The $10.53 Billion Question--When Are the Parties Bound?: Pennzoil and the Use of Agreements in Principle in Mergers and Acquisitions

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NOTE

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I. Introduction

On November 19, 1985, a Texas district court jury sent shockwaves throughout the mergers and acquisitions field by awarding Pennzoil Company (Pennzoil) 10.53 billion dollars in its claim against Texaco, Inc. (Texaco) for tortious interference with a contract.[1] Pennzoil and Getty Oil Company (Getty) had been negotiating a merger of their two companies. After considerable negotiations and agreement on some points, Pennzoil and Getty released a joint press release detailing many terms of the merger. This release stated that the parties had reached an "agreement in principle" to a merger of Getty and a newly formed entity owned by Pennzoil and the trustee of the Sarah C. Getty Trust. The press release also stated that the transaction was subject to the execution of a definitive merger agreement.

After the press release was issued, Pennzoil and Getty began drafting the formal merger agreement. Getty, however, then entered into negotiations with Texaco, and these two companies subsequently signed a merger agreement in which Texaco acquired one hundred percent of Getty. Pennzoil brought suit against Texaco for tortious interference with Pennzoil's contract to merge with Getty even though no merger documents or formal contracts were signed by Pennzoil and Getty.

The *Pennzoil* decision rests on an area of contract law that most mergers and acquisitions specialists considered already settled.[2] This area commonly is called the law of "agreements in principle with a formal contract contemplated."[3] When parties enter into negotiations and agree on terms one by one, they may expect

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1. Pennzoil Co. v. Texaco, Inc., No. 84-05905 (151st Dist. Ct., Harris County, Tex. Nov. 15, 1985), *aff'd*, Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. Ct. App. 1987). The appeals court reduced the punitive damage award from three billion to one billion dollars. *Id.* at 866. The stated facts were taken from the decision of the Texas Court of Appeals in Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. Ct. App. 1987). Pennzoil and Getty Trust drafted a Memorandum of Agreement detailing the proposed merger. The Getty Oil Board initially rejected this Memorandum by a 15 to 1 vote. The next day, the Getty Board voted to accept Pennzoil's merger proposal for a price of $110 per share with a $5 stub. The jury found that the Getty Board at this point accepted the Memorandum and agreed to be bound by its terms. *Id.* at 784. This finding is at the heart of the controversy.

2. *See Cautious Talks: Texaco-Pennzoil Case Makes Firms Careful About Merger Moves; Just What Is an Agreement Stirs Much Uncertainty; a Risk in Shaking Hands; But the Precedent May Fade*, Wall St. J., Apr. 15, 1986, at 1, col. 1 [hereinafter Wall Street]; DiBlasi & Cyganowski, *A Guide to Handshakes, Higher Bids*, N.Y.L.J., June 2, 1986, at 23, col. 6.

3. Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U. L. Rev. 673, 676-77 (1969).

to execute a formal contract later.[4] The legal question that arises is, when are the parties legally bound—before or after the signing of a formal contract?[5] Prior to the *Pennzoil* decision, mergers and acquisitions specialists believed that parties became bound only after the signing of a formal agreement.[6] *Pennzoil*, however, demonstrates that dangerous uncertainty surrounds the use of an agreement in principle with a formal contract contemplated in a merger or acquisition. This uncertainty over when the parties become bound and the risk of being held liable for tortious interference with a merger contract may lead to a decline in the number of competing bids in tender offers.[7] Congress and the Securities Exchange Commission (SEC) enacted the Williams Act and the rules promulgated thereunder with the intent of facilitating competing bids.[8]

Pennzoil also has created a new lock-up defensive weapon that target companies may use to discourage auctions and competitive bidding.[9] In addition, the decline in the number of competing bids caused by *Pennzoil* and the continued use of agreements in principle may have detrimental effects on targets' shareholders and society in general.[10] The repercussions of *Pennzoil*, therefore, raise a number of issues concerning agreements in principle and justify a search for possible solutions to avoid a decline in competitive bidding.

This Note addresses the problems created by *Pennzoil* and the use of agreements in principle in the area of mergers and acquisitions. Part II discusses the relevant law on agreements in principle formed before entering into the formal contract contemplated by the parties. Part III analyzes in depth the problems associated with agreements in principle in mergers and acquisitions. Finally, Part IV suggests three possible solutions that, if adopted, could avoid the problems discussed in Part III.

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4. 1 A. CORBIN, CORBIN ON CONTRACTS § 30 (1963).

5. *See infra* notes 16-18 and accompanying text.

6. *See infra* note 72 and accompanying text.

7. *See infra* notes 87-124 and accompanying text.

8. *See infra* notes 93-123 and accompanying text.

9. For a discussion of this new device, see *infra* notes 125-27 and accompanying text.

10. Commentators disagree over whether competing bids are beneficial or detrimental to society and shareholders. *Compare* Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) *with* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). *See also infra* notes 129-60 and accompanying text.

II. Agreements in Principle with a Formal Contract Contemplated by the Parties

A. *The Problem*

The parties to a contract often engage in substantial preliminary negotiations consisting of meetings, letters, or telephone conferences to discuss various terms on which they differ. During this sometimes lengthy negotiation process, the parties may agree to a particular term and move on to the next. By the end of the negotiations, the parties may have agreed on all, or substantially all, of the terms of the contract. In many cases, the parties contemplate the drafting and signing of a formal contract that embodies the agreed-on terms; this raises the issue of when the parties become bound by the contract.[11] Are the parties bound upon agreement to all of the essential terms, or are they bound only after the formal contract has been drafted and executed? These situations often are called "formal contract contemplated"[12] or "written memorial contemplated" cases.[13]

Determining exactly when the parties to the agreement become legally bound is often crucial. Until a party becomes legally bound to an agreement, the party may decide to enter into an alternative transaction of a similar nature with a third party or to refrain from action altogether. In either case, the party is not answerable to the abandoned party for disappointing expectations.[14] Once the parties become bound, however, any deviation from or refusal to follow the terms of the agreement can result in a breach of contract. The *Pennzoil* award illustrates both the importance of determining whether a binding contract exists and the disastrous consequences of wrongly concluding when the parties became bound.

B. *The Law before* Pennzoil

In the typical "formal contract contemplated" case, the parties clearly intend to bargain and have reached agreement on many, if not all, of the essential contractual terms. Both parties also con-

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11. E. Farnsworth, Contracts § 3.85, at 119 (1982).

12. Knapp, *supra* note 3, at 676.

13. *See* Restatement (Second) of Contracts § 27 (1981) [hereinafter Restatement].

14. Knapp, *supra* note 3, at 676. This rule applies unless the offeree's disappointment was caused by substantial, foreseeable reliance, in which case the offeree may have a remedy. *Id.* at 676 n.11.

template the later execution of a formal document.[15] The parties may not agree, however, on the extent to which they are legally bound prior to the formal contract.[16] The parties may believe that neither is bound until the signing of the document and, therefore, that either party may withdraw at any time regardless of what has been agreed on already.[17] On the other hand, the parties may believe that the execution of the formal document is a formality that only memorializes the terms agreed to earlier. Under the second scenario, the parties might expect to be contractually bound prior to the writing.[18]

The law in this area used to be relatively settled. Courts would effect the intent of the parties by adopting either of the two views discussed above.[19] Courts determined when a contract was formed by looking to the intent of the parties regarding when they intended to be bound.[20] Even if the parties agreed to all of the essential terms of a proposed contract, unless the parties intended to be bound prior to the execution of a formal written contract, no contract existed until such execution actually occurred.[21] Some courts have held execution of a formal contract to be a condition precedent to the finality of the agreement.[22] Courts also have held that if the parties agreed on all of the substantial terms of the contract

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15. *Id.* at 676.

16. *Id.* at 682.

17. *Id.* Professor Knapp states that the parties probably will hold this view if the following factors exist:

> a) the contract is of a type which requires writing for enforceability under the Statute of Frauds; b) the contract contemplated involves large sums of money; c) the contract has many details; d) the contract is an unusual one, for which a standard form is not available or appropriate; e) the parties were apparently unwilling to proceed with any performance until the formal document was prepared and signed.

Id.

18. *Id.* at 683. Professor Knapp lists four factors that could lead to this expectation:

> a) no independent policy of the law requires a writing for enforceability, or, if it does, the parties have exchanged letters, telegrams or other writings in which the agreed-upon terms are sufficiently reflected; b) the proposed contract appears relatively simple, and does not involve long-term obligations; c) the contemplated "formal" contract is a standard-form document, which itself contains the details necessary for a contract of this sort; or d) tbe parties themselves, without waiting for the formality of execution, have proceeded to perform, in a way that suggests they believed full and binding agreement to have been reached.

Id.

19. *Id.* at 681-82.

20. 1 A. CORBIN, *supra* note 4, § 30, at 98-99.

21. *See* R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69, 74 (2d Cir. 1984).

