevertheless, there is agreement on the most basic concepts of fiduciary law. This is evident in the attempts made by various scholars to synthesize fiduciary law into something resembling a definition. Consider the following examples. Professor Tamar Frankel, one of the leading scholars in the field of fiduciary law, has observed that, "[w]hile the definitions of fiduciaries [in the various areas of law] are not identical, all definitions share three main elements: (1) entrustment of property or power, (2) entrustors' trust of fiduciaries, and (3) risk to the entrustors emanating from the entrustment."[18] Professor DeMott believes that "[t]he defining or determining criterion [for a fiduciary relationship] should be whether the plaintiff (or claimed beneficiary of a fiduciary duty) would be justified in expecting loyal conduct on the part of an actor and whether the actor's conduct contravened that expectation."[19]According to Professor D. Gordon Smith, "fiduciary relationships form when one party . . . acts on behalf of another party . . . while exercising discretion with respect to a critical resource belonging to the [other]."[20] J.C. Shepherd claims that "[a] fiduciary relationship exists whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient of the power uses that power."[21] Finally, Professor Paul Miller argues that "[a] fiduciary relationship is one in which one party (the fiduciary) exercises discretionary power over the significant practical interests of another (the beneficiary)."[22]

Although these accounts vary, they paint a very similar picture. In their generality, these definitions may not describe exactly who will and will not be considered a fiduciary, but they do tell us a good deal about fiduciary relationships. At its core, a fiduciary relationship is one in which one party—the fiduciary—is trusted with power over the interests of another—the beneficiary—who becomes vulnerable as a result.

What flows from the recognition of a fiduciary relationship? Again, there is significant agreement on this question. The law imposes upon fiduciaries a special obligation—a duty to act in the interests of the beneficiary.

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16 Easterbrook & Fischel, *supra* note 10, at 438.

17 *See, e.g.*, Frankel, *supra* note 7, at 797 ("It could be argued that . . . [t]he differences among fiduciaries may be so great that treating them as a group would require a very high level of generality, rendering a unified examination of little use."); *see also* L. S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 73 ("The word 'fiduciary,' we find, is *not* definitive of a single class of relationships to which a fixed set of rules and principles apply.").

18 FRANKEL, FIDUCIARY LAW, *supra* note 8, at 4.

19 DeMott, *supra* note 13, at 936.

20 Smith, *supra* note 8, at 1402 (emphasis omitted).

21 J. C. SHEPHERD, THE LAW OF FIDUCIARIES 35 (1981).

22 Miller, *supra* note 6 (manuscript at 51).

The exact nature of this "fiduciary duty" may vary depending upon the particular context, but the general contours are clear.

At the very least, there is a duty of loyalty.[23] With respect to the fiduciary relationship, a fiduciary may not act counter to the interests of the beneficiary. In fact, fiduciaries must avoid conflicts of interest that might tempt them to act against the interests of the beneficiary.[24] Of course, a lot more can be said about the duty of loyalty, especially in particular areas of law. While the specifics may vary, however, the general principle is the same.[25] A fiduciary must use his power for the benefit of the beneficiary, and not for his own benefit or for the benefit of others.

There are some who argue that the duty of loyalty is the only true fiduciary duty.[26] However, that is a controversial claim. Almost equal in pedigree and stature to the duty of loyalty is the duty of care. A fiduciary must act (i.e., perform the service in question) diligently, exercising an appropriate level of care and skill.[27] Exactly what this definition means will depend upon the given context, but the general concept remains fairly constant.

Other fiduciary duties are less universal, and more contextual. For example, in corporate law there is a duty of good faith.[28] In the law of nonprofit organizations, there is a duty of obedience.[29] Other duties could be enumerated. In each case, the law protects the beneficiary from abuse at the hands of the fiduciary, in whatever form that abuse might take.

Although it is possible to consider care, loyalty, good faith, and obedience to be separate fiduciary duties, the better view is that they are interrelated. As Professors Claire Hill and Brett McDonnell have argued in the corporate law context, fiduciary duties can be understood at different levels of

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23 *See id.* at 9 & n.16 ("At the core lies the cardinal fiduciary duty of loyalty."); *see also* Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 633 (2010) ("[T]he duty of loyalty has, for good reason, been central to Delaware's approach to corporate law.").

24 *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY §§ 8.01–.05 (2006).

25 *See* WARREN A. SEAVEY, HANDBOOK OF THE LAW OF AGENCY 4 (1964) ("The duties of loyalty are substantially the same for all fiduciaries, varying only in intensity.").

26 *See, e.g.*, CONAGLEN, *supra* note 12, at 39-44 (arguing that "duties of care [and good faith] are not peculiar to fiduciaries and so do not merit consideration as 'fiduciary' duties"); Christopher M. Bruner, *Is the Corporate Director's Duty of Care a "Fiduciary" Duty? Does It Matter?* 2, 9 (Washington & Lee Legal Studies, Paper No. 2013-14, 2013), *available at* http://ssrn.com/abstract=2237400; Miller, *supra* note 6 (manuscript at 9); Smith, *supra* note 8, at 1409.

27 *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

28 *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006) (recognizing the importance of the duty of good faith in corporate law); Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 367-70 (Del. 2006) (discussing duty of good faith).

29 *See, e.g.*, Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999) ("[D]irector[s] of a not-for-profit corporation [must] 'be faithful to the purposes and goals of the organization,' [because] 'nonprofit corporations are defined by their specific objectives . . . .'").

abstraction.[30] At the highest level of abstraction, there is only one fiduciary duty: to pursue the interests of the beneficiary.[31] At lower levels of abstraction, there can be any number of fiduciary duties. Thus the duty of care represents the duty to pursue the interests of the beneficiary carefully; the duty of loyalty represents the duty to pursue the interests of the beneficiary loyally; and so on, for other duties.[32] Both views, along with other views at different levels of abstraction, have an equal claim to the truth.[33]

The most general level of abstraction most clearly reveals the true nature of fiduciary duties. Fiduciary duties are obligations imposed upon fiduciaries to require them to use the powers at their disposal to pursue the interests of the beneficiaries, at least with respect to the relationship.[34] The duty of loyalty protects beneficiaries from self-dealing, while the duty of care protects beneficiaries from shirking. Likewise, it could be said that the duty of good faith protects beneficiaries from intentional misconduct and that the duty of obedience protects beneficiaries from disobedience. Both generally and in each case, the purpose of fiduciary duties is to protect beneficiaries from abuse at the hands of the fiduciary.[35]

It is equally important to note at this point what fiduciary law is not about. It is not about protecting beneficiaries from third parties, nor is it about protecting beneficiaries from bad outcomes. Fiduciary duties are duties imposed upon fiduciaries to ensure that they act in the interests of the beneficiary, nothing more.[36] To be sure, entrustors seek out fiduciary relationships in order to secure good results. Generally, the fiduciary is an expert who can be expected to do a better job than the entrustor or beneficiary could do for himself. Thus, fiduciary relationships have the goal of enhancing beneficiary welfare. However, it is the fiduciary's skill that must secure good results, not fiduciary duties. There is no fiduciary duty to guarantee good outcomes.[37]

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30 *See* Claire A. Hill & Brett H. McDonnell, Essay, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1788-89 (2007) (discussing the levels of abstraction of fiduciary duties).

31 *Compare id.* (placing beneficiary interests at the highest level of abstraction), *with* Strine et al., *supra* note 23, at 635 ("[I]t is possible to conceive of there being only one core duty.").

32 *See* Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?*, 83 S. CAL. L. REV. 1231, 1301 (2010).

33 *See id.* at 1287-88 (explaining how multiple viewpoints are simultaneously correct).

34 *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).

35 Velasco, *supra* note 32, at 1301 ("Ultimately, there is one fundamental fiduciary duty—to pursue the interests of the corporation and its shareholders—but that core duty can be divided into . . . different concerns.").

36 *See supra* note 8 and accompanying text.

37 *Cf.* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule." (footnotes omitted)); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a . . . decision

Along the same lines, it is important to draw a distinction between fiduciary duties and the powers exercised by fiduciaries. Fiduciary duties are not themselves powers.[38] The powers that the fiduciary has in a fiduciary relationship are those that the entrustor (or, in some cases, other substantive law[39]) has given to it. Fiduciary duties, on the other hand, are obligations imposed by equity to ensure that the fiduciary's powers are not abused. Thus, fiduciary duties are not themselves powers, nor even extensions of power. To the contrary, they are limitations upon the discretionary use of otherwise legitimate powers.

B. *Corporate Law Fiduciary Duties*

Corporate law provides a classic example of fiduciary law principles. Shareholders are the owners of the corporation, but often they cannot manage it. This fact is most evident in large, public corporations where there are thousands of dispersed shareholders. Shareholders hire expert managers to run the business on their behalf. This arrangement is commonly referred to as the separation of ownership and control.[40] Under this arrangement, shareholders are the entrustors and beneficiaries, and the managers are the fiduciaries.

Corporate law mandates that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."[41] Thus, in a sense, directors' powers can be said to be "original and undelegated."[42] However, this is only part of the story. Corporate law is also clear that directors have fiduciary duties toward "the corporation and its shareholders."[43] Clearly, directors are not mere agents; they must exercise

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[is] substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests." (emphasis omitted)); *id.* at 968 ("If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors.").

38 *But see infra* note 358 and accompanying text (discussing *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 240 (Del. 2008)).

39 *See* Miller, *supra* note 6 (manuscript at 15) ("Fiduciary relationships may alternatively be established by non-contractual agreement, by unilateral undertaking, or by legislative or judicial decree.").

40 *See* BERLE & MEANS, *supra* note 9, at 277–87.

41 DEL. CODE ANN. tit. 8, § 141(a) (2011).

42 *See* N. Assur. Co. v. Rachlin Clothes Shop, Inc., 125 A. 184, 188 (Del. 1924) (quoting Hoyt v. Thompson's Ex'r, 19 N.Y. 207, 216 (1859)) (internal quotation marks omitted); *see also* Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

43 *See* N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("Delaware corporate law provides for a separation of control and ownership. The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners.' Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform *that* function." (footnotes omitted)); ACE Ltd. v. Capital Re Corp., 747 A.2d 95,

their independent business judgment.[44] However, they must always pursue the interests of the shareholders.

In corporate law, the two main fiduciary duties are the duty of care and the duty of loyalty.[45] The duty of care focuses on the decision-making process.[46] "[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."[47] More specifically, "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."[48] The duty of loyalty, on the other hand, is concerned primarily with conflicts of interest. "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."[49]

In recent years, a third duty—the duty of good faith—has risen in prominence. At one point, Delaware courts elevated this duty to be considered part of a triad of fiduciary duties (along with care and loyalty),[50] but more recently it has been demoted to a subset of the duty of loyalty.[51] I have argued that it does not make sense to consider good faith to be a subset of loyalty because they are motivated by entirely different concerns.[52] Regardless of its metaphysical stature, it is clear that the duty of good faith is concerned with the fiduciary's subjective intent.[53]

As I have argued elsewhere, it is reasonable to say that there are two other fiduciary duties that can be uncovered in Delaware case law.[54] There is

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109 (Del. Ch. 1999) ("Delaware law invests a substantial amount of authority in corporate boards to manage the affairs of corporations. But this investment of authority is dependent on the corresponding responsibility of corporate boards to exercise this authority in a careful and loyal manner.").

44 *See* People *ex rel.* Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911); *cf.* Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) (explaining that directors cannot abdicate responsibilities for managing business), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000).

45 *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006).

46 *See Brehm*, 746 A.2d at 264.

47 Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *see also* MODEL BUS. CORP. ACT ANN. § 8.30(b) (Supp. 1998/99).

48 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d at 254.

49 Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

50 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

51 *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006).

52 *See* Velasco, *supra* note 32, at 1285-96.

53 *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006) (citing *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755-56 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006)); *Stone*, 911 A.2d at 369.

54 *See* Velasco, *supra* note 32, at 1288-93.

a duty of "objectivity," requiring directors to avoid being influenced by their personal biases—even if those biases cannot fairly be considered a conflict of interest that rises to the level of self-dealing.[55] This duty is evident from the cases involving structural bias, such as takeover defenses[56] and derivative litigation.[57] More controversially, but also grounded in case law, is the duty of "rationality."[58] Ostensibly, at least, this duty is concerned with the actual substance of a business decision and its defensibility. Arguably, though, it is simply a proxy for good faith.[59]

If Professors Hill and McDonnell are correct, and fiduciary duties can be understood at various levels of abstraction, then it is fair to say that there is ultimately just one fiduciary duty—to pursue the interests of the shareholders—and that these three to five specific duties are merely aspects of the one general fiduciary duty.

> In other words, the duty of care represents the concern that the directors pursue the interests of the corporation and its shareholders *carefully*; the duty of loyalty represents the concern that they do so *loyally* (without conflicts); the duty of objectivity represents the concern that they do so *reasonably* (despite bias); the duty of good faith represents the concern that they do so *honestly* (without misconduct); and the duty of rationality represents the concern that they do so *rationally* (without waste).[60]

At least in corporate law, however, it is not enough to enumerate the various fiduciary duties because they are not enforced in a straightforward manner. Failure to satisfy fiduciary duties does not automatically lead to liability for a director, because corporate law is characterized by a pervasive divergence between standards of conduct and standards of review.[61] A standard of conduct is the rule as directed toward actors, telling them what they must do; a standard of review is the rule as directed toward judges, telling them how they should evaluate the actors' conduct.[62] In many areas of law, the two types of standards coincide; in corporate law, they do not. For various reasons, the standards of review in corporate law are significantly lower than the standards of conduct. Thus, it is fair to say that directors will not be held

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55 *See id.* at 1291-92.

56 *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

57 *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 780 (Del.), *order rev'd*, 430 A.2d 779 (Del. 1981).

58 *See* Velasco, *supra* note 32, at 1290-96.

59 *See id.* at 1252-56.

60 *See id.* at 1301.

61 *See* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993).

62 *See id.* at 437; *see also* Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625, 627 (1984).

liable for simple breaches of fiduciary duty—only for more egregious breaches.[63]

The root of this divergence is the business judgment rule. According to Delaware courts, the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[64] This presumption is very strong and cannot be rebutted easily,[65] resulting in a divergence between standards of conduct and standards of review.

Alternatively, the business judgment rule can be characterized as a standard of review.[66] "[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence."[67] Thus, while the duty of care may require that directors act with ordinary care (i.e., avoid negligence), they will only be held liable for gross negligence. This principle extends beyond the duty of care. The duty of loyalty is primarily about avoiding conflicts of interest.[68] However, under the standard of review, directors will not be held liable despite a conflict of interest if their actions are deemed entirely fair.[69] Likewise, the duty of good faith requires subjective good faith on the part of the director, though directors will only be held liable for intentional misconduct.[70] The same principle holds true for the two additional duties I have proposed.[71] Under the duty of objectivity, directors must not be influenced by personal biases, but their actions will be upheld notwithstanding structural bias if they are reasonable.[72] Finally, under the duty of rationality, directors are expected to make substantively good decisions, but directors will only be held liable if their decisions are irrational or amount to waste.[73]

The rationale for this divergence is what I have called the "room for error" theory.[74] Unlike many other beneficiaries in a fiduciary relationship,

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63 *See* Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM. & MARY L. REV. 519, 547 (2012).

64 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

65 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

66 *See* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 828 & n.18 (2004).

67 *Aronson*, 473 A.2d at 812.

68 "The duty of loyalty must be understood as the law's attempt to create an incentive structure in which the fiduciary's self-interest directs her to act in the best interest of the beneficiary." Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1074 (1991).

69 *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (describing the entire fairness test).

70 *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).

71 *See* Velasco, *supra* note 32, at 1244-48, 1252-56.

72 *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

73 *See, e.g.*, *Walt Disney Co.*, 906 A.2d at 62, 73-75.

74 *See* Velasco, *supra* note 63, at 546-53.

shareholders are willing to accept a significant amount of risk. They understand that, in the business world, risk and return are related. Thus, shareholders want their directors to take reasonable entrepreneurial risks. However, directors will be risk-averse if they have to fear personal liability. This tendency is especially true in a large, public corporation, where the damages for breach of fiduciary duty could exceed director wealth many times over. Any mistake—whether on their part, in accidentally breaching their fiduciary duties, or on the part of the courts, in erroneously concluding that directors have breached their fiduciary duties—could lead to ruinous liability. The divergence between standards of conduct and standards of review can provide directors with a degree of comfort, allowing them to take on healthy entrepreneurial risks. It assures them that small mistakes, whether on their part or on the part of the courts, will not lead to liability.

