Competing Merger Offers - Disclosure and Related Problems

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NOTES

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I. INTRODUCTION

An attractive company that makes known its desire to find a merger partner or announces an agreement in principle to merge with another corporation is likely to receive multiple inquiries or multiple offers from acquisition-minded corporations. This Note examines various problems and duties confronting a publicly held company[1] that receives multiple merger inquiries and offers. The starting point for this analysis is one court's directive[2] that a proxy statement soliciting shareholder approval of a merger recommended by management must disclose competing merger offers from third parties if such offers are "definitive" and "may" be more advantageous to the shareholders than the recommended merger.[3] The attempts to define this disclosure requirement and to determine how management decides which offers merit disclosure raise related issues: the extent of management's duty to investigate each merger inquiry to a definitive point, the nature of the disclosure required, the relevance of the timing of the competing offer in relation to the progress toward shareholder voting on the earlier proposal, and the obligations arising from the typical agreement requiring the board of directors to use best efforts to obtain shareholder approval of a particular merger. From both a policy and a practical standpoint, the overriding problem is to determine the proper roles of the directors and shareholders in making the decision to merge.

II. The Duty Under Federal Securities Laws To Disclose Competing Merger Offers

The critical factor in defining the duty imposed by federal securities law[4] to disclose competing merger offers is determining which competing offers, if disclosed, would assume actual significance in a reasonable shareholder's decision whether to vote for or

1. This Note focuses on publicly held corporations subject to the federal proxy rules adopted under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1976) (hereinafter cited as the 1934 Act), although the discussion of state corporate law also applies to privately held corporations.

2. The requirement is based primarily on rule 14a-9 promulgated under the authority of § 14(a) of the 1934 Act, *supra* note 1. The rule provides in pertinent part:

> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. § 240.14a-9 (1977).

This Note does not treat separately the other bases for liability for a misleading merger proxy statement that are provided by the Securities Act of 1933, §§ 11, 12(2), 17(a), 15 U.S.C. §§ 77k, 77l(2), 77q (1976), and the 1934 Act § 10(b), 15 U.S.C. § 78j(b) (1976). *See* Goolrick, *Some Disclosure Problems in Acquisition Proxy Statements and Prospectuses*, 28 Bus. Law. 111 (1972).

3. United States Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,691, at 99,053 (N.D. Ohio 1968).

4. *See* note 2 *supra*.

against the recommended merger.[5] Under present corporate law, shareholders do not decide which merger offer to accept; they decide only whether to accept the offer recommended by management.[6] Thus, for proxy statement purposes, the materiality of a second merger offer derives from the impact it may have on a shareholder's evaluation of the recommended offer and not from the availability of a second offer as a definitive, potentially more advantageous alternative. For example, in a corporation whose stock prices are temporarily depressed, the existence of several other merger offers slightly below the estimated value of the recommended merger could be material because they put into perspective any premium over market value contained in the recommended merger.[7] Before considering several ways in which disclosure of competing offers is material to a shareholder's decision to vote for or against the recommended merger, a close analysis of the leading case in this area, *United States Smelting, Refining & Mining Co. v. Clevite Corp.*,[8] and certain problems that it presents is necessary.

A. *The* Clevite *Opinion*

Clevite Corporation learned of large purchases of its stock by U.S. Smelting and immediately sought to arrange a defensive merger.[9] In its haste to consummate a friendly merger, Clevite's management signed a preliminary agreement to merge with T.R.W. nine days after the first contact between the two corporations, and four and one-half hours after T.R.W.'s first formal offer. Clevite's proxy materials failed to disclose that management had received

5. Goolrick, *supra* note 2, at 111 (materiality as the critical issue in proxy statement disclosure). The leading case defining materiality for purposes of rule 14a-9 states:

> An omitted fact is material if there is a suhstantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . [The standard contemplates] a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

6. *See, e.g.*, Ward, *The Legal Effect of Merger and Asset Sale Agreements Before Shareholder Approval*, 18 W. RES. L. REV. 780, 780 (1967), describing the statutory merger procedure as follows: "The directors' role in this process is to negotiate a bargain or approve one that the officers have made. The role of the shareholders, in most cases, is to accept or reject the bargain."