22. *See, e.g.*, Coulter v. Anderson, 144 Colo. 402, 410, 357 P.2d 76, 80 (1960); Bjornson v. Five Star Mfg. Co., 61 N.W.2d 913, 915 (1953).

with nothing left for future settlement, then an informal agreement was binding as long as the parties understood that the agreement was binding even without a writing.[23]

These rules were developed to enable parties to contract and bind themselves as they desire.[24] One court stated that the relevant factors are the parties' expressed intentions, words, and deeds that constitute objective signs of their intent under the circumstances.[25] Even though the question of intent is a factual question to be determined by the fact-finder,[26] very few courts have addressed which party bears the burden of proving that a present, binding contract exists when no formal document has been executed. The courts that have addressed this issue state that the burden rests with the party claiming that the contract was complete prior to the execution of a formal contract.[27]

Despite these relatively simple rules, determining the parties' intent in any particular case often presents a difficult question of fact.[28] The original *Restatement of Contracts* outlined the general rules concerning a party's intent to be bound,[29] but gave no factors for courts to consider in determining the question of intent.[30] Professor Karl Llewellyn criticized this aspect of the *Restatement* and its general rules by stating that no rule can be a good rule unless guided to the facts by some criteria.[31] The *Restatement (Second)*

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23. *See, e.g., R.G. Group, Inc.*, 751 F.2d 69. The court stated the rule as follows:

> Where there is no understanding that an agreement should not be binding until reduced to writing and formally executed, and "[w]here all the substantial terms of a contract have been agreed on, and there is nothing left for future settlement," then an informal agreement can be binding even though the parties contemplate memorializing their contract in a formal document.

Id. at 74.

The Restatement states the rule similarly:

> Manifestations of assent that are in themselves sufficient to conclude a contract will not be prevented from so operating by the fact that the parties also manifest an intention to prepare and adopt a written memorial thereof; but the circumstances may show that the agreements are preliminary negotiations.

RESTATEMENT, *supra* note 13, § 27.

24. *R.G. Group, Inc.*, 751 F.2d at 74.

25. *Id.*

26. *See* ABC Trading Co. v. Westinghouse Elec. Supply Co., 382 F. Supp. 600, 601 (E.D.N.Y. 1974); Johnston v. Johnston, 346 Pa. Super. 427, 431, 499 A.2d 1074, 1076 (1985).

27. *See, e.g.*, Miller Constr. Co. v. Stresstek, A Div. of L. R. Yegge, Co., 108 Idaho 187, 189, 697 P.2d 1201, 1203 (Idaho Ct. App. 1985).

28. 1 A. CORBIN, *supra* note 4, § 30, at 97. These decisions involve questions of fact, not law; therefore, the diverse outcomes of the cases do not indicate a conflict in the law. *Id.*

29. RESTATEMENT OF CONTRACTS § 26 (1932).

30. *Id.*

31. Llewellyn, *On Our Case-Law of Contract: Offer and Acceptance, I.*, 48 YALE L.J. 1

of Contracts followed Professor Llewellyn's suggestions for establishing definite criteria to aid the courts. The second *Restatement* lists a number of factors to consider in determining the intent of the parties in these cases.[32] These factors include oral testimony, correspondence, or preliminary or partially completed writings.[33]

The first factor concerns the extent to which the parties orally agreed to all of the terms to be included in the expected final contract.[34] Thus, courts will decide whether there was "literally nothing left to negotiate"[35] so that only the signing of the document remained to memorialize the agreement.[36] Courts, however, must be careful not to characterize certain disagreements as minor or technical.[37] The actual drafting of a contract often will reveal major areas of disagreement and other points that the parties did not originally discuss.[38] On these facts, the court should determine that no disagreement exists because the parties have the right to decide when the contract is complete and to enter into the exact contract they desire.[39]

(1938). Professor Llewellyn writes:

> Most so-called rules do indicate at least something about what facts they apply to . . . . But what needs note is that until even the most precise of expressions about legal consequence is guided to the facts which may emerge, the supposed rule can acquire no meaning *in life* . . . . [T]here is, and has been, good and shrewd judicial discussion of useful criteria to use—persuasive too, I suggest, to any court to which it might be quoted—*because it helps.*

Id. at 13-14 (footnotes omitted, emphasis in original). Llewellyn then suggests the factors, *see infra* note 32, discussed in Mississippi & Dominion S.S. Co. v. Swift, 86 Me. 248, 29 A. 1063 (1894). Llewellyn, *supra*, at 14 n.29.

32. RESTATEMENT, *supra* note 13, § 27 comment c. These eight factors are:

> [1] [T]he extent to which express agreement has been reached on all the terms to be included, [2] whether the contract is of a type usually put in writing, [3] whether it needs a formal writing for its full expression, [4] whether it has few or many details, [5] whether the amount involved is large or small, [6] whether it is a common or unusual contract, [7] whether a standard form of contract is widely used in similar transactions, and [8] whether either party takes any action in preparation for performance during the negotiations.

Id.

33. RESTATEMENT, *supra* note 13, § 27 comment c.

34. *Id.*; *see also* R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69, 76 (2d Cir. 1984) (stating that the question "is whether there was literally nothing left to negotiate or settle, so that all that remained to be done was to sign what had already been fully agreed to").

35. *R.G. Group, Inc.*, 751 F.2d at 76.

36. *Id.*

37. Winston v. Mediafare Entertainment Corp., 777 F.2d 78, 82-83 (2d Cir. 1985) (stating that courts must be careful not to state categorically that the parties have agreed on all major issues and that no further drafting remains to be completed).

38. *Id.*

39. *Id.* at 83. The court stated:

> It is not for the court to determine retrospectively that at some point in the evolution

A second important factor is whether the contract is one that parties typically put in writing.[40] In this regard, courts examine usage and custom of trade.[41] If a standard form contract is available and widely used for a particular type of agreement, a court will be more likely to find an intent to be bound prior to execution of a formal document.[42] The greater the complexity and importance of the transaction, the greater the likelihood that the parties intended that the agreement not be final prior to formal execution of a contract.[43] In *R. G. Group, Inc. v. Horn & Hardart Co.*,[44] for example, the Second Circuit examined the negotiations between Bojangles' of America, Inc. and the hopeful purchaser of a Bojangles' franchise. The Bojangles' franchise agreement included a twenty-year term and provided for such matters as trade secrets, purchase and development of real estate, rights on termination and default, and construction of restaurants.[45] One basis for the court's holding that the parties did not intend to be bound by an oral understanding was that agreements of this complexity are usually put in writing.[46]

Another important factor is whether the contract requires a formal execution for its full expression.[47] Again, the focus is on the

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> of a formal document that the changes being discussed became so "minor" or "technical" that the contract was binding despite the parties' unwillingness to have it executed and delivered. For the court to do so would deprive the parties of their right to enter into only the exact contract they desired.

Id.

40. RESTATEMENT, *supra* note 13, § 27 comment c; *see also R.G. Group, Inc.*, 751 F.2d at 69 (2d Cir. 1984); ABC Trading Co. v. Westinghouse Elec. Supply Co., 382 F. Supp. 600, 603 (E.D.N.Y. 1974).

41. *See* 1 A. CORBIN, *supra* note 4, at 105.

42. RESTATEMENT, *supra* note 13, § 27 comment c; *see also* Knapp, *supra* note 3, at 682.

43. 1 A. CORBIN, *supra* note 4, at 105-06.

44. 751 F.2d 69 (2d. Cir. 1984).

45. *Id.* at 77. The court stated that the most telling fact was an initial investment of over $2 million and alleged losses of $80 million. *Id.*

46. *Id.*; *see also* ABC Trading Co. v. Westinghouse Elec. Supply Co., 382 F. Supp. 600 (E.D.N.Y. 1974). In *ABC Trading Co.* the district court decided whether an oral settlement agreement following a breacb of contract for the shipping of wire and cable products from defendant to plaintiff was binding absent a formally executed written agreement. In finding the oral agreement not binding, the court examined the complexity and importance of the transaction. *Id.* at 603. The court stated that "while it is true that many settlement agreements are in fact concluded orally, a situation made possible by their relatively uncomplicated nature, *i.e.*, a sum of money is exchanged for a release, the involved nature of the instant settlement forecloses such an approach." *Id.*

47. RESTATEMENT, *supra* note 13, § 27 comment c; *see also* Reprosystem, B.V. v. SCM Corp., 727 F.2d 257 (2d Cir. 1984); Miller Constr. Co. v. Stresstek, A Div. of L.R. Yegge, Co., 108 Idaho 187, 189, 697 P.2d 1201, 1203 (Idaho Ct. App. 1985).

complexity of the agreement.[48] A court would determine whether a practical business need, such as the magnitude and complexity of the deal, exists to record the parties' commitments in formal documents.[49] If the court finds a business reason favoring a formal contract, then the parties probably did not intend to be bound absent such a writing.

Courts often consider whether the contract has few or many details.[50] In *Hill v. McGregor Manufacturing Corp.*,[51] for example, the parties signed a one-page "Memorandum of Understanding" settling complicated suits involving manufacturing rights and patents. The court noted that the parties failed to address many essential issues. The memorandum was so cursory in its treatment of certain important matters that the court held the parties never intended the document to be an enforceable agreement.[52]

Courts also examine the dollar amount involved in the agreement.[53] The court in *Miller Construction Co. v. Stresstek, a Division of L.R. Yegge Co.*,[54] for example, stated that the dollar amount was certainly relevant.[55] This criterion, however, is highly subjective and depends on the facts of each particular case.