Notwithstanding these interesting wrinkles in the implementation of fiduciary concepts in corporate law, it is important to note that the most basic principles of fiduciary law remain intact. Directors and shareholders are clearly in a fiduciary relationship. Directors, as fiduciaries, are obligated to pursue the interests of the shareholders. Fiduciary duties exist to protect shareholders from abuse at the hands of directors—whether in the form of shirking, self-dealing, intentional misconduct, or otherwise. Fiduciary duties do not exist to protect shareholders from third parties, nor to guarantee good results. Finally, fiduciary duties are not themselves grants of power, but rather limits on the directors' ability to exercise the powers they have been given.

II. FIDUCIARY OUTS

This Part examines fiduciary out provisions more closely. Section A explores what fiduciary outs are. Section B reviews the reasons for their existence.

A. *What Are Fiduciary Outs?*

Conceptually, a fiduciary out is a contractual provision that allows certain parties to avoid obligations under the contract based on their fiduciary duties.[75] In practice, fiduciary outs appear in acquisition agreements and prevent the directors of a company from having to breach their fiduciary duties to the shareholders.[76] Generally, fiduciary outs protect only the directors of the target company.[77] Of course, they could apply to both sets of directors.

75 *See supra* note 1 and accompanying text.

76 Allen, *supra* note 1, at 653.

77 *Id.* at 657.

However, because acquirers often can enter into acquisition agreements without shareholder approval, there is less need for the protection of a fiduciary out.[78] Outside of the acquisition context, fiduciary outs are virtually nonexistent.[79]

Fiduciary outs are contractual in nature and can be structured in many different ways. For example, the scope of a fiduciary out can be broad or narrow. A broad provision could allow the directors out of any contractual obligation, or even the entire agreement. A narrow provision could allow the directors out of only a specific obligation. Similarly, the trigger can be broad or narrow. Under a broad provision, directors might be excused whenever they deem it necessary or appropriate to comply with their fiduciary duties. Under a narrow provision, directors might be excused only upon the occurrence of certain events.

Early on, fiduciary outs were drafted quite broadly. For example, in *Smith v. Van Gorkom*,[80] the provision read as follows:

> The Board of Directors shall recommend to the stockholders of Trans Union that they approve and adopt the Merger Agreement ("the stockholders' approval") and to use its best efforts to obtain the requisite votes therefor. *GL acknowledges that Trans Union directors may have a competing fiduciary obligation to the shareholders under certain circumstances*.[81]

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78 *See supra* note 2.

79 *But see infra* Part V (discussing *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008)). Fiduciary outs have also found their way into poison pill policies. *See* THE CONFERENCE BOARD, DIRECTOR COMPENSATION AND BOARD PRACTICES: 2013 EDITION, at 100-01 (2013). Generally speaking, shareholders are opposed to poison pills and often have managed to get companies to adopt policies in which directors promise not to adopt a poison pill plan without shareholder approval. Sometimes, however, directors include a fiduciary out, "allowing for the adoption of a poison pill without shareholder approval in those extraordinary circumstances when the company determines it is in the best interest of shareholders to install a defense without delay." *Id.* at 101. This practice generally does not reflect a negotiated agreement and is therefore unrelated to the discussion of fiduciary outs in this Part. Rather, the practice reflects the directors' determination to retain their discretion to adopt a poison pill against the wishes of the shareholders. Some directors would argue that such a fiduciary out is required by law, but the one court that has decided the issue has concluded otherwise. *See* Unisuper Ltd. v. News Corp., No. 1699-N, 2005 WL 3529317, at *8-9 (Del. Ch. Dec. 20, 2005). Although the holding in that case is consistent with the view set forth in this Article, it is not entirely clear, in light of the *CA* decision, that the Delaware Supreme Court would reach the same conclusion. However, the issue is beyond the scope of this Article because it also involves the substantive issue of whether shareholders have the right to interfere with the directors' adoption of a poison pill. *See* Account v. Hilton Hotels Corp., 780 A.2d 245, 246 (Del. 2001) (upholding the power of directors to adopt a poison pill without shareholder approval); *see also* Julian Velasco, *Just Do It: An Antidote to the Poison Pill*, 52 EMORY L.J. 849, 851-54 (2003) (describing issue concerning legitimacy of anti-poison pill bylaws). If shareholders do not have that right, then fiduciary outs are entirely unnecessary. The issue is relevant only if shareholders do have the right to interfere. In that case, the position of this Article, set forth especially in Part V, is that fiduciary outs should not be required in poison pill plans.

80 488 A.2d 858 (Del. 1985), *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

81 *Id.* at 879.

This language is so vague that the court could not even accept that it amounted to a fiduciary out at all.[82] However, in retrospect, it is fairly clear that the intent of the parties was to allow the directors a fiduciary out. Without any specifics, the provision must be interpreted as being very broad—at least with respect to the trigger, if not the scope.

The problem with broad provisions is that they leave the decision as to whether the fiduciary out should be exercisable entirely to the discretion of the target directors, whose interests are not necessarily aligned with those of the acquirer. Even if the target and acquirer's interests are aligned at the time they enter into the agreement—a proposition which is debatable—they could certainly diverge if a superior offer comes along, or if circumstances change such that not consummating the transaction is preferable for target shareholders. At that point, the target directors may be tempted to exercise the fiduciary out opportunistically rather than act in good faith. From the perspective of the acquirer, this possibility essentially converts the contract into an option on the part of the target. This outcome would be unacceptable. Narrower provisions are intended to provide the flexibility that is deemed necessary while limiting the discretion of the directors to an acceptable range.

Over time, practice has converged toward a more narrow approach to fiduciary outs. The American Bar Association has provided a starting point for negotiation in its Model Merger Agreement.[83] Many acquisition agreements follow its rough outline.

Arguably, both the scope and the triggers of most contemporary fiduciary outs tend to be on the narrow end of the spectrum. It is common, for example, for an acquisition agreement to include fiduciary outs for two specific obligations: the "no solicitation" provision[84] and the shareholder recommendation covenant.[85] It is also common that the trigger is subject to various conditions, such as the making of a superior offer by a third party.[86] Under such provisions, directors are not free to decide at any point that their fiduciary duties require them to back out of the agreement. Rather, they are bound by the agreement generally and are released from key obligations only under circumstances that implicate their fiduciary duties.

On the other hand, it is not uncommon for fiduciary outs to be exercisable upon the occurrence of material developments that were not reasonably foreseeable.[87] Such an open-ended provision is, at least on its face, extremely

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82 *Id.* ("Clearly, this language on its face cannot be construed as incorporating . . . either the right to accept a better offer or the right to distribute proprietary information to third parties.").

83 AM. BAR ASS'N, MODEL MERGER AGREEMENT FOR THE ACQUISITION OF A PUBLIC COMPANY (2011) [hereinafter MODEL MERGER AGREEMENT].

84 *See id.* § 4.4.

85 *See id.* § 4.6.

86 *See id.* §§ 4.4(a), 4.6(c)(i).

87 *See id.* § 4.6(c)(ii), at 171.

broad. The language of such provisions is highly reminiscent of material adverse effect clauses.[88] Courts interpret material adverse effect clauses quite restrictively in order to avoid easy exit from an acquisition agreement.[89] No doubt, material development fiduciary out provisions are intended to be read similarly. However, whether this assumption will turn out as hoped is by no means clear.

In any event, it would be wrong to suggest that fiduciary out provisions have become standardized. There are plenty of issues on which negotiations take place and fiduciary outs can vary. One obvious point is the definition of a "superior offer" that is required to trigger the fiduciary out. The term can be defined generally or specifically, and can be more or less demanding.[90] Another point involves the conditions that supplement the superior offer requirement, such as advice of legal counsel[91] and a right of first refusal on the part of the other party to top a superior offer.[92] Ultimately, every aspect of a fiduciary out is negotiable. Because fiduciary outs are contractual, the possibilities are endless.

B. *Why Fiduciary Outs Exist*

On the surface, the primary beneficiary of a fiduciary out would seem to be the target directors. Such provisions ensure that compliance with fiduciary duties would not result in a breach of contract. However, it is by no means clear that compliance with fiduciary duties would ever constitute a breach of contract. The courts insist that directors may not enter into contracts that require them to breach their fiduciary duties: "To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."[93] Thus, it would seem that a fiduciary out is unnecessary and does little to protect target directors.

If this assessment is correct, one might wonder why fiduciary outs exist at all. The next obvious beneficiary would seem to be the acquirer. The acquirer does not want the acquisition agreement to be invalidated. Even if the

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88 *See generally* Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 357-58 (2005); Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2102 (2009).

89 *Cf. In re* IBP, Inc. Shareholders Litig., 789 A.2d 14, 68 (Del. Ch. 2001) ("[A] buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close.").

90 *See* MODEL MERGER AGREEMENT, *supra* note 83, § 4.4, at 156-61 (discussing possible objections to the provision).

91 *See id.* § 4.6(c)(i)(D)-(H), at 170-71.

92 *See id*., § 4.6(c)(i)(F), at 171.

93 CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008) (quoting Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 51 (Del. 1993)) (internal quotation marks omitted).

transaction itself is doomed because of the target directors' fiduciary duties, the acquirer would prefer to keep the contract intact. There are many provisions in an acquisition agreement which benefit the acquirer even if the desired transaction does not take place. Two important examples are covenants and termination fees. The former require the target to do, or not do, certain things that benefit the acquirer.[94] The latter act as liquidated damages provisions, ensuring that the acquirer is compensated if the transaction is not consummated through no fault of its own.[95] In order to secure these protections, the acquirer needs to ensure that the contract is not invalidated. A fiduciary out provision does this by severing the problematic obligations, which are excused under certain circumstances, from the other obligations of the contract, which remain enforceable. Since the target directors never have to breach their fiduciary duties, the acquisition agreement remains valid and the protective provisions remain enforceable. Thus, the acquirer may be the real beneficiary of the fiduciary out.

This account has some merit, but it seems unlikely to be the driving force behind fiduciary outs. Although certain provisions in acquisition agreements may be legally problematic, it is not clear that such provisions would lead to invalidation of the entire acquisition agreement. If a particular provision were to cause fiduciary duty issues, the courts could simply invalidate that provision.[96] Of course, it is possible that the courts could invalidate the entire agreement, or enough of it to cause serious problems for the acquirer. Thus, there is a benefit to protecting against this risk. However, the risk is a minor one, and the benefit of protecting against it is likely outweighed by the cost of giving target directors an ability to escape key obligations. Acquirers would prefer not to include fiduciary outs in acquisition agreements. They want to lock up the transaction as quickly as possible and not give the target any wiggle room. From their perspective, a fiduciary out is a necessary evil. They accept it because they must. Thus, acquirers are not the motivating force behind fiduciary outs.

Perhaps we must revisit the target directors. It is possible that they demand fiduciary outs not because they feel that they *need* them, but because they *want* them. However, this possibility is unlikely to explain the ubiquity of fiduciary outs because target directors, as a class, are ambivalent toward fiduciary outs. To the extent that such a provision provides directors with protection from liability, then it is, of course, welcome. To the extent that it resembles a discretionary option, it may also be welcome. It would allow directors to secure the current deal while also pursuing a better deal. For directors who seek to maximize shareholder value, this is clearly beneficial.

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94 *See* BLACK'S LAW DICTIONARY 419 (9th ed. 2009) (defining covenant).

95 *See generally* Gey Assocs. Gen. P'ship v. 310 Assocs., 346 F.3d 31, 33 (2d Cir. 2003) (per curiam) (defining termination fee).

96 A contract is only invalid "to the extent" that it is problematic. This is not necessarily the same thing as saying that a contract is invalid if any of its provisions are problematic. *See supra* note 93 and accompanying text.

However, a fiduciary out can also be problematic for the target directors. To the extent that the directors believe that they have found the best deal already, a fiduciary out can be a curse. Directors may want to close the current deal and resist offers from hostile third parties. However, a fiduciary out will enable directors to entertain and accept alternative offers. And, if directors can do so, then it is quite possible that the courts will conclude that their fiduciary duties require them to do so—even if the directors would prefer not to. This would seem to be reason enough to exclude fiduciary outs from many friendly acquisition agreements. Thus, it is unlikely that target directors are the driving force. Fiduciary outs can be advantageous or disadvantageous, depending upon the circumstances, so target directors would not demand them in every case.

In fact, as a class, target directors probably are not ambivalent toward fiduciary outs. The main benefit of the fiduciary out is that it can allow directors to entertain better offers. To the extent that this is the directors' goal, however, they could shop the company before entering into an acquisition agreement, or insist upon a "go shop" provision.[97] On the other hand, to the extent that directors want to close the current transaction, a fiduciary out can get in the way. Thus, even target directors are more likely to accept fiduciary outs than demand them.

If neither the target nor the acquirer is the motivating force behind fiduciary outs, there is only one possibility left: the courts. The courts sit in judgment over the directors when they are charged with a breach of fiduciary duty. In most cases, judicial review is quite deferential because of the business judgment rule.[98] However, situations involving acquisitions are different. Although independent directors cannot be said to be conflicted, at least not in the sense of engaging in self-dealing,[99] the courts have found them to be structurally biased in such situations.[100] Thus, defensive actions are reviewed with enhanced scrutiny—a less deferential mode of review.[101] In fact, in appropriate situations, the courts will demand that directors seek the best

97 *See generally* Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 238 n.2 (Del. 2009) (defining "go shop").

98 The business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). In fact, it is "a powerful presumption." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *see generally* Velasco, *supra* note 66, at 828-34.

99 *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("[T]he business judgment rule, including the standards by which director conduct is judged, is applicable here in the context of a takeover." (quoting Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984))).

100 *See id.* at 954 (recognizing an "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

101 *See id.* at 954-57.

price reasonably available.[102] Consequently, the specter of liability for breach of fiduciary duty looms—or at least the possibility of an injunction.[103] If directors include fiduciary outs in acquisition agreements in order to avoid this sort of judicial intervention, then the courts are the real motivating force.

The courts' concern is not misplaced. The real motive of the acquirer is to close the transaction as quickly as possible. Thus, it will demand certain contractual provisions—deal protection devices—that will "lock up" the deal. Such provisions may include stock or asset lockups,[104] no shops,[105] and termination fees,[106] to name just a few. Sometimes, the target directors may agree to such demands only reluctantly—because the acquirer insists. Other times, however, the target directors may be all too happy to accede—because they, too, want to close the deal quickly. Of course, the target directors may also refuse to include deal protection devices. Nevertheless, these provisions make courts uncomfortable.

Courts find deal protection devices problematic for at least three reasons. First, and most basically, such provisions do not obviously advance the goal of obtaining the best price reasonably available for shareholders. Any provision or device that would tend to make it more difficult for a superior offer to prevail would be suspect in this regard.

Second, the courts cannot ascertain whether the target directors are acting in the interests of shareholders or out of structural bias. The courts have concluded that these provisions are not per se unreasonable:[107] they could be used to advance shareholder interests, or they could also be used to the shareholders' detriment.[108] Of course, target directors could never be expected to admit to misconduct. Thus, courts must remain skeptical.

A third reason that courts find deal protection devices troubling is that they often interfere with shareholder rights. In many cases—most notably,

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102 *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (stating that when the breakup of the company became "inevitable," 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"); *see also* Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 48 (Del. 1993) ("[W]hen a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a breakup of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders." (emphasis omitted)).

103 An exculpation provision may eliminate the possibility of monetary damages, but not of equitable relief. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011); 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 227-28 (5th ed. 1998).

104 *See generally* THE DEALMAKER'S DICTIONARY OF MERGER AND ACQUISITION TERMINOLOGY 119 (Donnan Mandell ed., 1985) (defining lockups).

105 *See generally* BLACK'S LAW DICTIONARY 1161 (9th ed. 2009) (defining no-shop provision).