7. In contrast, if a company's original proxy materials disclose three offers that compete with the recommended merger, all four offers involving complex packages within a fairly narrow range of estimated values, it is not clear tbat another offer, within the same estimated value range, made by a fifth offeror two days before the scheduled shareholders' meeting, would be material. *See* text accompanying notes 64-102 *infra*.

8. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691 (N.D. Ohio 1968).

9. The court found no basis for Clevite's characterization of U.S. Smelting as a raider. *Id.* at 99,041.

approximately twenty other merger inquiries, which were not fully considered,[10] and that a definitive proposal had been submitted by Gould-National, offering a package to the holders of Clevite common stock worth almost twenty-four percent more than the T.R.W. package.[11] Clevite received a second Gould offer, approximately thirty-four percent higher than the T.R.W. offer, eight days before the scheduled shareholders' meeting. The meeting was postponed and supplementary proxy materials were sent advising the Clevite shareholders of the second Gould offer and affording them an opportunity to revoke any proxies previously executed.[12] The court found that Clevite's failure to disclose the first Gould offer in the original proxy materials was a material omission in violation of rule 14a-9,[13] and that this violation was not cured by the supplementary proxy materials disclosing the second Gould offer. The court stated that information about "other definite merger proposals available to the corporation" clearly would be material to a shareholder's decision whether to approve the recommended merger, "particularly" when such other proposals "*may* be of greater advantage to the shareholders."[14] Nevertheless, the court was unwilling to decide whether the failure to disclose background circumstances, such as the twenty unpursued merger inquiries and the hasty negotiation of the T.R.W. merger,[15] constituted material omissions. Judge Battisti explained that the materiality of these background circumstances was "almost inexorably tied to the issue of whether the officers and directors of Clevite have acted in good faith and consistent with their fiduciary duties to the shareholders."[16] For purposes of the preliminary relief being sought, the court was unwilling to find that Clevite's management had acted in bad faith. Although one commentator[17] has criti-

10. The court surmised that Clevite's reason for not investigating these inquiries was its belief that prompt consummation of a merger was necessary to avoid a takeover by U.S. Smelting. *Id.* at 99,042.

11. Clevite rejected the Gould offer because of potential antitrust problems and because it considered itself bound by the agreement that the board of directors had already signed with T.R.W. *Id.; see* text accompanying notes 157-86 *infra* (discussion of the legal effect of a merger agreement prior to shareholder approval).

12. The court criticized the ambiguity of the provision describing the right to revoke existing proxies but noted that clear disclosure of this right would not have changed the result. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) at 99,054.

13. *See* note 2 *supra.*

14. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) at 99,053 (emphasis in original).

15. Smelting challenged as material omissions the nondisclosure of thirteen different background circumstances tending to undermine the decision of Clevite's board to recommend the T.R.W. merger. *Id.* at 99,050.

16. *Id.* at 99,050-51.

17. Wander, *Special Problems of Acquisition Disclosure: Investment Banker's Reports,*

cized *Clevite*'s use of a "good faith" test as inconsistent with the negligence standard[18] applicable under rule 14a-9,[19] the interrelationship between management's bad faith and the materiality of certain circumstances surrounding a merger recommendation becomes apparent when one focuses on the nature of the decision to be made by a shareholder voting on a merger recommendation.[20] This interrelationship will be analyzed after considering the shortcomings of a materiality test that equates the duty to disclose with the selection of those competing merger offers that are "definitive" and "*may* be of greater advantage to the shareholders."[21]