Yet another factor courts examine to determine intent is whether the parties have begun performance in any way.[56] One party may have partially performed his duties under the agreement, and the other party may have accepted this performance. Even if the other party disclaims the contract, the actions of both parties demonstrate unmistakably that they intended to form a le-

48. *Reprosystem*, 727 F.2d at 262-63.

49. *Id.*

50. RESTATEMENT, *supra* note 13, § 27 comment c; *see also* Upsal St. Realty Co. v. Rubin, 326 Pa. 327, 192 A. 481 (1937) (holding that a preliminary agreement labeled "Application for Lease" was clearly incomplete); Plumbing Shop, Inc. v. Pitts, 67 Wash. 2d 514, 520, 408 P.2d 382, 385 (1965) (noting that "it cannot be said that all the terms of the agreement were settled . . . [and the parties] must have intended to set out those particulars . . . in the written contract"); E. FARNSWORTH, *supra* note 11, § 3.8, at 120-21.

51. 23 Mich. App. 342, 178 N.W.2d 553 (1970).

52. *Id.* at 345, 178 N.W.2d at 555.

53. RESTATEMENT, *supra* note 13, § 27 comment c; *see also* Miller Constr. Co. v. Stresstek, A Div. of L.R. Yegge, Co., 108 Idaho 187, 697 P.2d 1201 (Idaho Ct. App. 1985).

54. 108 Idaho 187, 697 P.2d 1201 (Idaho Ct. App. 1985).

55. *Id.* at 189, 697 P.2d at 1203; *see also* R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69, 77 (2d Cir. 1984). The parties in *R.G. Group, Inc.* had an investment of $2 million and alleged losses of $80 million. The court stated that "[w]ith that amount of money at stake, a requirement that the agreement be in writing and signed simply cannot be a surprise to anyone." *Id.*

56. RESTATEMENT, *supra* note 13, § 27 comment c; *see also* 1 A. CORBIN, *supra* note 4, at 107-09.

gally binding contract.[57]

Courts almost always consider one final indicator of the parties' intent—whether the parties made any explicit statements that they reserve the right to be bound only after signing a formal document.[58] Courts differ on how much weight to give such statements. That the parties considered the signing of a formal document constitutes some, but not conclusive, evidence that the parties did not intend to be bound until the execution of the document.[59] Some courts have held this circumstance to be "strong evidence" that the parties did not intend the negotiations to constitute an agreement prior to the execution of the formal writing.[60] Other courts have given this factor "considerable weight" and are reluctant to discount such a clear signal, regardless of whether the parties reserve the right to be bound during the course of bargaining or at the time of the alleged agreement.[61] Thus, the parties' contemplation of a written document is convincing evidence of their intent not to be bound prior to the document's execution.[62]

Courts employ some or all of these factors to determine whether the parties intended to be bound prior to the execution of a binding, formal instrument. In many cases, however, the factors do not point to a single conclusion. Viewed retrospectively, this solution to the problem of determining the intent of the parties when they reach an agreement in principle with a "formal contract con-

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57. *R.G. Group, Inc.*, 751 F.2d at 75-76. The court noted that when one party has partially performed and the other has accepted this performance, it "is an unmistakable signal that one party believes there is a contract; and the party who accepts performance signals, by that act, that it also understands a contract to be in effect." *Id.*

58. *See, e.g., id.* at 75; *Miller Constr. Co.*, 108 Idaho at 189, 697 P.2d at 1203.

59. Universal Prods. Co. v. Emerson, 36 Del. 553, 570, 179 A. 387, 394 (1935) (noting that whenever "the evidence discloses that in the negotiations between the parties, the execution of a formal written contract is contemplated, that is some evidence that any prior oral, or other informal agreement by correspondence, is merely tentative, and not final"); *see also* Priest v. Oehler, 328 Mo. 590, 600, 41 S.W.2d 783, 787 (1931) (stating that the parties' contemplation of a formal contract "is a matter to be taken into account in construing the evidence and determining whether the parties have really come to a final agreement or not").

60. *See, e.g.*, Sullivan v. Happy Hour Amusement Co., 177 A.D. 232, 163 N.Y.S. 715 (1917). Several cases stating this proposition are discussed in Annotation, *Formal or Written Instrument as Essential to Contemplated Contract Where the Making of Such Instrument Is Contemplated by Parties to Verbal or Informal Agreement*, 122 A.L.R. 1217, 1249 n.47 (1939).

61. *See, e.g.*, R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69, 75 (2d Cir. 1984).

62. *But see* Rankin v. Mitchem, 141 N.C. 277, 53 S.E. 854 (1906) (holding that reservation of the right to be bound, standing alone, is insufficient evidence of the parties' intent).

templated" can be difficult, doubtful, and unsatisfactory.[63]

III. EFFECTS OF "FORMAL CONTRACTS CONTEMPLATED" IN MERGERS AND ACQUISITIONS

A. *The Importance of the Law on Mergers and Acquisitions*

The use of agreements in principle with a "formal contract contemplated" can lead to costly litigation over the factual issue of the parties' intent to be bound prior to the execution of the formal contract. The use of the "formal contract contemplated" merits discussion particularly in the area of corporate mergers and acquisitions. Because of the various intricacies, sums of money, negotiations, and government regulations that characterize the typical merger or acquisition, these transactions seem particularly ill-suited for a concept of contract law that leaves room for factual manipulation and surprise.[64] In spite of these difficulties, many, if not most, parties in complicated mergers employ agreements in principle with a "formal contract contemplated" at some point during the course of their dealings.[65]

The general scenario for a traditional single-step merger begins with a period of preliminary negotiations during which the parties attempt to agree on a mutually satisfactory price.[66] During these preliminary negotiations, the parties normally do not deal in terms of final binding agreements.[67] Once the parties arrive at a meeting of the minds on the transaction, they have reached an "agreement in principle." At this stage in the negotiations, the parties usually have an oral agreement or a written memorandum of understanding. The parties often make this memorandum or oral agreement subject to further negotiation and execution of a defini-

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63. *See* Mississippi & Dominion S.S. Co. v. Swift, 86 Me. 248, 259, 29 A. 1063, 1067 (1894). As Professor Llewellyn wrote:

> [I]n all of Offer and Acceptance, few "rules" or situations can possibly be as practically important to the student whom scholars teach as this one. This is one of the few in which the future lawyer may hope to get a chance to *shape* the facts, not merely to argue over the picked bones of their prior slaughter.

Llewellyn, *supra* note 31, at 14 n.29 (emphasis in original).

64. *See, e.g.*, Freund & Easton, *The Three-Piece Suitor: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 BUS. LAW. 1679, 1687-90 (1979). The governmental regulation arises from the Williams Act. *See infra* notes 91-123 and accompanying text.

65. Freund & Easton, *supra* note 64, at 1687-88. In the traditional single-step merger, the parties negotiate until they agree on certain issues, at which point they have an agreement in principle. *Id.*

66. *Id.* at 1687.

67. *Id.*

tive merger agreement. Generally, the parties then issue a joint press release stating that they have reached an agreement in principle subject to the execution of a formal, signed merger agreement. Until *Pennzoil*, specialists in the securities field observed that such a release provides notice to any other corporation wishing to enter the bidding war that the target is for sale and that the parties are not yet contractually bound.[68]

When the parties reach an agreement in principle subject to the execution of a definitive merger document, the long period of final negotiation begins.[69] During this time, the buyer will further investigate the target's financial, structural, and managerial conditions. The parties also prepare proxy statements containing detailed information to submit to shareholders in anticipation of a shareholder vote on the proposed merger. Finally, the parties attempt to negotiate a definitive merger agreement detailing the preliminary agreements and any further matters that may have arisen.[70] After the parties sign the merger agreement, file the proxy materials with the SEC, and the target company's shareholders approve the merger, the merger is complete.[71]

According to several commentators, agreements in principle have no effect until the signing and approval of a definitive merger agreement.[72] Given the existing law on agreements in principle with a "formal contract contemplated,"[73] these commentators ap-

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68. *Id.* at 1688. Freund and Easton, both members of the New York bar, describe the effects of such a press release:

> [T]he world is put on notice that the target is up for sale at a time when the parties are *not* contractually obligated to each other. There is nothing to stop any other company interested in acquiring the target from entering the fray . . . . If the target is an attractive one, "grey knights"—dripping with cash or proffering attractive securities—can be expected to enter the picture.

Id. at 1688, 1689 (emphasis in original). Thus, Freund and Easton apparently believe that the parties are not bound prior to the signing. *See infra* notes 72-82 and accompanying text.

69. Freund & Easton, *supra* note 64, at 1688.

70. *Id.*

71. *Id.* at 1690. Mergers of this type generally will take at least three to four months to complete. *Id.*

72. *See, e.g., id.* at 1688. *See also* I BUSINESS ACQUISITIONS (J. Herz & C. Baller 2d ed. 1981), in which the editors state that a properly drafted letter of intent must reflect clearly that the parties do not consider the letter a legally binding document. The parties should provide that the letter "is merely a memorandum confirming the understanding of the parties, is subject to the preparation and execution of a definitive contract, and is not to be construed as legally binding on either party." *Id.* § 4.103. The editors further state that "a properly drafted letter of intent *has no binding effect.* [A disclaimer like the one above] operates to nullify any obligations, implicit or explicit, derived from the text of the letter." *Id.* § 4.104 (emphasis added).