106 *See generally* Gey Assocs. Gen. P'ship v. 310 Assocs., 346 F.3d 31, 33 (2d Cir. 2003) (per curiam) (defining termination fee).

107 *See Revlon*, 506 A.2d at 183 ("A lock-up is not *per se* illegal under Delaware law.").

108 *See id.* ("[W]hile 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.").

mergers—directors must seek the approval of the shareholders before an acquisition transaction can proceed.[109] To the extent that shareholders have a right to vote on a transaction, they should be free to vote as they wish.[110] It is fair to assume that shareholders will vote in favor of a transaction if they believe that it offers the best value reasonably available, and will vote against it otherwise. However, deal protection devices may interfere with their vote, making it difficult to vote as they would like. For example, a termination fee may make it expensive for shareholders to vote no, even if they are opposed to the agreement. A no shop provision may make it difficult for a third party to make a better offer, thereby undermining shareholder confidence that the current deal reflects the best value reasonably available. A lockup may make it nearly impossible for a third party to make a superior offer, pressuring shareholders to accept a deal with which they are uncomfortable. For directors to agree to provisions that interfere with shareholder voting rights is not only unseemly but actually strikes at the very foundations of corporate law.[111]

For such reasons, courts are uncomfortable with deal protection devices. They may be willing to strike down such provisions, or perhaps even the entire agreement containing them. It is important to note, however, that the focus of the courts' concern is not—or, at least, should not be—the acquirer's behavior. As third parties in arm's-length negotiations, acquirers are expected to pursue their own selfish interests. They have no duty to the target shareholders. Instead, the court's concern is focused on target directors. They are the ones who might be acting inappropriately by entering into agreements that interfere with shareholder rights. Thus, the courts use fiduciary duties as a shield to protect the shareholders from misconduct on the part of the directors.

A fiduciary out is a compromise provision. Rather than leaving the fiduciary duty issue entirely up to the courts, the target and the acquirer agree to decide the matter themselves, contractually. With a fiduciary out, the parties can (try to) set boundaries that limit the discretion of the target directors while also securing the enforceability of the remainder of the acquisition agreement, if not the transaction itself. Thus, a fiduciary out is essentially a contractual proxy for fiduciary duties.[112] Because they are derivative of fiduciary duties, fiduciary outs also ultimately exist in order to protect shareholders from abuse at the hands of their directors.

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109 *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c) (2011) (defining merger); *see also id.* § 271(a) (defining sale of substantially all assets).

110 *Cf.* Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 42 & n.11 (Del. 1993) ("Because of the overriding importance of voting rights, [the courts] have consistently acted to protect stockholders from unwarranted interference with such rights.").

111 *See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1126 (Del. 2003) (citing Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988)).

112 As a proxy, a fiduciary out not only stands in for, but also should serve the same purpose as, fiduciary duties.

Although they may have this effect, fiduciary outs—like fiduciary duties—do not exist to protect shareholders from abuse at the hands of third parties. That is the purpose of the fiduciary relation itself: shareholders are unable to manage the business well on their own, so they hire expert managers. It is the managers' expertise that should protect shareholders from third parties—not fiduciary duties or fiduciary outs.[113]

In addition, fiduciary outs do not exist in order to ensure that shareholders get the best deals. Given the court's insistence that directors pursue this goal, this might seem a difficult proposition to defend. However, the defense is straightforward. As a general matter, corporate law does not mandate good results; it mandates good faith effort on the part of fiduciaries.[114] Fiduciary duties and fiduciary outs exist only to ensure that good faith effort. Moreover, if the goal were to ensure that shareholders get the best deal reasonably available, there would be many superior options available to the courts. They could, for example, require auctions or market tests before acquisitions; yet they do not.[115] Moreover, they only require that directors seek the best value reasonably available when it has been determined that the company is for sale.[116] Before that point, directors may pursue long-term value according to their best judgment.[117] Thus, the goal is not so much to seek the best value reasonably available as it is to pursue the interests of the shareholders in good faith according to their best judgment.[118]

Thus, fiduciary outs do not exist because either the target or the acquirer demands them. Rather, the courts are the real motivating force. The courts enforce the fiduciary duties of the target directors to pursue the interest of shareholders and this can lead to the invalidation of acquisition agreements. Rather than accept that risk, targets and acquirers agree to a contractual proxy

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113 *See supra* note 37 and accompanying text.

114 *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only. Irrationality is the outer limit of the business judgment rule . . . [which] may tend to show that the decision is not made in good faith . . . ." (footnotes omitted)); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del.Ch. 1996) ("[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests.").

115 Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-87 (Del. 1989) ("[T]here is no single blueprint that a board must follow to fulfill its duties. . . . When . . . the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve the transaction without conducting an active survey of the market.").

116 *See supra* note 102 and accompanying text.

117 *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989) ("Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.").

118 Of course, if directors are acting in good faith, they will seek the best value reasonably available when it is appropriate to do so.

for fiduciary duties in the form of fiduciary outs. Understanding this concept is key to deciding how to interpret fiduciary outs provisions.

III. INTERPRETING FIDUCIARY OUTS

The previous Part explored what fiduciary outs are and why they exist. This Part examines how fiduciary out provisions are, and should be, interpreted. Section A considers a general fiduciary out—one without conditions. From the parties' perspective, the situation is problematic: such provisions will not have the effect the drafters intended. Section B considers how more narrowly tailored fiduciary outs are interpreted. Courts are not entirely comfortable with such provisions, and therefore the parties rely on them at their own risk. Section C addresses how fiduciary out provisions *should be* interpreted. It argues that fiduciary outs should be interpreted consistently with the purposes of fiduciary duties generally: to protect shareholders from abuse at the hands of directors, rather than to protect shareholders from third parties or bad circumstances.

A. *General Outs*

This Section considers the theoretical problems with interpreting fiduciary outs by analyzing the heart of a typical provision. Based on language from the ABA's Model Merger Agreement,[119] let us assume that a general fiduciary out provides as follows:

> [Notwithstanding any provision herein to the contrary,] this [Agreement] . . . shall not prohibit the Company from . . . [taking action inconsistent with its obligations hereunder] if . . . the Company Board concludes in good faith . . . that such action is required in order for the Company Board to comply with its fiduciary obligations to the Company's stockholders under applicable Legal Requirements . . . .[120]

Such a provision would allow the target directors to decide whether their fiduciary duties allow them to comply with the provisions of the agreement.

It is clear that such language is not intended to create a discretionary option on the part of the target board of directors. First, as discussed above, the forces motivating the parties to enter into the transaction are inconsistent with such an interpretation.[121] Second, the language itself does not grant an option that can be exercised at the directors' discretion, preference, or whim. Rather, directors are excused only if "such action is required" by their fiduciary duties. Such language is not suggestive of optionality, but rather of

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119 MODEL MERGER AGREEMENT, *supra* note 83, § 4.4, at 148-50.

120 *Id.*

121 *See supra* notes 93-97 and accompanying text.

strict necessity. Third, the directors must make that determination in good faith.

As a formal matter, if the fiduciary out is supposed to have limited application, it might seem strange to leave the determination regarding its availability to the target directors, who would be tempted to use it opportunistically. One explanation might be found in the business judgment rule. Under the business judgment rule, judicial review is very deferential and directors are very rarely found liable for breach of fiduciary duty.[122] Thus, it would seem obvious that the directors should rarely be *required* to avoid their obligations under an acquisition agreement. Under such an interpretation, it might not be so problematic to leave the determination in the hands of the target directors: it should be difficult to argue that fiduciary duties require any specific course of conduct.

Unfortunately, the law of fiduciary duties is more complicated. In particular, there is the divergence between standards of conduct and standards of review which was introduced earlier.[123] The drafters of fiduciary outs may have the standards of review in mind. They may assume that, because directors generally will be found to have breached their fiduciary duties only upon a finding of gross negligence, unfair self-dealing, or intentional misconduct, they cannot be required to avoid their obligations pursuant to a fiduciary out except under such circumstances. This would mean that the fiduciary out would rarely be exercisable. Courts, however, focus on standards of conduct. Courts demand that directors act with due care, utmost loyalty, and good faith. Any failure to satisfy the standards amounts to a breach of fiduciary duty—even if, because of the divergence in corporate law, they will not be held liable for such breach.[124] When determining whether a fiduciary out is triggered, courts will consider what the standards of conduct require, rather than what will lead to liability under the standards of review. This means that the fiduciary out would be exercisable quite often. Thus, fiduciary outs will be interpreted more expansively than the drafters intended.

In a previous work, I have addressed the divergence and its implications.[125] I noted that many people are led to believe that fiduciary duty standards of conduct are merely aspirational, and that the "real law" is the corresponding standard of review.[126] This view leads to the awkward and untenable conclusion that fiduciary duties only require directors to avoid gross negligence, unfair self-dealing, and intentional misconduct; and that they do not require directors to avoid mere negligence, conflicts of interest, or lack of

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122 *See supra* note 98 and accompanying text.

123 *See supra* notes 61-74 and accompanying text.

124 *See* Velasco, *supra* note 63, at 550-52.

125 *Id. passim*.

126 *See id.* at 522.

good faith.[127] In fact, the law is embodied in fiduciary duty standards of conduct.[128] However, for prudential reasons, corporate law does not enforce standards of conduct. It does this to avoid excessive risk aversion on the part of directors, among other reasons. Nevertheless, standards of conduct are mandatory. Directors are required to act with due care, utmost loyalty, and good faith.[129]

Understanding this principle is necessary in order to understand the interpretation of a fiduciary out. While the actors may think that they are preserving the deference that comes from the standards of review, they are wrong. When the courts interpret fiduciary out clauses, they have standard of conduct in mind. What is necessary to avoid a breach of fiduciary duty is not the same as what is necessary to avoid liability for breach of fiduciary duty. Rather, to avoid a breach of fiduciary duty, directors must act with due care, utmost loyalty, and good faith. In other words, directors must use their business judgment to act in the interests of the shareholders.

This requirement has significant ramifications for the interpretation of fiduciary outs. In interpreting such provisions, courts do not focus on the bare minimum that is required of directors, as they do when they weigh whether to hold directors liable for damages.[130] Instead, they insist that directors make their own determinations about what the situation requires.[131] Fiduciary duties require directors always to act in the interests of the shareholders. Therefore, if they are able to escape an obligation that is not in the shareholders' interests, they must do so. Failure to exercise the fiduciary out would itself be a breach of fiduciary duty—even if the breach would not lead to liability.[132] Thus, their rights under the fiduciary out provision are automatically triggered. Although fiduciary outs are not technically a discretionary option, they are functionally indistinguishable from the acquirer's perspective. The target company can avoid the acquisition agreement if it becomes in the shareholders' interest to do so.

In fact, the implications go further. If directors have the right to avoid a transaction, then they likely have a duty to do so. Because personal liability is not an issue when injunctive relief is sought by the shareholders, the courts

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127 *See id.* at 524.

128 Eisenberg, *supra* note 61, at 467-68.

129 *See* Velasco, *supra* note 63, at 568-71.

130 *See* Brehm v. Eisner, 746 A.2d 244, 255-56 (Del. 2000).

131 *See, e.g.*, ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 106 (Del. Ch. 1999).

132 *See* Velasco, *supra* note 63, at 554 ("Under the mandatory view, a failure to comply with the standard of conduct also could be considered a breach of fiduciary duty. Unless there is also a failure to comply with the standard of review, however, the plaintiffs cannot establish a breach that would invoke judicial intervention."); *see also id.* at 552 ("If directors or officers who violate the standards of reasonableness and fairness sometimes escape liability because of a less demanding standard of review, it is not because they have acted properly, but because utilizing standards of review that were fully congruent with the relevant standards of conduct would impose greater costs than the costs of letting some persons who violated their standards of conduct escape liability." (quoting Eisenberg, *supra* note 61, at 467-68)).

may be less deferential and willing to require the directors to exercise the fiduciary out.[133]

Sometimes court interference actually can be expected. For example, under the *Revlon* doctrine, if the corporation is "for sale," then it is explicitly the duty of the directors to obtain the best value reasonably available.[134] Under such circumstances, it would be difficult for the target directors to justify standing by the original transaction whenever an objectively superior offer comes along. In such case, it can no longer be considered a discretionary option, but rather a mandatory one. And, although true *Revlon* situations are not as common as might be expected,[135] similar concerns animate judicial review with respect to any acquisition agreements.

This result is arguably unfair because it is so divergent from the intent of the drafters. The target directors have little ground to complain: although they may have hoped that the provision would be interpreted otherwise, they are bound to act in the interests the shareholders and have no basis to complain when the courts require them to do so. However, the acquirer is in a different situation. The acquirer owes no fiduciary duties to the target shareholders. The acquirer has the right to contract in its own interests and can develop expectation interests in those contracts. Thus, it seems unfair to force the acquirer to bear the burden of protecting target shareholders from their own directors. Nevertheless, this Article argues that the situation is not as unfair as it may seem.

B. *Specific Outs*

If a general fiduciary out would be interpreted as broadly as this Article claims, then it might be preferable for the acquirer to risk entering into an agreement without a fiduciary out.[136] A general fiduciary out would seem to do nothing to limit the discretion of directors. As long as the acquirer is confident that the entire acquisition agreement would not be struck down in its absence, a general fiduciary out provides the acquirer with no benefit.

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133 *Cf.* 2 JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 10.08, at 512-13 (2d ed. 2003) ("A charter provision shielding directors from liability for breaches of care may well encourage the courts to scrutinize directors' decisions more closely without fear that substituting the court's judgment for that of the directors will also visit a draconian remedy on an individual director.").

134 *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).

135 "*Revlon* duties do not arise simply because a company is 'in play.' The duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control." Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242 (Del. 2009) (footnote omitted); *see also* Paramount Commn'cs, Inc. v. QVC Network, Inc., 637 A.2d 34, 47 (Del. 1993) (discussing "two circumstances which may implicate *Revlon* duties"). In addition, an exculpation provision in a corporation's charter may limit the court's analysis to duty of loyalty issues. *See Lyondell*, 970 A.2d at 239.

136 Of course, the target directors may insist upon its inclusion.

In order to avoid the breadth of a general fiduciary out, the parties to acquisition agreements draft more narrowly tailored provisions. One important method is to add conditions to the exercisability of the fiduciary out. The main goal of such conditions, and other limits, is to constrain the discretion of the target directors so that the acquisition agreement is not simply an option contract. Directors should be able to escape their obligations under the acquisition agreement only if legally necessary. They should not be able to do so simply because they have changed their opinions on the advisability of the transaction.

One common condition to the exercise of a fiduciary out is that the target directors seek the advice of external counsel.[137] A strong version of this condition would require the directors to obtain a written opinion of counsel stating that a given course of action is necessary to avoid a breach of fiduciary duty.[138] The goal behind such a requirement is not entirely unreasonable. In order to ensure that the exercise of a fiduciary out is actually necessary, and not simply desired by the target directors, the acquirer requires support in the form of a written opinion of counsel. A lawyer could not simply rely on his gut feelings but would have to provide reasoned argument and put his reputation on the line. Of course, the acquirer's unstated hope is that the attorney will be unable to conclude that any specific course of action is required by fiduciary duties, and the fiduciary out would not be exercisable.

Unfortunately for acquirers, the Delaware Chancery Court has had problems with such conditions. In *ACE Ltd. v. Capital Re Corp.*,[139] then-Vice Chancellor Strine suggested that that a requirement that the directors obtain a written opinion of counsel before they invoke the fiduciary out would be unacceptable.[140] According to the court, "[such a] provision is . . . pernicious in that it involves an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely that time in the life of the company when the board's own judgment is most important."[141] In other words, directors not only must comply with their fiduciary duties, they also must exercise their own independent business judgment in doing so. This jealous guarding of the directors' fiduciary duties is a consistent theme in Delaware: as fiduciaries, the directors must manage the corporation for the benefit of the shareholders and cannot delegate this responsibility to others—not even

137 *See, e.g.*, MODEL MERGER AGREEMENT, *supra* note 83, §§ 4.4(a)(2), 4.6(c)(i)(D).

138 *See* 1 ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS § 14.05[A][3][a], at 14-128 to -130 (Supp. 2012).

139 747 A.2d 95 (Del. Ch. 1999).

140 *Id.* at 106 ("If § 6.3 of the Merger Agreement in fact required the Capital Re board to eschew even discussing another offer unless it received an opinion of counsel stating that such discussions were required, and if ACE demanded such a provision, it is likely that § 6.3 will ultimately be found invalid.").

141 *Id.*

to the shareholders themselves.[142] As a result, the ability of the acquirer to constrain the discretion of the target directors is limited.

A more moderate version of this condition might require only that the board "take[] into account the advice of its outside legal counsel" in making its good faith determination.[143] In light of the *ACE Ltd.* opinion, this type of condition has become far more common than the stricter alternative.[144] There is no inappropriate delegation of the director's fiduciary duties because directors retain the right to make the ultimate decision. Thus, the condition is likely valid. Of course, as a result, it is also not nearly as effective from the acquirer's position. There is a hope that the directors will act more soberly if they must consult with others than they might if they were to act on their own. However, whether this condition has any meaningful effect is unclear. After all, directors in this situation are almost certainly seeking advice from outside legal counsel regardless of any contractual requirement to do so.

Another common provision allows the fiduciary out to be invoked only if a superior offer is in play.[145] In principle, this is reasonable: it limits the operation of the fiduciary out to those situations that are the most important as a substantive matter and that seem to concern the courts the most. It would prevent the target directors from simply changing their minds on the merits of the transaction and using fiduciary duties as an excuse to avoid the contract.

However, there may be problems with this type of fiduciary out as well. The acquisition agreement defines what will constitute a superior offer. Any offer that does not meet the specific requirements will not provide a basis for invoking the fiduciary out. It is possible for the acquirer to make a superior offer that does not meet the contractual definition of a "superior offer." Fiduciary duties could require the directors to consider the offer. If so, any provision that does not permit them to do so will likely be invalidated by the courts.[146] Of course, if the definition of superior offer is broad enough, there may be no such problem. However, a broad definition also does less to limit the discretion of directors than a narrower definition would. Thus, the acquirer must balance its desire to cabin the discretion of the target directors against the possibility that the courts will find their efforts to be excessive.

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142 Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) ("Directors may not delegate duties which lie 'at the heart of the management of the corporation.'" (quoting Chapin v. Benwood Found., Inc., 402 A.2d 1205, 1210 (Del. Ch. 1979))); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1989) ("The fiduciary duty to manage a corporate enterprise . . . may not be delegated to the stockholders.").

143 MODEL MERGER AGREEMENT, *supra* note 83, § 4.4(a)(2), at 149.

144 *See* FLEISCHER & SUSSMAN, *supra* note 138, § 14.05[A][3][a], at 14-128 to -130.

145 *See, e.g.*, MODEL MERGER AGREEMENT, *supra* note 83, § 4.4(a), at 148-49 (referring to disclosures and discussions "in response to an Acquisition Proposal that is, or is reasonably likely to result in, a Superior Proposal"); *see also id.* § 4.6(c)(i)(A), at 170 (referencing "an unsolicited, bona fide, written offer to effect a transaction of the type referred to in the definition of the term Superior Proposal").

146 *See supra* notes 93 and accompanying text.

One other provision can help put fiduciary outs in perspective. Acquisition agreements often have a "force the vote" provision that requires the directors to submit the agreement for a shareholder vote even if they should change their minds as to the advisability of the transaction. Such a provision is legal under Delaware law.[147] However, sometimes the agreement goes further and requires the target board of directors to recommend the transaction to the shareholders.[148] This requirement is much more problematic.

In order to comply with their duty of good faith, directors must be honest with shareholders.[149] If they no longer believe that a transaction is in the interest of the shareholders, they cannot lie to the shareholders by suggesting otherwise.[150] In addition to violating their fiduciary duties, such a lie would also violate the federal securities laws.[151] Any such contractual obligation is certain to be invalidated.[152] A broad fiduciary out could save the agreement, because it would allow the directors to speak the truth. However, a narrow fiduciary out that would only allow the directors to speak the truth under certain circumstances would not be helpful. If at any point the directors are not free to speak truthfully to the shareholders, there will be a fiduciary duty problem and the agreement risks invalidation.

It seems difficult to escape the conclusion that such conditions on the exercise of a fiduciary out are of limited legal value. As the law stands, an acquisition agreement cannot require directors to breach their fiduciary duties.[153] Any time a condition limits the ability of directors to invoke a fiduciary out, it risks being invalidated by the courts. To be sure, a reasonable condition is less likely to run into problems than a more demanding condition. But this is only because it does less. The fact remains that any restrictions on

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147 *See* DEL. CODE ANN. tit. 8, § 146 (2011).

148 FLEISCHER & SUSSMAN, *supra* note 138, § 14.05[A][3][b], at 14-136 ("Merger agreements commonly contain covenants requiring the target board of directors (and in a transaction requiring a vote of the shareholders of the acquiror, the board of the acquiror) to recommend that stockholders approve a transaction.").

149 *See* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("[W]hen directors communicate publicly or directly with shareholders about corporate matters, the *sine qua non* of directors' fiduciary duty to shareholders is honesty.").

150 *See* FLEISCHER & SUSSMAN, *supra* note 138, § 14.05[A], at 14-132 to -133 ("[A] merger agreement cannot limit the exercise of a board's fiduciary duties to review the transaction and make a recommendation that is consistent with these duties." (citing Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *102 (Del. Ch. Apr. 29, 2005))); *see also id.* at 14-133 n.370.

151 *See* 17 C.F.R. § 240.14a-9 (2012) (prohibiting use of false or misleading statements in connection with proxy solicitation).

152 *See* FLEISCHER & SUSSMAN, *supra* note 138, § 14.05[A][3][b], at 14-136 to -137 ("Any contractual obligation to recommend a transaction that does not allow a board to withdraw its recommendation if the board no longer believes the transaction is in the best interests of its stockholders may well be invalid."); Allen, *supra* note 1, at 658 ("Obviously, recommendation of a transaction that one in fact no longer believes is in the shareholders' best interest is deeply problematic. Thus, any provision that commits the board to recommend the deal at a future time must be accompanied by a fiduciary out clause.").

153 *See* FLEISCHER & SUSSMAN, *supra* note 138, § 14.05[A], at 14-132 to -133.

a fiduciary out are likely to be held invalid exactly when they are most valuable to the acquirer. If so, such provisions are of limited legal significance: they provide only the illusion of protection to acquirers. When push comes to shove, they are no better than a general fiduciary out.

That said, it is not necessarily the case that reasonable conditions on the exercise of a fiduciary out are entirely worthless. For example, if target directors believe them to be valid, the belief may lead them to conclude that compliance with the agreement would not lead to a breach of fiduciary duty. Moreover, it is possible that following procedures specified in the agreement could lead directors to conclude, in good faith, that they can stick with the original deal. It is also quite possible, at least in a marginal case, that a court could come to a different conclusion in the presence of a reasonable condition than it would in its absence. Thus, even if a provision has no legal value as a theoretical matter, it can be quite valuable as a practical matter.

It is also worth noting that some types of conditions are less likely to be problematic. Conditions that prevent the exercise of a fiduciary out are more likely to cause problems than those that require additional behavior upon its exercise. For example, it is common for acquisition agreements to provide that the target directors can exercise a fiduciary out and negotiate with a third party only if they keep the acquirer fully informed regarding such negotiations and grant to the acquirer a right of first refusal over the third party's final offer.[154] There is nothing inherently problematic about requirements such as these. Although fiduciary duties might require exploration in the face of a superior offer, they are unlikely to forbid the sharing of information or dictate which of two identical offers must be accepted. Thus, this type of condition can provide a clear benefit to the acquirer.

Of course, such provisions would not be entirely safe from legal challenge. Any provision could be structured in such an onerous way as to render it legally problematic. Nevertheless, there is a significant difference between the two types of conditions. This second type operates ex post rather than ex ante and is less of a condition on the exercise of a fiduciary out and more of a new covenant imposed upon the exercise of a fiduciary out. It may be better analyzed as a deal protection device (that itself might need to be subject to a fiduciary out) than as part of the fiduciary out. However, the difference is not especially important because, either way, the provision is likely to be invalid if it would require the target directors to breach their fiduciary duties.

In short, ex ante conditions on the exercise of a fiduciary out are of limited legal value. To the extent they would require directors to breach their fiduciary duties, such provisions are likely to be invalidated. To the extent they are worded to avoid such outcome, they are doing little work and begin to resemble a general fiduciary out. And although the invalidation of a condition to the exercise of a fiduciary out may seem unlikely, it is precisely

154 *See* MODEL MERGER AGREEMENT, *supra* note 83, §§ 4.4(a)(3)-(4), 4.4(b) (discussing the sharing of information); *id.* § 4.6(c)(i)(E)-(F) (discussing the right of first refusal).

when the protection of such provisions is most needed that they are most likely to cause problems.

C. *How Fiduciary Outs Should Be Interpreted*

How should a fiduciary out be interpreted? It should be interpreted consistent with its purpose. As previously discussed, fiduciary outs are contractual proxies for fiduciary duties.[155] Thus, fiduciary outs should be interpreted consistently with fiduciary duties.

The purpose of fiduciary duties is to protect shareholders from abuse at the hands of directors. As previously discussed, they are not about protecting shareholders from bad deals, nor are they about protecting shareholders from third parties.[156] It is the directors who are supposed to protect shareholders from bad deals and third parties, and when they fail to do so, the court may have to intervene. But, fundamentally, the sole purpose of fiduciary duties, and derivatively of fiduciary outs, is to protect shareholders from directors.

It is problematic, then, that one of the main effects of a fiduciary out is to protect shareholders from bad deals with third parties—the acquirers. Since the acquirer owes no fiduciary duties to target shareholders, it is not at all clear that they should be the ones to bear the burden of protecting shareholders from directors. If fiduciary outs are to withstand scrutiny, they require further justification.

To develop a justification, let us first consider a typical contract. Assume that the target is the purchaser under a sales contract, and the contract provides that the target directors may escape their obligations under the contract if necessary in order to avoid a breach of fiduciary duty. In such a case, it is difficult to imagine that the fiduciary out could ever be triggered because it is simply not a breach to comply with a legitimate contract. Although circumstances may change (e.g., market prices may fall or rise) such that it would be nice for the shareholders to get out of the contract, the corporation would still be bound by it. At least, I am unaware of any case to the contrary. A contrary rule would seriously undermine commercial law, for it would be implicated in very many cases.

The only way that a court could come to a different result would be if it interpreted the fiduciary out as itself creating an option on the part of a corporation.[157] If the corporation had an option to avoid the contract, then the

155 *See supra* note 112 and accompanying text.

156 *See supra* note 37 and accompanying text.

157 A second theoretical possibility would be if the directors had a fiduciary duty to breach a contract in situations amounting to an efficient breach. In that case, the fiduciary out clause could have the effect of eliminating the need to pay damages for the efficient breach—because once the directors have a fiduciary duty to avoid the transaction, they also have a contractual right to do so. However, the courts have not held that directors have a fiduciary duty to commit efficient breaches of contract.

directors arguably would have a fiduciary duty to exercise that right in appropriate circumstances. However, it is clearly not the intention of the parties to a fiduciary out provision to create an option contract.[158]

Ultimately, the possibility of accidentally creating an option is a mere distraction that can be eliminated by simple drafting. A fiduciary out provision can provide that it shall not be deemed to create any sort of option and that it is triggered only by a breach of a fiduciary duty that would exist in the absence of the fiduciary out.[159] In this case, and likely even without such a proviso, there would be no breach of fiduciary duty in complying with the contract, and thus no right to invoke the fiduciary out. From here on, this Article assumes that fiduciary outs are either so drafted or interpreted as if they were.

The limited effect of a fiduciary out in a typical contract flows logically from the nature of fiduciary duties. Their sole purpose is to protect beneficiaries from fiduciaries. A fiduciary cannot be required to do any more than his best. To the extent that a fiduciary has discretion, it is possible for him to abuse that discretion. To the extent that a fiduciary does not have discretion, however, it is impossible for him to breach his fiduciary duties.[160] If circumstances have changed, it might be desirable for the directors to be able to avoid a contract or lease—but they have no right to do so. Thus, there is no breach of fiduciary duty.

The same logic could be applied to an acquisition agreement. The mere fact that it would be in the best interest of the shareholders to avoid the agreement should not give the target directors the right to do so. In other words, it should not be a breach of fiduciary duty to comply with an acquisition agreement solely because it would be in the best interests of the shareholders not to do so. Thus, fiduciary outs are inherently problematic. If they are contractual proxies for fiduciary duties, they should be interpreted consistently therewith. Fiduciary duties do not allow directors to avoid ordinary contracts simply because they are no longer in the shareholders' interests. If the typical fiduciary out is to be justifiable, then it must be distinguished from other contracts in a meaningful way. Fortunately, as we will see in the next Part, there is such a distinguishing rationale.

IV. THE M&A CONTEXT

As discussed in the previous Section, a fiduciary out is inherently problematic. It allows one party to get out of the agreement while binding the other party to remain, making the acquisition agreement, in a very real sense,

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158 *See supra* notes 93-97 and accompanying text.

159 For the sake of argument, we could assume that the fiduciary out also provides that it shall not have any application with respect to an efficient breach.

160 *But see* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238-39 (Del. 2008).

an option on the part of the target company. From the perspective of the acquirer, this seems unfair.

Nevertheless, it is defensible. This Part explores the justification for fiduciary outs. Section A considers the arguments in favor of fiduciary outs in merger agreements. Section B explores the limits of those arguments using the *Omnicare* case as an example.[161] It concludes that, although the *Omnicare* case is highly controversial, it may have been correctly decided given the special context of a merger agreement.

A. *Mergers and Fiduciary Outs*

1. Justification

There is a longstanding principle of equity that fiduciaries cannot enter into contracts that would require them to breach their fiduciary duties. As the Delaware Supreme Court has put it, "[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of its fiduciary duties, it is invalid and unenforceable."[162] This is the rule that courts rely upon to strike down deal protection devices and, derivatively, the rule that underlies the use of fiduciary outs. Therefore, it is important to understand what the rule does and does not mean. Applying this rule is not a simple proposition because an overly broad interpretation could undermine nearly all business contracts.

How far should this principle extend? Certainly, directors should not be permitted to enter into contracts with the purpose of breaching fiduciary duties. This is a safe interpretation because most contracts cannot be characterized in this way. Beyond this point, things get complicated. Surely it would be problematic to forbid contracts that might require conduct that, if freely undertaken in the absence of contractual obligation, would be considered a breach of the fiduciary duty. For example, paying a higher-than-market price is problematic if freely undertaken on an open market, but fine if done pursuant to a pre-existing, long-term contract. Because almost any contract could cause problems under such an interpretation, it goes too far. The appropriate limits lie somewhere between these points.

Given the nature of fiduciary duties, which exist to protect shareholders from abuse at the hands of directors and not to ensure good results,[163] the appropriate interpretation should not be based upon the merits of the transaction or the consequences that result. Thus, it should not be a breach of fiduciary duty to comply with a contract that turns out to be suboptimal. If every

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161 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

162 Paramount Commn'cs Inc. v. QVC Network Inc., 637 A.2d 34, 51 (Del. 1993) (citing Wilmington Trust v. Coulter, 200 A.2d 441, 452-54); *see also CA*, 953 A.2d at 238-40 (noting cases that invalidated contracts limiting directors' exercise of fiduciary duties).

163 *See supra* notes 35-37 and accompanying text.

contract that turns out to be suboptimal for the corporation were to be subject to a fiduciary out or otherwise unenforceable, contracting would become impossible. With perfect hindsight, a better course of action was almost always available. Similarly, it should not be a breach of fiduciary duty to enter into a contract that forecloses the possibility of a better deal in the future. Again, very many contracts do that.[164]

Consistent with the nature of fiduciary duties, the appropriate interpretation for the rule must be based on the directors' conduct—including their future conduct. Thus, directors should not be able to enter into contracts that could be expected to lead to a breach of fiduciary duty. It is clearly problematic for directors to enter into contracts that they know will actually require them to breach their fiduciary duties. However, from the perspective of equity, it is equally problematic for directors to enter into contracts that *may* require them to breach their fiduciary duties. For example, directors have a duty of candor to speak truthfully to the shareholders.[165] Although they do not always have an affirmative duty to speak, they cannot lie when they do.[166] Thus, directors should not be permitted to enter into an agreement that could ever require them to lie to their shareholders. Doing so should amount to an agreement to breach their fiduciary duties, and complying with such an agreement certainly would. This behavior is precisely what the rule should seek to prohibit.