73. *See supra* notes 19-63 and accompanying text.

pear at first glance to be correct. In *Pennzoil* many of the factors[74] that courts use to determine intent should have indicated that the parties did not intend to be bound prior to the signing of a formal document. The court in *Pennzoil* applied New York law, which regards four factors to be important in determining the intent of the parties: (1) whether the parties have expressly reserved the right not to be bound prior to execution of a formal document; (2) whether either or both parties have partially performed the contract; (3) whether the parties have agreed upon all of the terms of the agreement; and (4) whether the agreement is of a type usually put in writing.[75]

The first of these criteria arguably was satisfied when the *Pennzoil* parties issued a joint press release stating that the parties had reached an agreement in principle subject to the execution of a definitive merger agreement.[76] The parties apparently did not engage in partial performance of the agreement;[77] therefore, the second listed factor for a non-binding agreement in principle also had been met. Regarding the third factor, many points, including the manner and time of payment and the payment of dividends,[78] ap-

74. *See supra* notes 32-63 and accompanying text.

75. R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69, 74-76 (2d Cir. 1984).

76. Baron & Baron, *The Pennzoil-Texaco Dispute: An Independent Analysis*, 38 BAYLOR L. REV. 253, 255 (1986). The Texas Court of Appeals rejected Texaco's argument that the language of the press release demonstrated an express reservation of the right to be bound. Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 789-90 (Tex. Ct. App. 1987). The court held that "any intent of the parties not to be bound before signing a formal document is not so clearly expressed in the press release to establisb, as a matter of law, that tbere was no contract at the time." *Id.* at 790.

77. Baron & Baron, *supra* note 76, at 273. Pennzoil argued that it had partially performed despite the shortened time period caused by Texaco's early interference. This performance included arranging to have one billion dollars ready in order to fulfill the contract. Brief for Appellee Pennzoil Co. at 192-93, Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. Ct. App. 1987) (No. 84-05905) [hereinafter Brief for Appellee]. Texaco disagreed, stating that the gathering of funds amounted only to preparatory action that Getty did not in any way accept. Reply Brief for Appellant Texaco, Inc. at 68 n.131, Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. Ct. App. 1987) (No. 84-05905) [hereinafter Brief for Appellant]. The Court of Appeals found little evidence of partial performance to show that the parties believed they were bound. *Pennzoil*, 729 S.W.2d at 791-92. The court stated that the absence of partial performance did not conclusively demonstrate the absence of a contract, but was merely a circumstance "that the finder of fact could consider in reaching a decision on whether the parties intended to be bound." *Id.* at 792.

78. Baron & Baron, *supra* note 76, at 272. Texaco argued that the parties never agreed on (1) who would buy the Getty Museum's shares; (2) price protections; (3) timing and offer of the sale; (4) which party would guarantee payment of the stub; and (5) whether Pennzoil would honor Getty's employee benefit plans. Brief for Appellant, *supra* note 77, at 49-50. Pennzoil, on the other hand, argued that some of these issues had been resolved, while others were insignificant issues which neither party would have allowed to disturb the con-

parently still needed to be finalized through further negotiation between Pennzoil and Getty. Finally, the size and complexity of the negotiations and the sums of money involved strongly suggest that the parties probably did not intend to be bound prior to the signing of the definitive merger agreement.[79]

Examination of both mergers in general and the facts leading up to the proposed merger in *Pennzoil* arguably compels the conclusion that reasonable persons would expect not to be bound before signing a formal document. Judge Friendly points out in his concurrence to *International Telemeter Corp. v. Teleprompter Corp.*[80] that during complex business dealings parties generally refrain from making binding agreements until their attorneys finalize the terms in a formal document. The parties' conduct prior to the signing of a final contract generally is not that of offer and acceptance, but of negotiation.[81] Nevertheless, the jury in *Pennzoil*, rightly or wrongly, decided that although no formal contract was signed, Pennzoil and Getty intended to be bound to a merger prior to the signing of any definitive merger agreement. The question of the parties' intent in these situations unarguably is one of fact for the jury to decide.[82] On February 12, 1987, the Texas Court of Appeals affirmed the jury's decision, merely decreasing the punitive damages awarded. Both the trial court decision and the appellate decision affirming its result vividly demonstrate the problems associated with using "formal contract contemplated" language in the

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tractual commitment. Brief for Appellee, *supra* note 77, at 194-202; *see also Pennzoil*, 729 S.W.2d at 792-95.

79. Baron & Baron, *supra* note 76, at 273. The court agreed that this factor supported Texaco's position that the parties to this type of transaction normally would expect to execute a signed contract before being bound. *Pennzoil*, 729 S.W.2d at 795. The court, however, also stated tbat the jury possessed sufficient evidence to find that the parties did intend to be bound. *Id.*

80. 592 F.2d 49 (2d Cir. 1979).

81. *Id.* at 57 n.1. Judge Friendly stated:

> The usual sequence of events [in complex business agreements] is not tbat of offer and acceptance; on the contrary, the [parties] who originally conduct the negotiations, often will consciously refrain from ever making a binding offer, realizing . . . that large deals tend to be complex and that its terms have to be formulated by lawyers before it can he permitted to become a legally enforceable transaction . . . . Once [the parties reach agreement on the important aspects,] negotiation is turned over to the lawyers, usually witb instructions to produce a document which all participants are willing to sign.

Id. (quoting 2 R. SCHLESINGER, FORMATION OF CONTRACTS: A STUDY OF THE COMMON CORE OF LEGAL SYSTEMS 1584-86 (1968)).

82. *See supra* note 26 and accompanying text. The Texas Court of Appeals continually stated that the entire issue of intent involved a factual question for the jury and that the court would uphold the jury's decisions as long as sufficient evidence existed to support the jury finding. 729 S.W.2d at 791, 793, 795.

complicated area of mergers and acquisitions.

B. *Effects of* Pennzoil *and "Formal Contracts Contemplated" on Mergers and Acquisitions*

1. Uncertainty after *Pennzoil*

Investment bankers and attorneys are divided on the precise effect that the *Pennzoil* decision will have on mergers and acquisitions. Most observers agree, however, that *Pennzoil* has increased uncertainty to some extent on the point at which parties in contractual negotiations become legally bound.[83] Uncertainty about the law regarding the "formal contract contemplated" restrains competition because investors rely on their belief that rules will be applied objectively and predictably.[84] Some analysts, however, believe that the effect of the *Pennzoil* decision will be negligible[85] and consider the case an aberration that will be reconsidered on appeal.[86] The general consensus among experts seems to be that, at the very least, negotiators will have to be extremely cautious about the use of agreements in principle with a "formal contract contemplated."

83. The *Wall Street Journal*, for example reported heightened uncertainty on this issue and described the *Pennzoil* decision as "casting a long, cold shadow across American business." *See* Wall Street, *supra* note 2. Michael Zaleski, a New York investment banker, described a series of tough negotiations that culminated in an agreement in principle. He attempted to shake hands on the deal, but the opposing attorney refused. Zaleski stated, "I never thought a handshake was anything more than a moral commitment . . . . But now people are afraid to make even a moral commitment for fear someone will use it against them." *Id.* Mr. Jay Grogan, an attorney with the Dallas firm of Jackson, Walker, Winstead, Cantwell & Miller, agreed: "The lesson learned is that the most general of writings can be construed as an agreement." *Id.*

84. *New York's Stake in the Texaco Case*, N.Y. Times, July 26, 1986, at 27, col. 5. Uncertainty restrains competition. *Pennzoil* creates uncertainty because "[c]orporations make investment decisions on the understanding that accepted rules will be applied objectively, consistently, predictably." *Id.* Because of the uncertainty generated by *Pennzoil*, both the Business Council of New York State and New York Attorney General Robert Abrams filed an amicus curiae brief with the Texas Court of Appeals. *Id.* Mr. Abrams stated that the case "will have a direct impact on how business people and corporations comport themselves while doing business in New York." *Id.* (quoting from Mr. Abrams' amicus curiae brief).

85. Wall Street, *supra* note 2, at 1, col. 1. Blaine V. Fogg, an attorney with the New York City firm of Skadden, Arps, Slate, Meagher & Flom, declared that "[t]he impact of *Pennzoil v. Texaco* on mergers and acquisitions will be negligible." Letter from Blaine V. Fogg to Author (Jan. 6, 1987) (discussing impact of *Pennzoil*).

86. Wall Street, *supra* note 2, at 1, col. 1. Mr. Daniel J. Good, a mergers and acquisitions specialist with E.F. Hutton and Co., stated: "The most sophisticated legal talent on Wall Street are incredulous that this decision was decided on the facts." *Id.*

2. Decrease in Number of Competing Bids

Another significant potential impact of the jury's decision in *Pennzoil* is a decrease in the number of competing bids and auctions, which could lead to two results. Even though the parties in *Pennzoil* used "formal contract contemplated" language, the jury found that a contract existed prior to the signing of a formal merger agreement. The jury also found that Texaco tortiously interfered with this contract. Thus, if parties to a merger or acquisition continue to use the ambiguous "formal contract contemplated" concept, fewer competing bids and auctions will take place because of fear on the competing bidder's part of being found liable for tortious interference with a contract.[87] This chilling effect contravenes the intent of Congress and the SEC in the Williams Act to encourage such auctions.[88]

A second result of the decrease in auctions and competing bids involves the potential consequence of the impact of mergers on society. Some commentators state that competing bids should be encouraged in order to maximize both shareholder wealth and social welfare.[89] Other commentators regard competing bids and auctions as inherently bad for other corporations and society in general.[90] Thus, depending on the point of view, any decrease in auctions resulting from the uncertainty generated by the *Pennzoil* case could entail either positive or negative consequences.

a. *The Williams Act and Competing Bids*

Competing bids arise because of external competition for takeover targets.[91] In the typical merger, competing companies often enter the picture and attempt to outbid the original bidder.[92] The Williams Act and other SEC regulations are the primary tools that facilitate the opportunity to place successful competing bids.

Until the 1960s, corporations attempted takeovers by one of

87. *See infra* notes 124-27 and accompanying text.
88. *See infra* notes 91-127 and accompanying text.
89. *See infra* notes 129-49 and accompanying text.
90. *See infra* notes 150-58 and accompanying text.
91. Freund & Green, *Substance Over Form S-14: A Proposal to Reform SEC Regulation of Negotiated Acquisitions*, 36 Bus. Law. 1483, 1500 (1981). Intense competition exists among corporations for desirable targets and takeovers. *Id. See generally* Ehrbar, *Corporate Takeovers Are Here To Stay*, Fortune, May 8, 1978, at 91-100.
92. Freund & Green, *supra* note 91, at 1500. During 1977 the buyers paid more than $100 million in at least 10 takeover attempts. In each of these 10 attempts at least 2 companies competed for the target. Ehrbar, *supra* note 91, at 91.

two methods[93]—proxy solicitations regulated under Section 14 of the Securities Exchange Act of 1934[94] or exchange offers of securities[95] regulated under the registration requirements of the Securities Act of 1933.[96] During the 1960s, corporations began to make extensive use of the cash tender offer,[97] which occurs when an individual, group, or corporation offers to buy or bids on a set percentage of stock in the target corporation.[98]

One advantage of the cash tender offer over the other two types of takeover attempts was that cash tender offers could be carried out in extreme secrecy.[99] The bidder was not compelled to disclose anything about itself or its motives. This secrecy meant that target shareholders frequently lacked adequate information to decide whether to tender their shares.[100] In 1968 Congress remedied this problem by enacting the Williams Act,[101] which amended

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93. *See* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 22 (1976); *see also* H.R. REP. No. 1711, 90th Cong., 2d Sess. 2, *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 2811, 2812-13 [hereinafter Legislative History].

94. 15 U.S.C. § 78n (1982). The Securities Exchange Act regulates takeovers attempted through proxy contests. *Id.* The SEC rules promulgated under section 78n require the challenger to divulge to the shareholders the identity of all takeover participants, their shareholdings, and when they acquired their interests. *See* 17 C.F.R. § 240.14a-102 (1986). The challenger must file this information with hoth the SEC and any national security exchange upon which any security of the issuer is listed and registered. *See* 17 C.F.R. § 240.14a-11(c) (1986).

95. *Piper*, 430 U.S. at 22.

96. 15 U.S.C. § 77e (1982). When a company attempts to take over another company through a stock-for-stock exchange, the company must register the offer in compliance with the Securities Act of 1933. Registration provides the shareholder with a prospectus stating the identity of the buyer and the plans proposed for the company and allows the shareholder to make an informed decision. Legislative History, *supra* note 93, at 2812-13.

97. *Piper*, 430 U.S. at 22; *see* Legislative History, *supra* note 93, at 2811-12. This proliferation of cash tender offers is analyzed in Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV., Mar.-Apr. 1967, at 135.

98. Legislative History, *supra* note 93, at 2811.

99. Both the proxy contest and the stock-for-stock exchange require extensive disclosure allowing the shareholder to make an informed decision whether to tender his shares or hold them. *See supra* notes 94 & 96.

100. The person seeking control hy the tender offer was not required to disclose his identity, the sources of his funds, or his plans for the company. Unless incumbent management publicly revealed this information, the shareholder would possess no information on which to decide whether to tender his bids, hold them, or sell them on the market. Legislative History, *supra* note 93, at 2812.

101. As House Report No. 1711, the legislative history to the Williams Act, states:

> [W]ithout knowledge of who the hidder is and what he plans to do, the shareholder cannot reach an informed decision. He is forced to take a chance. For no matter what he does, he does it without adequate information . . . . This is precisely the kind of dilemma which our Federal securities laws are designed to prevent.

Id. at 2812-13.

the Securities Exchange Act of 1934[102] to require disclosure by both bidder and management and purported to maintain the balance of power between management and target while protecting shareholders.[103]

Section 13(d)[104] of the Williams Act is the principal disclosure provision. This section generally requires that any person who through acquisition becomes the beneficial owner of more than five percent of any class of equity securities in a corporation file a disclosure form within ten days of the acquisition.[105] The disclosure must reveal the background of the owner, the source and amount of funds used to make the purchases, and any plans or purposes of the owner for the future of the target corporation.[106]

The other major disclosure provision under the Williams Act is Section 14.[107] Section 14(d)(1) requires any person making a tender offer which would result in that person becoming the beneficial owner of more than five percent of the securities at the consummation of the tender offer to file a disclosure form with the SEC.[108] Section 14(d) also contains provisions for withdrawal rights[109] and pro rata purchase.[110] According to Section 14(d)(5), a security holder who tenders his securities may withdraw them at any time prior to or during the first seven days of the offer and any time after sixty days from the date of the original tender offer.[111] Section 14(d)(6) states that a bidder who offers to buy less than one hundred percent of the securities of a corporation must purchase the percentage he desires on a pro rata basis from those

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102. 15 U.S.C. §§ 78l(i), 78m(d)-(e), 78n(d)-(f) (1982 & Supp. 1987).

103. Legislative History, *supra* note 93, at 2813; *see also* Childers, *The Federal Scheme of Tender Offer Regulation*, 7 J. Corp. L. 525, 527 (1982).

104. 15 U.S.C. § 78m(d) (1982).

105. *Id.; see also* Childers, *supra* note 103, at 530. This disclosure must he filed with the SEC, the issuer, and each exchange upon which the security is traded. *Id.* at 531.

106. 15 U.S.C. § 78m(d)(1)(A)-(C) (1982). The five-percent owner also must disclose the numher of shares beneficially owned, the number of shares that he has the right to acquire either directly or indirectly, and information about any agreements concerning securities of tbe issuer. 15 U.S.C. § 78m(d)(1)(D)-(E) (1982).

107. 15 U.S.C. § 78m(d)(1) (1982); *see also* Childers, *supra* note 103, at 534 (providing a summary of this code section and its requirements).

108. 15 U.S.C. § 78n(d)(1) (1982). This form must include all of the information required by Section 13(d)(1), including any "such additional information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors." *Id.*

109. 15 U.S.C. § 78n(d)(5) (1982).

110. 15 U.S.C. § 78n(d)(6) (1982).

111. 15 U.S.C. § 78n(d)(5) (1982). The SEC expanded the right to withdraw to encompass the period during which the tender offer remains open. 17 C.F.R. § 240.14d-7(a) (1987).

who tendered their shares within the first ten days of the tender offer.[112]

Finally, the Williams Act contains a broad antifraud provision.[113] Section 14(e) prohibits any material misstatements or omissions and any fraudulent, deceptive, or manipulative practices.[114] The SEC has used its rule-making authority[115] to promulgate regulations designed to prevent fraudulent, deceptive, or manipulative acts within the meaning of Section 14(e) of the Act.[116] Regulation 14E states that a tender offer must remain open at least twenty business days from the date of commencement.[117]

Even though the purpose of the Williams Act originally was to require the provision of information to shareholders during a tender offer by means of disclosure provisions,[118] one of the practical effects of the Act has been to facilitate and encourage competing bids and auctions.[119] Specific provisions facilitate auctions by providing for withdrawal rights[120] and a minimum number of days during which tender offers must be kept open.[121] For example, the Act provides time for the shareholders of the target corporation to recognize and evaluate the potential benefits from competing bids.[122] The Act also provides potential competing bidders the time and information necessary to evaluate the target company and to

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112. 15 U.S.C. § 78n(d)(6) (1982). The bidder must purchase a pro rata share of all stock tendered. *Id.*

113. 15 U.S.C. § 78n(e) (1982).

114. *Id.*

115. 15 U.S.C. § 78n(e) (1982) provides: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

116. 17 C.F.R. §§ 240.14e-1 to -3 (1987). These provisions are entitled Regulation 14E. *Id.*

117. 17 U.S.C. § 240.14e-1(a) (1982). This Section states that "no person who makes a tender offer shall: (a) Hold such offer open for less than twenty business days from the date such tender offer is first published or sent or given to security holders." *Id.*

118. *See supra* notes 93-103 and accompanying text.