Although it may not be a breach of fiduciary duty for directors to comply with a valid obligation, a breach may be found in entering into the agreement in the first place. Directors should not be able to prevent themselves from complying with their fiduciary duties in the future, so it should be a breach of their fiduciary duties for directors to enter into a contract that presents a sufficient risk of doing so. Moreover, if it is a breach to enter into the agreement, then the contract is not a valid obligation, and attempting to comply with it in may also be a breach.[167]

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164 *See* Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. 1996) ("[B]usiness decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action. A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another. This is an inevitable fact of life and is not an abdication of directorial duty."), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000); Jewel Cos. v. Pay Less Drug Stores Nw., Inc., 741 F.2d 1555, 1564 (9th Cir. 1984) ("[A]ll contracts are formed at a single point in time and are based on the information available at that moment. The pursuit of competitive advantage has never been recognized at law as a sufficient reason to render void, or voidable, an otherwise valid contract.").

165 *See supra* note 149 and accompanying text.

166 *See* Gantler v. Stephens, 965 A.2d 695, 710-11 (Del. 2009); Emerald Partners v. Berlin, 726 A.2d 1215, 1223 (Del. 1999).

167 Whether there is a second breach depends upon whether, at the time in question, the actions taken in compliance with the agreement amount to a breach.

With this interpretation in mind, we can now proceed to distinguish acquisition agreements from most other contracts. Perhaps the most significant difference between the two classes of contracts is the role of the shareholders. Under corporate law, directors manage the business.[168] Shareholders have no say in ordinary business decisions. However, for certain fundamental transactions, shareholders do have a say. For example, in order for a merger agreement to become effective, it must be approved by the directors and the shareholders of both corporations.[169] The same is true for a sale of substantially all of a corporation's assets.[170] Although a tender offer does not require a shareholder vote at the corporate level, it does require the voluntary act of shareholders tendering their shares, which is similar to a vote in many respects. Although shareholders do not get to vote on most contracts, they do have the right to vote—or at least a say—on most acquisition agreements.[171]

The courts have recognized that "the stockholder franchise has been characterized as 'ideological underpinning' upon which the legitimacy of the directors [sic] managerial power rests."[172] "Because of the overriding importance of voting rights, [the courts] have consistently acted to protect stockholders from unwarranted interference with such rights."[173] Thus, directors have a duty to respect the shareholder right to vote. In their zeal for a particular transaction, directors may not be as respectful as they should be. If so, judicial intervention may be necessary.

As a general matter, the courts have indicated a willingness to enjoin director action if shareholders can prove that directors acted for the primary purpose of thwarting a shareholder vote.[174] This is a high bar, and it is a difficult test for shareholders to pass.[175] However, it must be understood in context. This test is a standard of review rather than the standard of conduct. The standard of conduct may be that directors should not purposefully interfere with shareholder voting. Because of the presumption of the business judg-

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168 DEL. CODE ANN. tit. 8, § 141(a) (2011).

169 *Id.* § 251(c).

170 *See supra* note 109 and accompanying text.

171 However, shareholders do not have a say on all acquisitions. For example, the acquirer's shareholders do not necessarily have a vote on an asset purchase. *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1148 (Del. 1989) (merger was restructured into asset purchase to avoid shareholder vote). Similarly, in a triangular merger, a vote of the shareholders can be avoided for one of the two corporations (usually, but not necessarily, the acquirer). *See* BLACK'S LAW DICTIONARY 1079 (9th ed. 2009) (defining triangular merger).

172 MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1126 (Del. 2003) (quoting Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988)).

173 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 & n.11 (Del. 1993) (citing cases).

174 *Blasius Indus.*, 564 A.2d at 661-62.

175 *See MM Cos.*, 813 A.2d at 1130; Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996).

ment rule, the duty may not be enforced very strictly in many circumstances.[176] However, in the context of a business combination, less deference may be appropriate.[177] In any event, my purpose here is not to propose reconsideration of the *Blasius* standard, but rather to provide a justification for fiduciary outs in acquisition agreements.

It would be inconsistent with their fiduciary duties for directors to interfere with a shareholder vote. Thus, for directors to enter into an agreement with deal protection devices that they know could interfere with a shareholder vote would implicate their fiduciary duties.[178] Why would directors agree to provisions that might impinge upon the shareholder vote? There might be many reasons. At the most basic level, they might honestly believe that this is the best transaction for the shareholders. However, they might too easily believe that the transaction that is preferred by them or by the officers is objectively superior. Another reason, inconsistent with their duty of loyalty, is that they might have negotiated a deal that is best for them, as opposed to for the shareholders. Whatever the reason, it is inappropriate for the directors to restrict the legal right of the shareholders to vote against the transaction if they desire.[179] A fiduciary out can help to ensure that no contractual provision ends up having this effect.

Whether deal protection devices would lead to a finding of a breach of fiduciary duties in any particular case—under the *Blasius* principle or otherwise[180]—may not be entirely clear for the reasons discussed above. However, the existence of the fiduciary out changes the calculus in the shareholders' favor. The directors are permitted—and therefore required—to avoid an obligation if it would lead to a breach of fiduciary duty. Even conduct that might not lead to a judicial finding of a breach of fiduciary duty (under the deferential standard of review) could still amount to a breach of fiduciary duty (under the more demanding standard of conduct).[181] Interfering with the shareholder vote is a perfect example. If a deal protection device interferes with the shareholder right to vote, it amounts to a breach of fiduciary duty under the standard of conduct which can serve as the basis for an exercise of the fiduciary out. Thus, protecting the shareholder right to vote could form the basis for an exercise of the fiduciary out.

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176 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) *modified*, 636 A.2d 956 (Del. 1994).

177 *See supra* note 3 and accompanying text.

178 *See supra* note 111 and accompanying text.

179 *See supra* note 172 and accompanying text.

180 *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985).

181 *See* Velasco, *supra* note 63, at 550-51.

This principle is one of the key purposes of the fiduciary out: to protect the shareholder right to vote on the underlying transaction.[182] Although fiduciary outs are inherently problematic, they are justified in the limited context of acquisitions because they protect the shareholder right to vote against the agreement, which is a concern that is not present with respect to other contracts.[183] Importantly, this justification is consistent with the purposes of fiduciary duties generally. Fiduciary outs, like fiduciary duties, exist to protect shareholders from directors. The ability of the corporation to avoid certain obligations under an acquisition agreement—and the corresponding obligation of the directors to do so—is necessary to protect the shareholder right to vote against the transaction from interference by the directors.

Any effect on the acquirer is entirely incidental. Although this conclusion may not be very comforting to the acquirer, there are two important reasons why their complaints do not carry much weight. The first is that there is not yet a binding agreement. While a sales contract or lease becomes a valid and binding obligation the moment it is executed by the officers or directors of the corporation, acquisition agreements generally do not. Shareholder approval is often required.[184] Thus, until such approval is obtained, the acquirer's expectation interest is attenuated.

The second reason that acquirers are less sympathetic is that they do not exactly have clean hands. The acquirer negotiated the agreement with the target directors. It likely demanded the deal protection devices in order to lock up the transaction against any risks—including shareholder rejection. It did so in full knowledge of the fact that the shareholders have a legal right to vote on the transaction and that the target directors have a fiduciary duty to protect this right. Thus, the acquirer may be considered complicit in any breach of fiduciary duty by the target directors.[185] Although the acquirer itself does not have any fiduciary duty toward the target shareholders, neither does it have the right to circumvent the legal requirements for the transaction it desires.

Although the concept of a fiduciary out is generally problematic, it is not nearly as problematic in the context of an acquisition agreement. The

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182 *Cf.* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 109 (Del. Ch. 1999) ("[F]iduciary responsibilities are of special importance in situations where a board is entering into a transaction as significant as a merger affecting stockholder ownership rights. For that (sometimes unspoken) reason, our law has subordinated the contract rights of third party suitors to stockholders' interests in not being improperly subjected to a fundamental corporate transaction as a result of a fiduciary breach by their board.").

183 *See supra* note 109 and accompanying text. Most corporate contracts do not require shareholder approval. DEL. CODE ANN. tit. 8, § 141(a) (2011).

184 *See supra* note 109 and accompanying text.

185 *Cf.* Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1993) ("Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable features of the . . . Agreement. It cannot be now heard to argue that it obtained vested contract rights by negotiating and obtaining contractual provisions from a board acting in violation of its fiduciary duties.").

acquirer has both a diminished expectation interest and increased culpability. Moreover, the effect on them is incidental rather than intended. The real purpose is, as it should be, to protect the shareholders from directors.

2. Professor Regan's Factors

In an insightful article written over a decade ago, Professor Paul Regan addressed the issue of how courts should deal with preclusive lockups in acquisition agreements.[186] He stressed the need to balance the interests of shareholders in the fiduciary relationship with directors, on the one hand, against the expectation interests of the acquirer in the underlying contract.[187] He developed a four-factor test to aid the courts in doing so.[188] This test has caught the Delaware Court of Chancery's attention and was employed by Chancellor Strine (then vice chancellor) in an important opinion.[189] Regan's analysis therefore deserves attention. Because fiduciary outs are simply a contractual proxy for fiduciary duties, it is quite possible that Regan's test could be helpful in interpreting fiduciary out provisions.

Regan summarized his four-factor test as follows:

> In determining whether a corporate acquirer 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.[190]

At first glance, these four factors seem eminently sensible.[191] However, the test presupposes that balancing the competing interests is the proper approach. This is not necessarily the case. Because fiduciary duties are intended to protect shareholders from the directors and not third parties,[192] arguably there should be a strong presumption in favor of enforceability of contracts negotiated with third parties at arm's length. On the other hand, because ac-

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186 Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups*, 21 CARDOZO L. REV. 1 (1999).

187 *Id.* at 115.

188 *See id.* at 8-9.

189 *See* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 105-06 (Del. Ch. 1999).

190 *See* Regan, *supra* note 186, at 102.

191 It is worth noting, however, that Strine only considered three of the four factors. He gave no reasons for not considering the fourth. *See ACE*, 747 A.2d at 106.

192 *See supra* notes 35-37 and accompanying text.

quisition agreements are fundamentally different than other types of contracts in that they require shareholder approval[193] and generally involve the "omnipresent specter" of action against the interests of shareholders,[194] there is a strong argument for allowing fiduciary duties to trump contractual expectations. Thus, rather than a straightforward balancing, the better approach might be to presume the validity of most contracts but to give a strong preference to fiduciary duties with respect to acquisition agreements.

In any event, the factors Professor Regan suggested are not as useful as they seem. They are more helpful in distinguishing acquisition agreements from other contracts than they are in helping to distinguish among different provisions in acquisition agreements. Fiduciary outs are found almost exclusively in acquisition agreements. Thus, the test is not very helpful.

Let us consider the four factors individually. The first factor is "whether the acquirer knew, or should have known, of the target board's breach of fiduciary duty."[195] It is often impossible to say with any confidence that the acquirer knows or should know of a breach. I say this not because fiduciary duties are indeterminate;[196] I have argued that they are not.[197] Rather, because the parties to acquisition agreements tend to push the boundaries of acceptability while avoiding conduct that is known to be unacceptable, the law is inevitably unclear. It is generally impossible to *know* that there has been a breach of fiduciary duty. At most, it could be said that the acquirer should know that there *might* be a breach of fiduciary duty. If that is the test, however, it will be satisfied in almost every case—or, at least, every interesting case. Thus, the first factor does very little to distinguish legitimate lockups or fiduciary outs from illegitimate ones.

The second factor is "whether the change of control transaction remains pending or is already consummated at the time that judicial intervention is sought."[198] In the vast majority of cases, the legal battle is fought at the injunction stage. No doubt, this is a testament to the importance of this factor. However, it also means that this factor adds very little to the analysis.

The third factor suggested by Regan is "whether the board's violation of fiduciary duty relates to policy concerns that are especially significant."[199] This factor is better suited to distinguishing acquisition agreements from other types of contracts. Acquisition agreements generally relate to policy concerns that are especially significant.[200] However, this factor provides little guidance in distinguishing among different acquisition agreements.

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193 *See supra* notes 109, 183 and accompanying text.

194 *See supra* note 3 and accompanying text.

195 Regan, *supra* note 186, at 102-04.

196 *See, e.g.*, Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1932-33 (1998).

197 *See* Velasco, *supra* note 63, at 544-46.

198 Regan, *supra* note 186, at 102, 104-06.

199 *Id.* at 102, 106-07.

200 *See infra* note 232 and accompanying text.

Regan's final factor is "whether the acquirer's reliance interest under the challenged agreement merits protection in the event a court were to declare the agreement unenforceable."[201] The idea, it seems, is that the acquirer, as an innocent third party, should not necessarily be left empty-handed. Although this concern is a legitimate one, the relevant issues can be addressed in other ways. One example is the use of a termination fee. As mentioned earlier, one effect of a fiduciary out provision is to allow portions of the acquisition agreement—such as a termination fee—to survive even when the underlying transaction does not.[202] The termination fee acts as a form of liquidated damages provision that compensates the acquirer for its losses if the transaction is not consummated.[203] Thus, it ensures that the acquirer does not go away empty-handed upon the exercise of a fiduciary out. This result seems to be satisfactory to Regan.[204]

Moreover, the acquirer is in a weaker position than most parties to a contract. First, the acquisition agreement is not a binding contract until it is ratified by the shareholders; thus, the acquirer's expectation interest is attenuated. Second, it may not be so innocent: the acquirer could be interpreted to be a co-conspirator in the target board's breach of fiduciary duty.[205] Thus, it is conceivable that the acquirer should go away empty-handed. In fact, it is possible that the termination fee itself could be part of an attempt to lock up the transaction.[206] If so, it should not be upheld.

As a result, Regan's fourth factor adds little to the analysis. Courts need not worry about acquirers because they can protect themselves with a simple termination fee. Rather than worrying about the acquirer, the courts should focus on whether the shareholders are being harmed by the target directors.

The weakness of Regan's analysis in distinguishing among legitimate acquisition agreements can be seen in the example that Regan offers to illustrate an application of the test. He applies the test to the facts of *Paramount Communications, Inc. v. QVC Network, Inc*.[207] However, his application is deficient.

Briefly, the facts of the *QVC* case are as follows.[208] Paramount had been searching for a strategic partner with which to merge.[209] Prior to this case, Paramount had failed in its effort to acquire Time, Inc.[210] Time had proposed a strategic merger with Warner Bros., and Paramount sought to interrupt the

201 Regan, *supra* note 186, at 102, 107-11.
202 *See supra* notes 94-96 and accompanying text.
203 *See supra* note 95.
204 *See* Regan, *supra* note 186, at 113-14.
205 *See supra* notes 184-85 and accompanying text.
206 *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).
207 637 A.2d 34 (Del. 1994).
208 *See generally id.* at 37-41.
209 *Id.* at 38.
210 *Id.*

transaction with a superior offer.[211] In order to protect the original deal, Time and Warner restructured the transaction so as to avoid a shareholder vote.[212] However, the Warner transaction never offered the Time shareholders consideration superior to that offered by Paramount.[213] Nevertheless, in *Paramount Communications, Inc. v. Time Inc.*,[214] the court upheld the Time-Warner transaction as part of a long-term strategic plan.[215] Many interpreted the court's opinion as holding that a "just say no" strategy—in which a corporation could simply reject an unsolicited offer without offering shareholders a superior alternative—would be legally viable.[216] Thereafter, Paramount turned its attention to Viacom.[217] It negotiated a strategic merger with Viacom and implemented deal protection devices to lock up that transaction.[218] QVC stepped in and offered superior consideration for Paramount.[219] In the end, Paramount's deal protection devices were struck down.[220] The court extended the *Revlon* doctrine to hold that, whenever there is a sale of corporate control, the directors have a duty to obtain the best price reasonably available.[221] Paramount was "for sale" because Viacom's majority shareholder would become a majority shareholder of the combined company.[222] Time, on the other hand, was held not to be up for sale because there would not be a controlling shareholder.[223]

For the first factor, Regan suggests that Paramount should have known there was a breach of fiduciary duty with respect to the lockup.[224] However, this is unfair. After the decision in *Time*, it seemed reasonable to assume that a board of directors could "just say no" to a hostile bidder in order to implement a long-term strategic plan.[225] This is exactly what Paramount was trying

211 Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1147 (Del. 1989).

212 *Id.* at 1148.

213 *Id.*

214 571 A.2d 1140 (Del. 1989).

215 *Id.* at 1154-55.

216 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 41 (Del. 1993).

217 *Id.* at 38.

218 *Id.* at 39.

219 *Id.* at 40.

220 *Id.* at 51.

221 *Id.* at 44.

222 *QVC*, 637 A.2d at 43.

223 *Id.* at 47.

224 *See* Regan, *supra* note 186, at 112.

225 *See* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 849 (2006) ("[M]any commentators concluded *Time* validated the so-called 'just say no' defense, pursuant to which the target's board simply refuses to allow the firm to be acquired, and backs up that refusal by a poison pill or other takeover defenses."); *see also* Leo E. Strine, Jr., *The Professional Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863, 876 (2002) ("[T]he *Time-Warner* and *Unitrin* opinions provided rhetorical support for the idea that corporate directors could block a bid simply because they

to do. The *QVC* court asserted that "Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable features of the Stock Option Agreement."[226] If by this the court meant that Viacom knew or should have known that the features in question would be considered unreasonable by the courts, then the court is wrong. The *QVC* opinion marked a change in direction on the part of the Delaware courts.[227] Although the *QVC* and *Revlon* opinions can be (and were) harmonized ex post, it would not have been easy to do this from an ex ante perspective. Thus, it cannot be said that Paramount knew or should have known that it was breaching its fiduciary duties. The most that could be said is that Paramount knew that there was a *risk* that the courts would conclude that it had breached its fiduciary duties. But that is always true in the acquisition context.

With respect to the remaining points, Regan's analysis is fine but unhelpful. He points out that the second factor would allow for judicial intervention because the transaction was not yet complete.[228] This is typically the case in acquisition litigation. For his third factor, Regan claims that there was an "especially strong public policy concern" because "Viacom bargained with notice of the special risks attending heightened judicial scrutiny of such transactions."[229] In other words, as with the second factor, this factor will generally be present in acquisitions. As for his fourth factor, Regan seems satisfied that the survival of the negotiated termination fee adequately protected Viacom's interests.[230]

In short, Regan's illustration of the application of his test reaffirms the view that it is not especially helpful. Although the four factors are insightful in distinguishing acquisitions from other contracts, they are not helpful in distinguishing among acquisition agreements and fiduciary outs.

3. Policy Justification

There are additional policy reasons why a fiduciary out makes sense in the special context of an acquisition agreement. This Section briefly surveys those reasons.

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believed that the stockholders (although well-informed) might accept it, rather than follow the board's more expert, negative view of the matter.").

226 *QVC*, 637 A.2d at 51.

227 *See, e.g.*, Thomas A. Gentile, *Refining the* Revlon *Doctrine's Applicability to Changes of Control:* Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1993)*, 17 HARV. J.L. & PUB. POL'Y 895, 895, 903 (1994) ("Prior to *QVC Network* many observers had posited that the Court's decision in *Time* had limited the universe of *Revlon*-triggering circumstances to include only the inevitable dissolution of a corporate entity.").

228 *See* Regan, *supra* note 186, at 112.

229 *Id.*

230 *See id.* at 113.

First, the stakes in an acquisition agreement are higher than in most other contracts. As the U.S. Supreme Court stated in *Basic v. Levinson*,[231] "[A] merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death . . . ."[232] Although it is possible for another type of contract to be more significant, as a quantitative matter, than an acquisition agreement, no other class of contracts is as important on a qualitative scale. It might make sense to allow fiduciary outs because of the significance of acquisition agreements.

Moreover, acquisition agreements generally involve final period problems.[233] Thus, corporate management is significantly less trustworthy in this context than in other situations. This suggests that courts should be less deferential when reviewing corporate action for breach of fiduciary duty in such circumstances.

One final policy consideration that weighs in favor of fiduciary outs in acquisition agreements is the result that follows. Fiduciary outs tend to allow target companies out of a transaction if a superior offer comes along. This rule encourages interested third parties to make superior offers. The result is an auction of the target company—or at least a market test.[234] An auction or market test is beneficial because it is one of the best ways to ensure that shareholders are getting the best value reasonably available. Courts were unwilling to require an auction because, in theory, there may be other ways to secure the best value.[235] However, some academics might prefer to require an auction.[236] To them, it seems imprudent to defer to directors who may be conflicted and are, at least, structurally biased.[237] An auction is an objective way to be confident of the value of the target company. Although directors, in their discretion, may be free to choose another path, shareholders also have a say in such transactions. Shareholders can be expected to prefer an auction or market test. The fiduciary out effectively gives this option to them. The result is a situation in which we can be comfortable that the shareholders have received the best value reasonably available. Although this result is not the primary goal of fiduciary duties, it is nevertheless an affirmative good. Moreover, as previously discussed, the fiduciary out is aimed at ensuring that the

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231 485 U.S. 224 (1988).

232 *Id.* at 238 (quoting SEC v. Geon Indus., Inc., 531 F.2d 39, 47 (2d Cir. 1976)) (internal quotation marks omitted).

233 *See generally* Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899 (2003).

234 For purposes of this Article, I do not distinguish between the two. I distinguish between broad attempts to secure the best price available on the one hand and attempts to negotiate with one or a few parties toward a better price on the other. Although there were only two parties in this case, the facts qualify for the former category: efforts were made to find additional bidders, but none could be found.

235 *See supra* note 115 and accompanying text.

236 *See, e.g.*, Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1050 (1982) ("[A] rule of auctioneering has significant benefits.").

237 *See supra* note 3 and accompanying text.

shareholders are not abused by their directors who, by not seeking an auction or market test, may have been derelict in their fiduciary duties.

Although fiduciary outs are inherently problematic (and indefensible when applied to most contracts), they may nevertheless be appropriate (or at least acceptable) in the special context of an acquisition agreement. However, even in the context of an acquisition agreement, fiduciary outs must be assessed carefully. The next Section illustrates the potential difficulties.

B. *The* Omnicare *Decision*

One of the most important cases dealing with fiduciary outs is *Omnicare, Inc. v. NCS Healthcare, Inc.*[238] That case was decided by a divided court, and the court's opinion is considered highly controversial.[239] This Section analyzes the opinion. Subsection 1 summarizes the facts of the case, as well as the holding and the dissenting opinions. Subsection 2 presents the argument, consistent with the analysis in this paper, as to why the case was wrongly decided. Although those arguments have considerable force given the facts of the case, Subsection 3 argues that the court's opinion may nevertheless be justifiable.

1. The Opinions

Because of changes in the healthcare industry, NCS Healthcare, Inc. was experiencing serious financial difficulties beginning in 1999.[240] By 2000, the company was exploring strategic alternatives, including a sale of the company.[241] Omnicare, Inc. was one of the few companies interested in purchasing NCS.[242] In 2001, it offered to purchase the company's assets in a bankruptcy sale.[243] Its offers were so low that they would not leave NCS shareholders with anything, and would not even pay off all of the company's creditors.[244] The NCS board of directors did not consider the offers acceptable.[245]

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238 818 A.2d 914 (Del. 2003).

239 *See* Bainbridge, *supra* note 225, at 831 ("*Omnicare* is proving to be a highly controversial decision."); Justin W. Oravetz, Comment, *Is a Merger Agreement Ever Certain? The Impact of the* Omnicare *Decision on Deal Protection Devices*, 29 DEL. J. CORP. L. 805, 841 (2004) ("The *Omnicare* decision is one of the most controversial decisions in Delaware Supreme Court history . . . .").

240 *See Omnicare*, 818 A.2d at 920.

241 *Id.*

242 *See id.* at 920-21.

243 *Id.* at 921.

244 *See id.*

245 *See id.*

In early 2002, Genesis Health Ventures, Inc. entered the scene.[246] It was willing to enter into a negotiated merger agreement that would provide full compensation to NCS creditors, as well as provide $24 million of value to the company's shareholders.[247] However, Genesis was not willing to serve as a "stalking horse" to allow NCS to secure a better offer from Omnicare.[248] Genesis itself had recently emerged from bankruptcy and had lost a bidding war to Omnicare in another transaction.[249] Therefore, it demanded an exclusivity agreement as well as other deal protection devices.[250] As would later come out in court: "[Genesis] wanted to have a pretty much bulletproof deal or they were not going to go forward."[251] Given its lack of success with Omnicare, the NCS Independent Committee signed an exclusivity agreement with Genesis.[252]

When Omnicare learned of NCS negotiations with another buyer, it made a better, but highly-conditional, offer.[253] "Despite the exclusivity agreement, the Independent Committee met to consider a response to Omnicare."[254] The Independent Committee decided to seek, and was able to obtain, better terms from Genesis.[255] In return, however, Genesis demanded an immediate acceptance of its offer and a complete lockup.[256] The Independent Committee unanimously recommended acceptance of Genesis's offer:[257]

> After receiving similar reports and advice from its legal and financial advisors, the [full Board of Directors] concluded that "balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's letter, results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction."[258]

After the transaction was executed, Omnicare filed a lawsuit attempting to enjoin the merger and announced a conditional offer to acquire NCS at a superior price.[259] After further negotiations, Omnicare irrevocably committed

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246 *Omnicare*, 818 A.2d at 921.
247 *See id.* at 922-23.
248 *Id.* at 922.
249 *Id.* at 921.
250 *See id.* at 921-22.
251 *Id.* at 923.
252 *See Omnicare*, 818 A.2d at 922-23.
253 *See id.* at 924-25.
254 *Id.*
255 *Id.*
256 *See id.*
257 *Id.*
258 *Omnicare*, 818 A.2d at 925.
259 *See id.* at 926.

itself to a transaction with NCS with terms superior to those offered by Genesis.[260] However, because of the complete lockup obtained by Genesis, it was impossible for the directors to accept Omnicare's superior offer.[261]

The lockup obtained by Genesis consisted of two important components. First, there was a "force the vote" provision under section 251(c) of the Delaware General Corporation Law, which required the directors to submit the merger agreement for shareholder approval, even if the directors should change their minds regarding the advisability of the merger.[262] Second, the two majority shareholders granted to Genesis an irrevocable proxy to vote their shares in favor of the merger.[263] Thus, despite the existence of a superior offer, the shareholders would get to vote on the merger and their approval was a forgone conclusion.

The court held that this complete lockup was unenforceable under Delaware law.[264] The court concluded that these deal protection devices were subject to enhanced scrutiny under *Unocal Corp. v. Mesa Petroleum Co*.[265] Under the second prong of the *Unocal* test, a board's response "must be reasonable in relation to the threat posed."[266] Under *Unitrin, Inc. v. American General Corp.*,[267] a response that is either coercive or preclusive is draconian, and therefore unreasonable.[268] The combination of the two deal protection devices mentioned above was considered to be both coercive and preclusive. It was coercive because "NCS's public stockholders . . . [would] be forced to accept the Genesis merger because of the structural defenses approved by the NCS board."[269] It was preclusive because it was "'mathematically impossible' and 'realistically unattainable' for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal."[270]

The court also held "that the NCS board did not have authority to accede to the Genesis demand for an absolute 'lock-up.'"[271] "Instead . . . the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer."[272] Without a fiduciary out, the combination of deal protection provisions in the Genesis "agreement completely prevented the board from discharging its fiduciary

260 *See id.*
261 *See id.* at 927.
262 *See id.* at 925.
263 *See id.* at 926.
264 *See Omnicare*, 818 A.2d at 936.
265 *Id.* at 934; 493 A.2d 946 (Del. 1985).
266 *Unocal*, 493 A.2d at 955.
267 651 A.2d 1361 (Del. 1995).
268 *Id.* at 1387-88.
269 *Omnicare*, 818 A.2d at 935-36.
270 *Id.* at 936.
271 *Id.* at 938.
272 *Id.*

responsibilities to the minority stockholders when Omnicare presented its superior transaction."[273]

The majority opinion was accompanied by heated dissents. Chief Justice Norman Veasey objected to the creation of a per se ban on complete lockups.[274] Chief Justice Veasey concluded that "a joint decision by the controlling stockholders and the board of directors to secure what appeared to be the only value-enhancing transaction available for a company on the brink of bankruptcy"[275] should be upheld. Justice Steele authored a second dissent in which he emphasized the good faith on the part of the directors.[276] He argued "that the absence of a suggestion of self-interest or lack of care [should] compel[] a court to defer to what is a business judgment that a court is not qualified to second guess."[277]

2. Was *Omnicare* Wrongly Decided?

This Article's thesis is that fiduciary outs, as a contractual proxy for fiduciary duties, should serve the purpose of protecting shareholders from abuse at the hands of their directors. They should not, except incidentally, protect shareholders from third parties or bad deals. If this premise is accepted, one could easily conclude that *Omnicare* was wrongly decided.

There is no plausible argument that the directors of NCS abused the shareholders, whether by shirking, self-dealing, or misconduct. To the contrary, the directors were clearly seeking the best value reasonably available to shareholders.[278] In fact, they were seeking value for shareholders in circumstances where it was arguably unreasonable for them to expect any.[279] No arguments were raised, nor were any plausible arguments available, that the directors were not acting in subjective good faith. Moreover, given the circumstances, there was no structural bias argument, either: the directors were not seeking to close the transaction with Genesis because they preferred Genesis management to Omnicare management.[280] It was a pure sale in which they sought to maximize value to shareholders. If they failed to get the best price available, it was not for a lack of effort. A board with purer intentions,

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273 *Id.* at 936.

274 *See id.* at 942-43 (Veasey, C.J., dissenting).

275 *Omnicare*, 818 A.2d at 940 (Veasey, C.J., dissenting).

276 *See id.* at 946-47, 949-50 (Steele, J. dissenting).

277 *Id.* at 949.

278 *See supra* notes 238-54 and accompanying text.

279 *See Omnicare*, 818 A.2d at 921 ("At that time, full recovery for NCS's creditors was a remote prospect, and any recovery for NCS stockholders seemed impossible.").

280 *See* Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of* Omnicare v. NCS Healthcare, 29 J. CORP. L. 569, 588 (2004) ("The specter of entrenchment thus does not seem to have been present in *Omnicare*.").

or one that was more faithful, could hardly be imagined. For this reason alone, one would expect the courts to uphold the board's decisions.[281]

Some scholars believe that an auction, or a process similar to an auction, should be required in every sale.[282] To the extent that these concerns have any bearing on the decision, the NCS/Genesis transaction should have been upheld. Although NCS did not actually conduct an auction, it had been searching actively for an acquirer for well over a year.[283] There was no suggestion that this effort fell short in any respect. In fact, because NCS was "on the brink of bankruptcy,"[284] its only interest was to secure as much consideration in a sale as was possible. After a long search, the deal offered by Genesis was the best one available.[285] NCS had sought a deal with Omnicare, but Omnicare was playing hardball. Omnicare offered very little consideration, and it could not be persuaded to improve its offer.[286] At the time the exclusivity agreement with Genesis was signed, it offered the best value reasonably available—by far.[287] Only after the deal was signed did Omnicare attempt to offer more. Even then, its offer continued to have a due diligence condition for a while—making it risky, and hence not clearly superior.[288] Arguably, it would have been unreasonable for the NCS directors to have done anything differently.

Furthermore, I have argued that the role of the fiduciary out is to protect the shareholder right to vote on the transaction.[289] However, the NCS/Genesis transaction should have been upheld based on this criterion. Although the court tried to paint a different picture, the shareholders were able to vote freely on the transaction—and in fact they did so![290] Shareholders represent-

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281 *See Omnicare*, 818 A.2d at 946 (Steele, J., dissenting).

282 *See supra* note 236 and accompanying text.

283 *See Omnicare*, 818 A.2d at 920, 924 (began in February 2000 and concluded in July 2002).

284 *See id.* at 940 (Veasey, C.J., dissenting).