119. Bebchuk, *supra* note 10, at 1029 n.13, 1051-54; *see also* Easterbrook & Fischel, *supra* note 10. Easterbrook and Fischel present a strong argument against allowing competing offers, but acknowledge this effect of the Williams Act. *Id.* at 1179 n.46; *see also* Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371, 373 (1980) (stating that "[d]isclosure requirements and the delay of execution caused by minimum offer periods . . . freely provide potential competing bidders with time and information").

120. 15 U.S.C. § 78n(d)(5) (1982); 17 C.F.R. § 240.14d-7 (1987). For an explanation of these provisions see *supra* notes 109-11 and accompanying text.

121. 17 C.F.R. § 240.14e-1 to -2 (1987); *see also supra* notes 115-17 and accompanying text.

122. Bebchuk, *supra* note 10, at 1051-54.

determine whether to compete in the auction.[123] The *Pennzoil* case establishes that simple agreements between corporations that previously had been viewed as mere negotiations now may be held to be binding contracts. The resulting uncertainty created by *Pennzoil* has had a chilling effect on auctions and bidding wars[124] and undermined provisions of the Williams Act designed to facilitate competing bids and auctions.

b. A New Defensive Weapon

The uncertainty of the law regarding the "formal contract contemplated" after the *Pennzoil* decision creates a new defensive weapon. The *Pennzoil* jury decided that the parties became bound by an agreement in principle prior to any written contract. Therefore, target management may employ this concept defensively as a form of lock-up.[125] Once a target and bidder reach an agreement in principle to merge, the target's management can employ the lock-up device to discourage other companies from offering competing bids.[126] According to one source, the *Pennzoil* decision already has been used to the detriment of shareholders by preventing competi-

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123. *Id.*

124. As Peter Waldman wrote for the *Wall Street Journal*:

> This "post-Texaco" climate of uncertainty is having a chilling effect on bidding competition. Some companies, accustomed to vicious bidding wars . . ., have grown gun-shy in the wake of the Texaco verdict, especially when a potential target has entered any type of agreement with a third party.

Wall Street, *supra* note 2, at 1, col. 1.

Texaco further argued that the judgment will "[deter] the initiation of contests for corporate control across the country." Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768, 858 (Tex. Ct. App. 1987). In its brief to the Texas Court of Appeals, Texaco argued that the judgment violates the Commerce Clause by chilling interstate tender offers. Texaco argued that if Texaco can he subjected to liahility on those facts, then no competing bidder could take the risk of making a competing bid when an initial offeror previously has engaged in any negotiations of substance with the target. Brief for Appellant, *supra* note 77, at 112-13. The Texas Court of Appeals disagreed, stating:

> This cause of action is for tortious interference with a contract. Judgment was not rendered because Texaco won in a competitive tender offer situation. Rather, it was rendered pursuant to the jury's finding that Texaco had tortiously interfered with a binding agreement. A judgment based upon such a finding will not deter the "invitation of contests for corporate control throughout the country"; however, it should deter tortious interference with a binding agreement between parties.

Pennzoil, 729 S.W.2d at 859. The question, however, is not whether the third parties can interfere with a binding contract, but whether a binding contract even exists.

125. *Id.* A lock-up is "[a]n arrangement made in connection with the proposed acquisition of a publicly held business, that gives the proposed acquiror an advantage in acquiring the subject company over other potential acquirors." TENDER OFFERS: DEVELOPMENTS AND COMMENTARIES 273-74 n.1 (M. Steinberg ed. 1985).

126. Wall Street, *supra* note 2, at 17, col. 1.

tive bids during an actual acquisition.[127]

Thus, use of the agreement in principle with a "formal contract contemplated" can contravene the intent of Congress and the SEC expressed in the Williams Act. While this contravention may not rise to the level of criminal conduct, it does provide reason for concern over the continued use of "formal contracts contemplated" in the area of mergers and acquisitions. Congress and the SEC have fashioned a policy of facilitating competing bids, but the use of these agreements can stifle competing bids by effectively locking up the target company.

c. Impact on Shareholders and Society at Large

The chilling impact that agreements in principle have had on competing offers has elicited approval from some experts and disdain from others.[128] Some commentators believe that competing bids should be facilitated as much as possible.[129] Lucien Bebchuk,[130] for example, believes that competing tender offers are desirable because they benefit both the target's shareholders and the general society.[131] Bebchuk advocates a rule for auctioneering that would, through regulation of offers under the Williams Act and state statutes, provide sufficient time for competitors to submit bids.[132] This rule also would allow the target's incumbent management to solicit competing bids by providing information about the target corporation to any potential buyer.[133]

Bebchuk discusses four motives to explain why offerors initi-

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127. The *Wall Street Journal* reported that in negotiations between Texas Air and Eastern Airlines, *Pennzoil* "was used as a negotiating tool to stop the bidding process . . . and it was used to the detriment of the shareholders." *Id.* (quoting an unidentified Braniff Airline official). Texas Air and Eastern Airlines agreed on an acquisition price, and, at a news conference two days later, Eastern President Frank Borman dismissed the possibility of a competing bid, saying, "You probably have heard of Texaco and Pennzoil." This statement reportedly played a part in preventing two competing bids. *Id.*

128. *See, e.g.*, Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply*, 35 STAN. L. REV. 23 (1982); Bebchuk, *supra* note 10; Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985); Easterbrook & Fischel, *supra* note 99; Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

129. *See, e.g.*, Bebchuk, *supra* note 10, at 1030; *see also* Gilson, *supra* note 128, at 51-52.

130. Bebchuk is a member of the Society of Fellows, Harvard University.

131. Bebchuk, *supra* note 10, at 1030. Gilson believes that competing bids will increase allocative efficiency and may increase return on investment in the searcb for target companies. Gilson, *supra* note 128, at 66.

132. Bebchuk, *supra* note 10, at 1030, 1051-54.

133. *Id.* at 1030, 1054-56.

ate takeover bids. [134] First, the bidder may decide that the target's management operates inefficiently and that new management could increase profits and decrease costs.[135] Second, combining the operations may increase profits through economies of scale.[136] Third, the offeror may believe that, for whatever reason, the target's stock is undervalued.[137] Finally, the offeror may be motivated by a kind of managerial entrepreneurship,[138] a belief that management's income, prestige, and perquisites tend to increase in proportion to the firm's size.[139]

Bebchuk also claims that allowing auctions will benefit the target's shareholders by increasing the premiums paid on their shares of stock.[140] Typically, target shareholders are dispersed and cannot bargain readily with the initial offeror's takeover bid. The shareholders must either tender their shares at the offered price or hold on to their shares. Whatever a shareholder decides, the choice will not affect the other shareholders, and no bargaining over the bid will take place.[141] Only competing offers will force the offered price to rise and allow the shareholders to obtain a better share of

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134. *Id.* at 1030. The management of a corporation often will begin to shirk responsibilities and not perform at peak efficiency because much of the benefit of their work inures to others, namely shareholders or other managers. Because managers often feel like a small cog in a big wheel, they may become less efficient. Prospective bidders become aware of this decrease in efficiency and decide to remedy the problem. Easterbrook & Fischel, *supra* note 10, at 1169-73.

135. Bebchuk, *supra* note 10, at 1030-31. This motive was suggested first by Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965).

136. Bebchuk, *supra* note 10, at 1031-32. The acquiror may possess some skills that will be useful to the target. The takeover also may yield tax savings or an increase in combined market power. *Id.; see also* P. STEINER, MERGERS: MOTIVES, EFFECTS, POLICIES 75-95 (1975).

137. Bebchuk, *supra* note 10, at 1032-33.

138. *Id.* at 1033; *see, e.g.*, R. MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM 122-24 (1964).

139. Bebchuk, *supra* note 10, at 1033.

140. *Id.* at 1038-41. Professor Bebchuk agrees that auctions are not detrimental to the initial offeror because the rewards for the search are high relative to the risks. *Id.* at 1034-38. Professor Gilson argues that competitive bidding can increase benefits to the initial offeror by allowing those persons who spent the money gathering information about the target to "sell" the information to a subsequent bidder. The initial bidder gathers the information and purchases the maximum amount of stock in a company possible without having to make a public disclosure, then releases the information. This information may alert a company who desires to bid, causing the price to rise and benefitting the initial information gatherer. Gilson, *supra* note 128, at 52-56.