285 *See id.* at 925 (majority opinion) ("After receiving similar reports and advice from its legal and financial advisors, the board concluded that 'balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's letter, results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction.'").

286 *See id.* at 921 ("Omnicare responded that it was not interested in any transaction other than an asset sale in bankruptcy.").

287 *See id.* at 941 (Veasey, C.J., dissenting) ("Negotiations with Genesis led to an offer paying creditors off and conferring on NCS stockholders $24 million—an amount infinitely superior to the prior Omnicare proposals.").

288 *See id.* at 924 (majority opinion); *id.* at 948 (Steele, J., dissenting) ("At the time the NCS board and the majority stockholders agreed to a voting lockup, the terms were the best reasonably available for all the stockholders, balanced against a genuine risk of no deal at all.").

289 *See supra* Part IV.A.1.

290 *See Omnicare*, 818 A.2d at 944-45 (Veasey, C.J., dissenting).

ing the majority of the outstanding shares voluntarily approved the transaction.[291] The only difference was that they did so immediately. That the minority shareholders would be "forced" to accept the transaction is irrelevant: minority shareholders are always forced to accept the vote of the majority.[292] If there were any indication that the vote of the majority block was not free, there might have been a reason for the court to interfere with the transaction. However, there was no such indication. Thus, the transaction should not have been rejected based on shareholder voting rights.

The *Omnicare* opinion is difficult to understand because it does not truly champion shareholder voting rights. It cannot even be said to have championed *minority* shareholder voting rights. The fact is that, in the Genesis transaction, each shareholder would have been permitted to vote as he pleased, without any type of coercion.

The value that the *Omnicare* opinion seems to uphold in the end is the right to some sort of delay between the director vote and the shareholder vote. Every shareholder could have voted freely, but perhaps the majority shareholders voted too soon: they delivered irrevocable proxies before the actual vote.[293] There are two problems with this argument. First, irrevocable proxies are legitimate under circumstances such as these.[294] Second, there is no basis in law to require any delay before a shareholder vote.[295] Delays are nearly ubiquitous not because they are required by law, but simply because they are necessary as a practical matter.[296] Perhaps the courts can simply create a shareholder right to a delayed vote. But what purpose would this serve? The most obvious purpose would be to allow time for an auction or market test to transpire. However, auctions and market tests are not demanded by the courts.[297] Moreover, even if such a requirement would make sense in many transactions, it would not be true in this case: there had already been a lengthy search for a buyer. Therefore, requiring a delay that is not mandated by law would be unnecessary and inappropriate.

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291 *See id.* at 944 ("[T]he NCS controlling stockholders . . . made an informed choice to commit their voting power to the merger.").

292 *See id.* at 944-45 ("The minority stockholders were deemed to know that when controlling stockholders have 65% of the vote they can approve a merger without the need for the minority votes. Moreover, to the extent a minority stockholder may have felt 'coerced' to vote for the merger, which was already a *fait accompli*, it was a meaningless coercion—or no coercion at all—because the controlling votes . . . were already 'cast.'").

293 *See id.* at 926 (majority opinion).

294 *See* DEL. CODE ANN. tit. 8, § 212(e) (2011).

295 Transcript of Oral Argument at 127, Optima Int'l of Miami, Inc. v. WCI Steel, Inc., No. 3833-VCL (Del. Ch. June 27, 2008), *available at* http://lawprofessors.typepad.com/mergers/files/-0702120713_001.pdf ("Nothing in the DGCL requires any particular period of time between a board's authorization of a merger agreement and the necessary stockholder vote.").

296 For example, federal securities law requires the preparation, filing, review, and distribution of proxy statements. *See* 17 C.F.R. §§ 240.14a-3, -6 (2008).

297 *See supra* note 115.

By requiring a delay, the court effectively mandated a post-signing market test—even though there had already been a good faith search for the best value available. The problem with such a rule is that it undermines director authority to seek the best price. The advantages of an English auction[298]—where bidders continuously attempt to top each other—and a blind auction[299]—where bidders secretly submit their best offers—can be debated, but the court's holding seems to require the former. Under this rule, bidders have no incentive to offer the best price before signing because they know the deal remains vulnerable to a topping bid. Regardless of the merits of this approach, it does not seem appropriate for a court of equity to be making this type of business decision—especially not on a per se basis.

Based on the foregoing arguments, it would seem that *Omnicare* was wrongly decided. In fact, my sympathies lie in that direction. Fiduciary outs are inherently problematic, and although they may be justifiable in acquisition transactions, the facts of this particular case do not support a breach of fiduciary duty or the invocation of a fiduciary out provision. Nevertheless, the holding in *Omnicare* may be defensible on other grounds.

3. Justification for *Omnicare*

The facts of *Omnicare* make it a rare case.[300] There is no suggestion of any conflict of interest or even of structural bias on the part of the target directors. Nor is there any suggestion whatsoever that the directors were not acting in subjective good faith. In fact, other than the complete lockup itself, which was struck down by the court, there is no suggestion that they breached any fiduciary duty—even when judged by the standards of conduct rather than the standards of review. Therefore, this case does not turn upon the directors' conduct. Rather, the case boils down to the question of whether complete lockups should be permissible, or whether they must be accompanied by a fiduciary out. The holding amounts to a per se rule against complete lockups.[301]

Another way in which the *Omnicare* case is special is the fact that the directors had actively sought the best value available. They had specifically negotiated with the hostile bidder. Omnicare simply failed to make the best offer. There was no claim of unfairness in those procedures. In a sense, the

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298 *English Auction*, GAMETHEORY.NET, http://www.gametheory.net/dictionary/auctions/EnglishAuction.html (last visited Sept. 27, 2013); s*ee also* VIJAY KRISHNA, AUCTION THEORY 2 (2002) (describing English auctions).

299 *Blind Auction*, GAMETHEORY.NET, http://www.gametheory.net/dictionary/auctions/BlindAuction.html (last visited Sept. 27, 2013); s*ee also* KRISHNA, *supra* note 298, at 2 (describing sealed-bid, first-price auctions).

300 *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (Del. 2003) (Veasey, C.J., dissenting) ("[T]he peculiar facts presented render this case an unlikely candidate for substantial repetition.").

301 *See id.* at 942-43.

question became whether a hostile bidder should be able to run around the procedures of the target directors that were undeniably fair and actually intended to obtain the best price available for shareholders.

In these two important respects, the *Omnicare* case was uncommon. In most cases, a claim of structural bias, if not disloyalty, can be raised. Likewise, in many cases in which the hospital bidder loses, there is some claim of procedural unfairness. Because *Omnicare* is such a rare case, it might seem an appropriate candidate for an exception to an established rule, particularly one in equity.[302] However, it is precisely because it is such a rare case that it may be unwise to create an exception. An exception, once established, may grow beyond its intended limits.[303] An exception that was originally intended to be applied rarely might end up becoming rather commonplace, to the detriment of the law. If that is a significant risk, it might make more sense not to create the exception.

In corporate law, there is a great risk that an exception could swallow the rule because of the business judgment rule. In close cases, and even not-so-close cases, the courts tend to defer to the directors.[304] Thus, a balancing test could lead to the wrong result in most cases. The problem seems to lie in the burden of proof. Assume, for example, that a fiduciary out ought to be required unless it is clear that the directors have acted entirely in good faith. The problem remains that, in most cases, it is difficult to determine whether subjective good faith is present. The business judgment rule reflects a conscious decision on the part of the courts to assume that directors have acted in good faith. Shareholders therefore have the heavy burden of proving director misconduct. As an unavoidable result of the business judgment rule, fiduciary outs would not be required unless the shareholders can prove that directors have not acted in good faith—even though the better rule would be that fiduciary outs are required unless directors can prove that they have acted in good faith. Because of this dynamic, it would be better to have a per se rule requiring fiduciary outs. A per se rule might lead to a bad result in a rare case, but it would lead to the correct result in most cases.

The argument can be illustrated with an arbitrary numerical example. Assume that the target directors can prove they have acted in good faith only

302 *Cf.* Speiser v. Baker, 525 A.2d 1001, 1011 (Del. Ch. 1987) ("[O]ur law is the polar opposite of technical and literal when the fiduciary duties of corporate officers and directors are involved."); Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take that Action: The Implicit Corollary to the Rule of* Schnell v. Chris-Craft, 60 BUS. LAW. 877, 902 (2005) ("[*Omnicare*'s] reasoning renders indistinct the line between law and equity . . . .").

303 *Cf.* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.").

304 *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000) (dismissing the case on pleadings despite acknowledging that it was "a close case" and "potentially a very troubling case on the merits," and even that the facts "pushe[d] the envelope of judicial respect for the business judgment of directors in making compensation decisions").

15% of the time, that shareholders can prove that the directors have not acted in good faith another 15% of the time, and that the truth eludes proof the remaining 70% of the time.[305] Under such assumptions, the ideal rule might require a fiduciary out 85% of the time (i.e., to protect shareholders in every case in which directors cannot clearly establish their own good faith). However, because of the deference of the business judgment rule, a balancing test would result in fiduciary outs being required only 15% of the time (i.e., in cases in which shareholders cannot establish that the directors lacked good faith). Under such circumstances, a reasonable person could prefer a per se rule over a balancing test. A per se rule would lead to an inappropriate result only 15% of the time, whereas a balancing test would lead to an inappropriate result 70% of the time.

Thus, perhaps the question should not be whether *Omnicare* was correctly decided on the facts. Instead, the question should be what rule of law would be best as a practical matter. Arguably, the best rule of law would be to require fiduciary outs in most cases, in order to protect the shareholder right to vote. By this standard, a per se rule may be superior to a balancing test. If so, then perhaps *Omnicare* was correctly decided on the law.

V. OTHER CONTEXTS

Thus far, the Article has argued as follows: fiduciary outs are contractual proxies for fiduciary duties; they are inherently problematic conceptually; nevertheless, they may be appropriate in acquisition agreements because of the unique circumstances involved; and, although there may be cases in which a complete lockup may make sense, it may also be reasonable to apply a per se rule against them. Since most contracts do not share the unique circumstances of acquisition agreements, the inherently problematic nature of fiduciary outs provides a strong argument against exporting the concept to other contracts.

This Part reviews a case in which the Delaware Supreme Court exported the concept of fiduciary out to another context. In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court seemed to demand a fiduciary out in the context of a shareholder-proposed bylaw.[306] This Part argues that the Delaware Supreme Court's decision was not only misguided, but actually dangerous—both in the context of that particular case and more generally.[307]

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305 In acquisitions, that 70% is often tainted with structural bias. *See supra* note 3 and accompanying text.

306 *See* 953 A.2d 227, 240 (Del. 2008).

307 For another article taking a similar position, see generally Sabrina Ursaner, *Keeping "Fiduciary Outs" Out of Shareholder-Proposed Bylaws: An Analysis of* CA, Inc. v. AFSCME, 6 N.Y.U. J.L. & BUS. 479 (2010).

Section A summarizes the facts of the case and the court's opinion. Section B argues that the case was wrongly decided with respect to proxy contest reimbursement bylaws. Section C explains why the court's holding is misguided and even perverse in more general terms.

A. *The Case*

The facts of *CA* are straightforward because the case arose as certified questions from the SEC.[308] Shareholders of CA, Inc. sought to include a proposal to amend corporate bylaws on management's proxy, but management wanted to exclude the shareholder proposal.[309] The SEC had to determine whether the proposal could be excluded.[310] Under the federal proxy rules, there are various grounds on which a shareholder proposal could be excluded.[311] The two most relevant were "if the proposal is not a proper subject for action by shareholders under [state law],"[312] and "if the proposal would, if implemented, cause the company to violate any state . . . law to which it is subject."[313] Rather than try to answer these questions itself, the SEC decided to certify these questions to the Delaware Supreme Court.

The shareholder proposal would have amended the company's bylaws to require the directors, under certain circumstances, to cause the corporation to reimburse shareholders for reasonable expenses incurred in nominating candidates for a contested election of directors.[314] Because the court was faced with certified questions of law, there were no facts to contextualize the issues. As the court put it, "[t]he certified questions . . . request a determination of the validity of the Bylaw in the abstract."[315]

As to the first issue—whether the proposal was a proper subject for action by the shareholders—the court upheld the proposed bylaw.[316] The court's reasoning, in brief, was as follows:

> The shareholders of a Delaware corporation have the right "to participate in selecting the contestants" for election to the board. The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election. The Bylaw would accomplish that by committing the corporation to reimburse the election expenses of shareholders whose candidates are successfully elected.

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308 *See CA*, 953 A.2d at 229-30.
309 *Id.*
310 *Id.* at 230.
311 *See* 17 C.F.R. § 240.14a-8 (2008).
312 *Id.* § 240.14a-8(i)(1).
313 *Id.* § 240.14a-8(i)(2).
314 *CA*, 953 A.2d at 230.
315 *Id.* at 238.
316 *Id.* at 237.

> That the implementation of that proposal would require the expenditure of corporate funds will not, in and of itself, make such a bylaw an improper subject matter for shareholder action.[317]

As to the second issue, however—whether the bylaw would cause the company to violate any state law—the court ruled against the shareholder proposal.[318] The court "conclude[d] that the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[319] It reasoned as follows:

> Under Delaware law, a board may expend corporate funds to reimburse proxy expenses "[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management." But in a situation where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board's fiduciary duty could compel that reimbursement be denied altogether. . . .
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> . . . [T]he Bylaw contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all.[320]

Thus, the court concluded that the bylaw, if implemented, could require directors to breach their fiduciary duties and, thus, to violate state law.[321]

B. *Proxy Reimbursement Bylaws*

This Section considers whether the court's holding was appropriate in the context of proxy expense reimbursement bylaw provisions. Because the court concluded that the provision involved "a proper subject for shareholder action,"[322] this Section focuses on the second provision considered by the court: whether the proposed bylaw "would cause [the company] to violate any Delaware law to which it is subject."[323]

The court concluded that "the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[324] Part of the reason for this decision was

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317 *Id.*
318 *Id.* at 240.
319 *Id.* at 238.
320 *CA*, 953 A.2d at 240 (footnotes omitted).
321 *See id.* at 238.
322 *Id.* at 236.
323 *Id.* at 237.
324 *Id.* at 238.

the "abstract" nature of the challenge arising in a certified question: "we must necessarily consider any possible circumstance under which a board of directors might be required to act [in breach of fiduciary duty]."[325] This was an odd conclusion on the part of the court. The more appropriate approach to a facial challenge would be to ask whether the provision is valid in some circumstances, leaving later courts to decide whether it is inappropriate as applied to any particular case.[326] In fact, Justice Jacobs, the author of the majority opinion in *CA*, has suggested that this may have been a poor choice on the part of the court, made as a result of the rushed nature of the proceedings.[327] As interesting as this debate may be, it is not relevant to the discussion of fiduciary outs in principle. Therefore, this Article does not address this issue in depth. Rather, it argues that fiduciary outs are inappropriate in the bylaw context.

According to the court, the reason that the proposed bylaw could require directors to breach their fiduciary duties is as follows:

> Under Delaware law, a board may expend corporate funds to reimburse proxy expenses "[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management." But in a situation where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board's fiduciary duty could compel that reimbursement be denied altogether.[328]

This rationale is inadequate, both as a legal matter and as a matter of common sense.

As a legal matter, there is no specific statutory provision that requires directors to make a determination as to the validity of a proxy expense reimbursement. From the perspective of the statute, proxy expenses are no different from any other expenses. The court had already decided that bylaws could require expenditures.[329]

The court seems to suggest, but does not quite say explicitly, that the directors' power, and corresponding fiduciary duty, to make determinations

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325 *Id.*

326 *See* Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985) ("The bylaws of a corporation are presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws.").

327 Holger Spamann, *Justice Jack Jacobs at Harvard Law School*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION, at 58:27-1:00:23 (Dec. 2, 2008, 10:05 AM), http://blogs.law.harvard.edu/corpgov/2008/12/02/justice-jack-jacobs-at-harvard-law-school/; *cf. CA*, 953 A.2d at 238 ("Were this issue being presented in the course of litigation involving the application of the Bylaw to a specific set of facts, we would start with the presumption that the Bylaw is valid and, if possible, construe it in a manner consistent with the law."). Justice Jacobs also seems to acknowledge that the likelihood of the bylaws being problematic in an actual case or controversy was slim. *See, e.g.*, Spamann, *supra*, at 52:50 ("There at least was a subset, maybe a very small subset, of cases where arguably fiduciary duty would be breached . . . .").

328 *CA*, 953 A.2d at 240 (footnote omitted).

329 *See supra* note 317 and accompanying text.

regarding the advisability of proxy reimbursement stems directly from section 141(a).[330] That section provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."[331] It has been interpreted as a core provision of Delaware General Corporation Law,[332] empowering directors very broadly. Ultimately, of course, most director powers stem from that provision. However, that provision has very little to say about any particular expenditures, such as proxy reimbursements. It is simply a broad grant of power.

The rule that the court raises is not a matter of law, but rather of equity. It is a restriction that is imposed upon directors as a matter of fiduciary duty.[333] Therefore, the rule should be interpreted consistently with the purposes of fiduciary duties: to protect shareholders from abuse at the hands of directors. As an equitable rule arising out of fiduciary duties, the rule should apply only to the actions of directors, not those of shareholders.

"It is well-settled that a corporation may, through its board of directors, expend reasonable sums in a contested election of directors in the solicitation of proxies where the expenditures are in the interest of intelligent exercise of judgment by its shareholders."[334] This rule applies even though the directors are conflicted in that the proxy contest will decide whether or not they keep their positions. However, in order to prevent directors from abusing this power, the courts imposed a limitation upon such expenditures: to justify the expense, there must be a benefit to the shareholders. The line that the courts have drawn is that there is no benefit if the proxy contest is about purely personnel matters, and there is a benefit if the proxy contest is about policy matters.[335]

Essentially, this rule is a prohibition against self-dealing on the part of directors in the context of a proxy contest. However, the rule was futile *ab initio*. As the court should have been able to imagine, the difference between

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330 *See CA*, 953 A.2d at 238 (describing the rule of equity at issue as "derived from Section 141(a)"); *see also id.* at 240 ("[W]e express no view on whether the Bylaw as currently drafted . . . would create a better governance scheme from a policy standpoint. We decide only what is, and is not, legally permitted under the DGCL. That statute, as currently drafted, is the expression of policy as decreed by the Delaware legislature.").

331 DEL. CODE ANN. tit. 8, § 141(a) (2011).

332 *See CA*, 953 A.2d at 232 n.7 ("[T]he board's managerial authority under Section 141(a) is a cardinal precept of the DGCL . . . ."); McMullin v. Beran, 765 A.2d 910, 916 (Del. 2000) ("One of the fundamental principles of the Delaware General Corporation Law statute is that business affairs of a corporation are managed by or under the direction of its board of directors."); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291-92 (Del. 1998) ("One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation.").

333 *See CA*, 953 A.2d at 240.

334 5 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2052.90 (perm. ed., rev. vol. 2003).

335 *See supra* note 328.

policy and personnel matters is difficult to sustain.[336] Any restrictions the distinction might impose could be avoided easily because it would not be difficult to frame any proxy contest as involving some policy matter. As a leading treatise states, "[n]o decision has been found in which the court has enjoined management's proxy contest expenditures."[337] In other words, the rule was entirely ineffective.[338]

To apply this rule in the context of a mandatory reimbursement bylaw is not simply misguided, but actually perverse. It is misguided because it does not serve the purpose of fiduciary duties to invoke this principle. As the court stated,

> The context of the Bylaw at issue here is the process for electing directors—a subject in which shareholders of Delaware corporations have a legitimate and protected interest. The purpose of the Bylaw is to promote the integrity of that election process by facilitating the nomination of director candidates by stockholders or groups of stockholders.[339]

In other words, the shareholder proposal was an attempt by shareholders to protect themselves from the directors. Invoking the equitable rule against reimbursement of proxy expenses furthers neither this goal nor the goal of fiduciary duties generally. In fact, to apply the rule in this context would work against both of these goals and thus would be perverse. Because the policy/personnel distinction is so elusive, directors would be able to argue, more often than appropriate, that there are no policy issues at stake, only personnel issues, and that reimbursement is therefore inappropriate.[340] If courts are deferential, this would allow the directors, in at least some cases, to deny the

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336 *See* COX & HAZEN, *supra* note 133, § 13.28, at 783 ("In most contests for corporate control . . . it is impossible to sever questions of policy from personality because questions of policy usually are inexorably intertwined with personalities. Thus, the courts have had difficulty drawing a line between the two.").

337 *Id.*

338 *See* RANDALL S. THOMAS & CATHERIN T. DIXON, ARONOW & AINHORD ON PROXY CONTESTS FOR CORPORATE CONTROL § 21.03[A], at 21-13 (3d ed. Supp. 2001) ("In short, the policy/personal distinction places virtually no limitations on management's ability to expend corporate funds.").

339 CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 237 (Del. 2008) (footnote omitted).

340 If the policy/personnel distinction is meaningless, then directors should *never* be able to prevent reimbursement for shareholders' candidates, just as they have not been denied reimbursement in other situations. *See supra* note 337 and accompanying text.

In a footnote, the *CA* court proposes a hypothetical in which the denial of reimbursement might be appropriate:

> Such a circumstance could arise, for example, if a shareholder group affiliated with a competitor of the company were to cause the election of a minority slate of candidates committed to using their director positions to obtain, and then communicate, valuable proprietary strategic or product information to the competitor.

CA, 953 A.2d at 240 n.34. In addition to being far-fetched, the hypothetical fails on the merits. Although the result contemplated by the hypothetical would be against the shareholders' interests, fiduciary duties do not exist to guarantee good results. *See supra* note 37 and accompanying text. Despite a bad result, directors are bound by their legitimate obligations, whether they arise under law or contract. Just as the reimbursement that shareholders thought necessary—and this would be true despite the fact that the directors are inherently conflicted with respect to proxy contests.

The irony is palpable. The fiduciary duty rule that was intended to protect shareholders from the directors in proxy contests, but which failed miserably, was reinvigorated so as to allow directors to protect themselves from shareholders in proxy contests. In other words, the court turned a rule that was supposed to be a shield for the benefit of shareholders into a sword for the benefit of directors.

Perhaps the worst aspect of the court's decision is that it had the effect of blocking the bylaw proposal altogether. Even accepting the court's rationale for the sake of argument, a more appropriate application of the principle would be to allow the bylaw, and to allow directors to avoid payments in appropriate cases. In other words, the courts could block the application of any bylaw in cases where it would require a breach of fiduciary duty. Instead, the court's opinion prevented the shareholder proposal from being adopted at all. It should not have done so on the basis of hypothetical possibilities.[341]

According to the court, the proposed bylaw was otherwise a valid provision.[342] The only problem was that it might require the directors to breach their fiduciary duties. However, the purpose of fiduciary duties was not offended by the bylaws, and the rule that the courts relied upon was a particularly weak basis for rejecting the shareholder proposal. Thus, on its particular facts, the *CA* case was wrongly decided.

C. *Implications of the* CA *Ruling*

As a general matter, the court's holding is problematic because it fundamentally misunderstands the purpose of fiduciary duties. Fiduciary duties are duties imposed upon directors in order to prevent them from abusing shareholders with powers that have been entrusted to them. Fiduciary duties are duties, not powers. They limit what directors can do with other valid powers; they do not grant the directors new powers. Yet this is exactly what the court's opinion seems to do. It gives directors the power to avoid an otherwise valid bylaw provision.

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directors could not refuse to seat such ill-motivated directors, neither should they be able to deny reimbursement. The proper remedy lies elsewhere. Such communication would result in a breach of fiduciary duty on the part of the newly elected directors, and the proper course of action would be for the directors to seek some sort of equitable relief from the courts. Any relief that is given by the courts would—or at least should—be based on the newly elected directors' breach of fiduciary duty, not the incumbent directors' powers to exercise their fiduciary duties. Directors do not have any "power to exercise their fiduciary duties." *See infra* text accompanying note 353.

341 *See supra* note 327.

342 *See supra* note 317 and accompanying text.

A fiduciary duty is a limit on a discretionary power.[343] To the extent that directors are free to decide whether or not to do something, the court may decide that they have fiduciary duties with respect to the exercise of that power. However, to the extent that the directors do not have discretion with respect to a matter (e.g., to the extent that there is a valid obligation), fiduciary duties are not relevant. Directors must comply with corporate obligations. To do so is not a breach of fiduciary duty; to the contrary, not satisfying corporate obligations could be a breach of fiduciary duty. So, to the extent that a bylaw provision, or any other contractual provision, is valid—and, in this case, the court concluded that it was, in other respects[344]—the board cannot breach fiduciary duties by complying therewith.[345]

The plaintiffs raised this argument before the court:

> Because the Bylaw would remove the subject of election expense reimbursement (in circumstances as defined by the Bylaw) entirely from the CA's board's discretion (AFSCME argues), it cannot fairly be claimed that the directors would be precluded from discharging their fiduciary duty. Stated differently, AFSCME argues that it is unfair to claim that the Bylaw prevents the CA board from discharging its fiduciary duty where the effect of the Bylaw is to relieve the board entirely of those duties in this specific area.[346]

The court improperly dismissed the argument as "more semantical than substantive."[347] However, the argument goes beyond semantics and straight to the substantive core of fiduciary duties. The court is wrong to suggest that "the Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude."[348] Fiduciary duties neither could nor should preclude a mandatory payment.

The court had already decided, in the first certified issue, that the bylaw was legitimate even though it required certain expenditures.[349] The court's issue with the proposed bylaw was not that all expenditures must be subjected to director review. In fact, it specifically rejected this argument.[350] The invalidation of the bylaw was based entirely on the fiduciary duty rule that pre-

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343 *See supra* Part II.A and accompanying text.

344 *See CA*, 953 A.2d at 237.

345 *See* Brett H. McDonnell, *Setting Optimal Rules for Shareholder Proxy Access*, 43 ARIZ. ST. L.J. 67, 98-99 (2011) (describing the court's reasoning as "stupefying" and arguing that, if shareholders establish "a rule that is within their power to set, then the board's fiduciary duty comes to an end on that matter").

346 *CA*, 953 A.2d at 239.

347 *Id.*

348 *Id.* at 240.

349 *See id.* at 237.

350 *Id.* at 236 ("[A] bylaw that requires the expenditure of corporate funds does not, for that reason alone, become automatically deprived of its process-related character.").

vents directors from using corporate funds to pay for proxy contests involving solely personnel issues.[351] However, that rule was developed to limit director discretion, not to empower directors.

By legitimately making reimbursement a mandatory obligation, the bylaw removed director discretion—and, therefore, fiduciary duties—from the equation. The question was no longer whether directors might abuse shareholders by using corporate funds to pay for proxy solicitation expenses when they might involve solely personnel issues.[352] The question became whether fiduciary duties should empower directors to avoid payment of an otherwise valid obligation. The answer to that question must be no.

Allowing the fiduciary duty rule to trump the otherwise valid bylaw would empower directors to block action by shareholders intended to protect themselves from the directors, and to do so with arguments that lack any credibility. Supposedly, this would be done in the name of fiduciary duties. However, there is no need to worry about abuse at the hands of directors in the enforcement of the proposed bylaw. To the contrary, it would be the ability to avoid the obligations established by the bylaw that could lead to abuse.

The court's emphasis on director "power to exercise their fiduciary duty to decide"[353] is misguided. Directors do not have *power to exercise fiduciary duties*; they have *fiduciary duties to exercise their powers properly*. Fiduciary duties do not give directors power to do anything that they are not otherwise empowered to do. To the contrary, they limit what directors are otherwise empowered to do. Thus, this passage can only mean that directors cannot limit themselves when their fiduciary duties require freedom to act, as by entering into obligations that would have that effect.[354] However, shareholder-adopted bylaws can obligate the directors just as surely as the law and the charter can.[355]

A bylaw would be invalid only if it were inconsistent with the law or the charter. The court suggests that the shareholder-proposed bylaw would be inconsistent with section 141(a)'s grant of power to directors,[356] but this is not the case. It is not section 141(a) that requires directors to screen proxy expenditures; it is their fiduciary duties. However, these fiduciary duties apply to the directors, not to the shareholders. Thus, fiduciary duties were not implicated. The proposed bylaw might have been inconsistent with the fiduciary duty rule in question if it had originated with the directors; but it did not. The proposed bylaw was otherwise valid, and there would be no breach

351 *See supra* notes 319-320 and accompanying text.

352 *See supra* Part V.B.

353 *CA*, 953 A.2d at 240.

354 *See supra* notes 165-167 and accompanying text.

355 *See* DEL. CODE ANN. tit. 8, § 109(b) (2011). *But see CA*, 953 A.2d at 234-35 ("It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.").

356 *See CA*, 953 A.2d at 239-40.

on the part of the shareholders in adopting it. Thus, the bylaw would be valid, if adopted. It would be binding on the directors, and there would be no breach of fiduciary duty on their part in complying with it. If anything, it would be a failure to comply with the bylaw that would result in a breach of fiduciary duty!

Although we have been speaking of fiduciary duties rather than fiduciary outs, the two are relatively interchangeable. As previously discussed, fiduciary outs are contractual proxies for fiduciary duties.[357] In fact, the court suggests that a fiduciary out may have saved the proposed bylaw: the court noted that "the Bylaw contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all."[358] Although the Article's discussion has been framed in terms of fiduciary duties, it applies equally to the necessity of a fiduciary out.

The problem with a fiduciary out in this context is that it might create an option on the part of the directors—one that does not, or at least should not, exist otherwise. A fiduciary out would seem to authorize directors to refrain from making a payment thereunder if they felt that their fiduciary duties prevented them from doing so. Their judgment on this issue would not be second-guessed by the courts, and the decision would be subject to reversal only if it were itself (proven to be) a breach of fiduciary duty.[359] By contrast, in the absence of a fiduciary out, directors presumably would have less freedom to ignore the bylaw. It would be challenging to establish that they should not have to pay a valid obligation because their fiduciary duties prevent them from doing so—especially given their inherent conflict of interest.[360] Thus, even if it were granted that valid obligations could be avoided because of directors' fiduciary duties, it nevertheless was inappropriate to require a fiduciary out. The device itself inappropriately shifts the burden of proof from the directors onto the shareholders.

Ultimately, the Delaware General Assembly reversed this part of the Supreme Court's decision when it promulgated section 113 to the General Corporation Law.[361] However, this Article is not about shareholder access. It is about the legitimacy of fiduciary out provisions. Even though the *CA* case may have no continuing effect on the development of shareholder access rules, its reasoning could have serious repercussions for the development of the law of fiduciary outs. Therefore, it is important to understand that the

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357 *See supra* note 118 and accompanying text.

358 *CA*, 953 A.2d at 240.

359 Of course, "[a] decision by directors to deny reimbursement on fiduciary grounds would be judicially reviewable." *Id.* at 240 n.35. However, as discussed in Part IV, *supra*, fiduciary outs are interpreted consistently with the standards of conduct rather than the standards of review and thus necessarily give to directors a great deal of discretion to decide, albeit in good faith, upon the appropriate course of action. *See supra* text accompanying notes 123-132.

360 *See supra* note 237 and accompanying text.

361 DEL. CODE ANN. tit. 8, § 113 (2011).

court was wrong not simply as a policy matter, but as a matter of law and equity.

CONCLUSION

The fiduciary out is a curious and inherently problematic device. It is virtually ubiquitous in the context of acquisition agreements but almost unheard of in other contexts. Although it is not intended to do so, it almost necessarily transforms an agreement into an option in the hands of one party.

Nevertheless, fiduciary outs make sense in the context of acquisition agreements. The key to understanding why and how they do is to recognize that fiduciary outs are contractual proxies for fiduciary duties. As such, they should be interpreted consistently with the general purpose of fiduciary duties: to protect shareholders from abuse at the hands of directors. Fiduciary outs do this in the context of acquisition agreements by protecting the right of the shareholders to vote against the transaction in question against interference by the directors.

However, this rationale does not extend beyond the context of acquisition agreements. Shareholders do not have the right to manage the business and affairs of the corporation and therefore do not have the right to vote on almost any other contract. Thus, although fiduciary outs should remain permissible in the context of acquisition agreements, they should not be extended to any other context.