141. Bebchuk, *supra* note 10, at 1038-40. Shareholders who own large volumes of stock often take into account the effect of their decisions on the success of the tender offer, potentially strengthening the bargaining ability of the target shareholders. However, as long as the majority of the stock is owned by small shareholders, the bargaining ability of any individual shareholder remains very limited. *Id.* at 1040.

the gains that the bidder expects to realize from the takeover.[142]

Bebchuk states that auctions also provide substantial benefits to society[143] by (1) increasing the likelihood of the target being acquired by the firm to which its assets are most valuable;[144] (2) encouraging socially desirable investment in potential targets;[145] (3) encouraging the management of potential targets to look for an appropriate acquiror;[146] and (4) increasing available information in order to minimize the potential for bad acquisitions that yield losses or, at best, no gains.[147]

If Bebchuk's view that auctions are valuable to society is correct,[148] the implications of using the "formal contract contemplated" in mergers and acquisitions are apparent. Because the *Pennzoil* case may cause merger and takeover specialists to react to these types of agreements defensively, decreasing the number of competitive bids,[149] target shareholders and society both may suffer injury. Such a decrease in competitive bids that would injure target shareholders and society as a whole supports the call for reform in the use of the "formal contract contemplated" in mergers and acquisitions.

Some commentators, however, believe that competing tender offers should be discouraged. Frank Easterbrook and Daniel Fischel,[150] for example, argue that the management of tender offer targets should not seek competing offers to increase the wealth of shareholders.[151] Instead of encouraging competing bids that ulti-

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142. Auctions also may increase the premiums for a target's shareholders in negotiated acquisitions. The target's management will use the threat of soliciting competing bids to negotiate a higher purchase price. *Id.* at 1041-46.

143. *Id.* at 1046-50.

144. *Id.* at 1048; *see also* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 872-74 (1981) (stating that "[a]s a general principle, allocating resources among competing claimants by price is desirable because it places resources with the most efficient users"). This allocation benefits the acquiring company because of increases in post-offer prices of the acquiror's stock. *Id.* at 873.

145. Bebchuk, *supra* note 10, at 1049.

146. *Id.*

147. *Id.* at 1049-50.

148. Other commentators also assert that auctions should be encouraged. *See, e.g.*, Gilson, *supra* note 128, at 51.

149. *See supra* notes 124-27 and accompanying text.

150. At the time they wrote the article, Frank Easterbrook was an Assistant Professor of Law at the University of Chicago and Daniel Fischel was an Assistant Professor of Law at Northwestern University. Easterbrook is currently a judge on the United States Court of Appeals for the Seventh Circuit. Fischel is presently the Director of the Law and Economics Program at the University of Chicago.

151. Easterbrook & Fischel, *supra* note 10, at 1161; Jarrell & Bradley, *supra* note 119.

mately may result in no change in management, hostile takeovers are a means of correcting inefficiencies in the management of the corporation, which increases the wealth of society as a whole.[152]

Easterbrook and Fischel further argue that the encouragement of competition actually decreases the total number of tender offers.[153] The first offeror may expend considerable time, money, and effort researching firms that are likely candidates for a takeover.[154] When the offeror announces its bid, potential competing firms may learn that the target company is ripe for a takeover.[155] The competing bidder acquires this information at a substantially lower cost than the initial bidder[156] and thus may be able to pay a higher price per share while making an equal or greater profit.[157] As a result, fewer firms are willing to be the first bidder. The number of tender offers therefore decreases, and the management of target firms has less incentive to operate efficiently.[158]

If the thesis of Easterbrook and Fischel concerning the effect of competing offers is correct, then the use of agreements in princi-

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Professors Jarrell and Bradley argue that the Williams Act and state regulations requiring disclosure and waiting periods provide time and information to potential competing bidders during a tender offer. *Id.* at 373. While this bidding does lead to higher premiums for targets' shareholders, the overall effect is to increase social costs and to decrease the numher of tender offers. *Id.*

152. Easterhrook & Fischel, *supra* note 10, at 1168-74. Other commentators have agreed, stating that "corporate takeovers are beneficial exchanges of corporate control that generally result in more efficient management of target resources." Jarrell & Bradley, *supra* note 119, at 380.

153. Easterbrook & Fischel, *supra* note 10, at 1178; *see also* Jarrell & Bradley, *supra* note 119, at 373-74.

154. Easterbrook & Fischel, *supra* note 10, at 1178.

155. *Id.* Thus, both the hid itself and the suhstantial amount of disclosure required by the Williams Act, *see supra* notes 91-117 and accompanying text, provide information ahout the target to the bidder. Easterbrook & Fischel, *supra* note 10, at 1178; *see also* Jarrell & Bradley, *supra* note 119, at 373 (noting that "[d]isclosure requirements and the delay of execution caused by minimum offer periods and legal actions freely provide potential competing bidders with time and information"). The mere existence of the offer notifies other firms of potential takeover targets. Such modification allows competing firms to avoid the high costs of searching for a prospective takeover, costs the first offeror cannot avoid. Easterbrook & Fischel, *supra*, at 1178 n.45.

156. Easterbrook & Fischel, *supra* note 10, at 1178-79. Such disclosure of information means that bidding will occur and that winning bidders will he forced to pay higher premiums in order to win the hattle. This increase in the premium over that which would have been the premium had there been no auction imposes a "tax" on the acquisition of information. This "tax" reduces the production of knowledge and deters some otherwise profitable takeovers. Jarrell & Bradley, *supra* note 119, at 386.

157. Easterbrook & Fischel, *supra* note 10, at 1178-79.

158. *Id.; see also* Jarrell & Bradley, *supra* note 119, at 404 (concluding that "some otherwise profitable takeovers are deterred, and all takeovers occurring after regulation produce relatively smaller social gains").

ple after *Pennzoil* should not reduce the overall number of tender offers. These two commentators argue that discouraging competing bids actually has a favorable impact on the environment for tender offers. However, even Easterbrook and Fischel, and others who ascribe to their thesis, should be concerned about the cloud of uncertainty that *Pennzoil* has cast over the mergers and acquisitions marketplace. The best way to facilitate tender offers, which Easterbrook and Fischel agree are beneficial to society, is to ensure that negotiations are as accurate and certain as possible.

IV. Possible Solutions

A. The Contract to Bargain

While the cumulative effects of agreements in principle with a "formal contract contemplated" have yet to be fully realized, the magnitude of the problems already identified justifies a search for possible solutions. One possible solution to the ambiguity caused by the use of the "formal contract contemplated" has been suggested by Charles L. Knapp.[159] The parties' intentions and expectations during negotiations often become frustrated by the law regarding the "formal contract contemplated" because the common law characterizes all dealings as either contract or no contract and ignores other possible intentions.[160] Even without legal redress for breach of contract, the parties to negotiations often consider themselves to some extent morally or ethically bound.[161] Knapp, therefore, proposes that courts create a legally recoguized "contract to bargain"[162] to be used by parties who, through negotiations, have

159. Knapp, *supra* note 3, at 673.

160. *Id.* at 678. Knapp discusses the ambiguities and problems associated with the use of the "formal contract contemplated," stating:

> It is suggested that in a number of cases, the . . . "written contract contemplated" rule . . . run[s] . . . counter to the intentions and expectations of the parties at the time of the transaction under scrutiny. This is because the common law's dichotomy of contract/no-contract does not exhaust the catalog of possible intentions.

Id.

161. *Id.* at 679. The parties have agreed on as many terms as they can and leave it to attorneys to put this agreement in writing and add the necessary legalities. The parties may feel bound etbically to the broad outline of tbe agreement. If a substantial issue cannot be resolved, however, the parties may feel perfectly free to withdraw. *Id.* at 684.

162. *Id.* at 685. By using the word "contract" in the phrase "contract to bargain," Knapp stresses that the relationsbip between the parties entails some binding obligations, the breach of which may result in liability. The word "bargain" emphasizes that the parties are not absolutely required to perform or even to agree to perform; the contract to bargain creates a duty to bargain in good faith to reach agreement within a reasonable time. *Id.*

settled many but not all of the terms of a contract, but nevertheless feel committed to the entire proposed agreement.[163] In the "contract to bargain" each party agrees to negotiate in good faith to reach a final contract. If, however, agreement cannot be reached despite good faith efforts by the parties, either party may withdraw without liability.[164]

Under Knapp's contract to bargain, the intent necessary to create an agreement is present when the parties have agreed on the essential terms of the bargain and become committed to an overall plan.[165] The parties' intent is determined by looking to the writings of the parties and all of the surrounding circumstances.[166] The burden of proving willingness to be bound rests with the proponent of the contract to bargain.[167]

Conduct constituting bad faith establishes a breach of the contract to bargain.[168] The most obvious example of bad faith occurs when a party withdraws simply because a third party bas made a better offer.[169] Courts probably will enforce the contract to bargain only when one party has unilaterally withdrawn from negotiations or insisted on terms so unreasonable that acceptance could not be expected, coupled with a demonstrable advantage to be gained by the defendant in avoiding the contemplated transaction.[170] Knapp does not delineate the specific remedies that a court may award for breach of a contract to bargain.[171] He suggests, however, that a successful plaintiff should recover at least reliance damages and

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163. *Id.* Parties generally consider withdrawal unjustified for any reason except failure to agree on the remaining points. *Id.*

164. *Id.* at 685-86.

165. *Id.* at 720-28.

166. *Id.* at 720.

167. *Id.* at 720-21. This burden of proof should be no greater than for any other contract, and the court should allow the proponent to rely on both oral manifestations of intent and any written memoranda, such as a memorandum of agreement. *Id.* at 720-21.

168. *Id.* at 721-23.

169. *Id.* at 721. Professor Knapp cautions that the good faith requirement may be objected to for two reasons:

> [It] may be used to penalize a party for "insufficient bargaining" . . . [and] . . . whenever an extraneous factor . . . makes withdrawal from the contract materially advantageous to one party, that party runs the risk of being held liable even if he withdraws from the transaction only after extensive bargaining has failed to produce a complete agreement.

Id. at 722.

170. *Id.* at 722-23.

171. *Id.* Knapp refers to RESTATEMENT (SECOND) OF CONTRACTS § 90 (Tent. Draft No. 2, 1965) (providing that remedies in promissory estoppel may be limited as justice requires).

possibly expectation damages or specific performance.[172]

Knapp's concept of the contract to bargain reflects the parties' actual beliefs concerning the degree that they intend to be bound in the contractual relationship.[173] In the area of mergers and acquisitions, however, proving the parties' intent to be bound by a contract to bargain is as difficult as in the area of the "formal contract contemplated." Many of the same factual questions arise in both situations. Perhaps the difference is that a lesser showing of intent is needed in the contract to bargain in which the proponent must show only that both parties have agreed on certain essential terms and intend to work in good faith toward a contract.[174] In contrast, the proponent in a "formal contract contemplated" case must show that the parties intended to be bound on all terms prior to the execution of a formal contract.[175] The question of intent remains difficult to solve and provides no clear-cut, bright-line rule for guidance.

Several issues arise concerning the requirement of good faith in the contract to bargain. Knapp states that the clearest example of bad faith is acceptance of a better offer from a third party. In the area of mergers and acquisitions, acceptance of a competing bid after reaching a contract to bargain would constitute bad faith and result in liability. Thus, in order to avoid charges of bad faith, a party should not accept a competing bid until after he formally withdraws in good faith from the first set of negotiations.

B. *The Bright-Line Approach*

Perbaps a better method of avoiding the problems created by *Pennzoil* is the bright-line approach. In the concurring opinion to *International Telemeter Corp. v. Teleprompter Corp.*,[176] Judge Friendly emphasized the gap between contract law and the reality of complex business transactions.[177] He then stated a rule to the effect that no contract exists in complex business agreements until the signing and completion of a contract.[178] Until this formal exe-

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172. Knapp, *supra* note 3, at 723-26. Damages, of course, must be proven with reasonable certainty. The plaintiff also must demonstrate proximate cause and foreseeability. *Id.* at 723 & n.172.

173. Knapp provides numerous situations in which the contract to bargain would have been feasible by applying it to actual cases. *Id.* at 698-719.

174. *See supra* notes 165-67 and accompanying text.

175. *See supra* notes 20-27 and accompanying text.

176. 592 F.2d 49, 57-58 (2d Cir. 1979) (Friendly, J., concurring).

177. *Id.* at 57.

178. Judge Friendly said that "under a view conforming to the realities of business

cution, the parties remain free to negotiate over new issues of form or substance or to withdraw altogether.[179]

Judge Friendly's bright-line rule would eliminate the uncertainties generated by the current law concerning the "formal contract contemplated." In negotiations toward a merger or acquisition, no legally binding agreement would exist until the negotiating parties agreed on all of the terms and signed a formal contract. As a result, negotiating parties could avoid the kind of complex, vexing, and costly litigation that recently has arisen because of the uncertainty generated by the law on "formal contracts contemplated." This rule also would allay fears that tend to decrease the number of competing bids because firms that wish to offer a competing bid would know exactly when the original parties are bound.

The problem with the bright-line rule is that it has not yet been recognized or accepted by any court.[180] The rules governing when parties become legally bound absent a formally executed document have existed for well over one hundred years.[181] However, a bright-line rule seems simple to apply and would provide clear guidance to the parties in a merger or acquisition. Because of the complexity and vast amounts of money typically involved in a merger or acquisition, the rule would also reflect the intent of most parties not be bound prior to the execution of a formal, written merger agreement.

C. *The Cautious Approach*

Because the bright-line approach has not been adopted by any court of law, the parties engaged in negotiating a merger or acquisition should take steps during their negotiations to express clearly and unequivocally the intent of the parties not to be bound prior to the definitive merger agreement. First, the parties wishing not to be bound before a formal execution should include a statement

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life, there would be no contract in [complex business agreements] until the document is signed and delivered; until then either party would be free to bring up new points of form or substance, or even to withdraw altogether." *Id.* at 57-58.

179. *Id.* at 58. Judge Friendly stated that most parties in complex business transactions do not intend to be bound prior to the signing of the formal contract; the formal document is viewed as the contract and not just a written memorial of a previously reached oral agreement. *Id.*

180. *Id.* Judge Friendly states that neither New York courts nor the *Restatement* has gone this far and was unable to find a "fair basis for predicting that the New York Court of Appeals is yet prepared to do so." *Id.*

181. *See, e.g.*, Mississippi & Dominion S.S. Co. v. Swift, 86 Me. 248, 29 A. 1063 (1894).

to this effect in all writings between the negotiating parties.[182] The statement should provide that the parties do not intend to be bound prior to the execution of a definitive merger agreement, regardless of any oral agreements or preliminary documents. Negotiating parties should incorporate this statement in all preliminary documents or correspondence.[183] Second, the parties involved should exercise caution at all times. Once the boards of directors of the corporations approve the terms of the negotiations, the boards should adopt a resolution stating that this approval is given subject to the execution of a definitive merger agreement.[184] The parties to the negotiations should further provide that certain negotiators, such as investment bankers, have no power to form binding agreements.[185] In addition, the parties should advise all participants involved in negotiations to use extreme caution when taking notes during negotiations. Notes stating that the parties have reached an agreement often are misleading.[186] Therefore, all of the parties' writings should be examined carefully to ensure that nothing can be interpreted as a binding contract.[187]

Given the existing law in this area, parties to a merger never can be entirely sure that they will not be bound prior to the signing of a written contract. Thus, these suggested preliminary precautions are not guaranteed remedies,[188] but they may assist negotiating parties in avoiding problems like those encountered in the *Pennzoil* dispute. Also, by observing that the original parties have

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182. DiBlasi & Cyganowski, *supra* note 2, at 24, col. 1.

183. *Id.* These documents include offers to purchase or sell, correspondence confirming an agreement, draft agreements, and press releases. *Id.* Because a letter of intent often outlines all or most of the major points of agreement between the parties, one could misconstrue such a letter as a binding contract. Thus, the drafters should include disclaimers stating that neither party intends to be bound by the letter. I BUSINESS ACQUISITIONS, *supra* note 72, §§ 4.103b, 4.103d-4.106b.

184. DiBlasi & Cyganowski, *supra* note 2, at 24. Such a resolution is particularly important if the transaction does not involve shareholder approval. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *See supra* note 1 and accompanying text. Pennzoil's and Getty's press release stated that the agreement was subject to execution of a definitive merger agreement. DiBlasi and Cyganowski write:

> Given the general nature of these rules and the wide variety of circumstances relating to mergers and acquisitions in which they may be applied, it is not surprising that their application may not yield uniform results. Nonetheless, there are certain steps that participants . . . can take to reduce the risk that they will be unintentionally and prematurely bound to an informal agreement.

DiBlasi & Cyganowski, *supra* note 2, at 24.

taken these proposed steps, bidders could be more confident in making a competing bid that no liability will attach for tortious interference with a contract.

V. Conclusion

The rules of contract law regarding the formal contract contemplated are imprecise and uncertain. The use of agreements in principle may lead to damaging court battles in mergers and acquisitions. *Pennzoil* has demonstrated at least that much.[189] The cumulative effects of *Pennzoil* probably have not been realized. They may in fact be negligible, but the tremendous difficulty that has resulted from this single case demonstrates the need to create an alternative to agreements in principle. A bright-line rule seems to be the best method to avoid the problem. This approach would remove much of the uncertainty in "formal contracts contemplated" and would help companies to avoid expensive, time-consuming litigation. The contract to bargain, the antithesis of the bright-line approach, is generally unsuited for use in mergers and acquisitions and would not be as precise as the bright-line method. Because no state has yet adopted a bright-line rule, corporate attorneys should exercise extreme caution at all stages of the negotiation process to ensure that agreement cannot be inferred when not intended. These suggested steps may provide a simple and straightforward method of avoiding the catastrophic problems that Texaco encountered in *Pennzoil.*

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189. Although the Texas Court of Appeals reduced the punitive damage award from $3 billion to $1 billion, damages still stand at $8.53 billion, plus interest. Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 866 (Tex. Ct. App. 1987). The Court of Appeals stated that many amicus curiae briefs suggested that the verdict be reduced or overturned "because of the adverse economic impact it would have . . . on certain states and industries, and on Texaco's many shareholders." *Id.* at 865. The court, however, stated that the evidence supported the damage award and that, therefore, the court could not overturn it. *Id.* Texaco filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-74 (1987), on April 12, 1987, "in order to forestall enforcement of a $10.53 billion judgment against it awarded to Pennzoil by a Texas court in December 1985." *Texaco and Pennzoil Lock Horns Again: Fight Erupts on Bid to Drop Chapter 11 Panel,* Wall St. J., Oct. 5, 1987, at 6, col. 1.