B. *Definitive Merger Offers*

Limiting the materiality test to definitive offers eliminates disclosure of casual inquiries that the inquiring party chooses not to pursue. Such inquiries are too tentative to be significant.[22] Furthermore, public disclosure of every casual merger inquiry might be "disconcerting" to shareholders and, if staggered over a period of time, might contribute to "unfortunate gyrations" in the market price of the target company's stock.[23] According to one court, the exemption from disclosure requirements also extends to any proposal that the board of directors has reasonable grounds to believe has been withdrawn.[24]

The definitiveness test for materiality works well in ordinary circumstances, when management[25] seeks the best available merger terms and pursues all promising inquiries. Nevertheless, if manage-

Conflicts of Interest, Competing Offers, in SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 521, 546 (1976).

18. *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-1301 (2d Cir. 1973).

19. *See* note 2 *supra.*

20. Because the shareholders' role in a merger transaction is simply to approve or reject the agreement that management has negotiated, they must rely to a large extent on management's good faith in developing and presenting a proposed merger containing the best available terms. Circumstances indicating that bad faith tainted the process of negotiating the recommended merger are of critical importance to the shareholders' decision whether to approve or reject the merger agreement produced by that process. *See* text accompanying notes 87-102 *infra.*

21. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,053 (emphasis in original).

22. Scott v. Multi-Amp Corp., 386 F. Supp. 44, 65 (D.N.J. 1974) (telephone call without any follow-up). *See also* Richland v. Crandall, 262 F. Supp. 538, 554 (S.D. N.Y. 1967) (willingness to pay more was not a fact when higher price merely was mentioned during negotiations); text accompanying note 76 *infra. But see* Wander, *supra* note 17, at 547-48.

23. Elgin Nat'l Indus., Inc. v. Chemetron Corp., 299 F. Supp 367, 371 (D. Del. 1969).

24. Alameda Oil Co. v. Ideal Basic Indus., Inc., 337 F. Supp. 194 (D. Colo. 1972).

25. The term "management" is used here in recognition of the fact that officers typically take the lead in finding a merger partner and negotiating the terms, which are then submitted for review and approval by the directors. *See* Ward, *supra* note 6, at 780 n.3.

ment rebuffs preliminary inquiries, either because it is hastening to consummate a defensive merger or a merger otherwise particularly attractive to management[26] or because it believes that a preliminary agreement to merge signed by the directors precludes consideration of subsequent offers,[27] conditioning the duty to disclose on the existence of an inquiring party persistent enough to submit a definitive proposal would exalt form over substance.[28] In such cases, definitiveness should not be a necessary element for materiality.

C. *Better Offers—And Who Decides Which Offers Are Better*

The questions whether the duty to disclose competing offers applies only to offers that may be better than the recommended merger and, if so, how much deference should be accorded to the directors' judgment that a competing offer is not advantageous enough to merit disclosure remain unresolved.[29] Although *Clevite* states that other definitive merger proposals are particularly material when the competing proposals may be more advantageous to shareholders than the recommended merger, the opinion can be interpreted as requiring disclosure of all definitive proposals, regardless of their relative merits.[30] When read broadly, *Clevite* dilutes management's role in screening merger offers and gives shareholders a primary role in choosing between alternatives available to the corporation.[31] In contrast, the decision in *Alameda Oil Co. v. Ideal Basic Industries, Inc.*[32] suggests that other definitive merger offers do not require disclosure if they are less advantageous than the merger recommended by management.[33] To determine which offers do not merit disclosure because they are less advantageous, the *Alameda* court seemed willing to rely on the good faith judgment of the directors, absent clear evidence contrary to their evaluation.[34]

26. *See* text accompanying notes 92-93 *infra.*

27. *See* text accompanying notes 187-94 *infra.*

28. *See* Goolrick, *supra* note 2, at 120. Indeed, Gould-National was one of the twenty inquiring parties that Clevite had rebuffed, but Gould proceeded to submit its definitive proposals anyway. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) at 99,051.

29. Wander, *supra* note 17, at 545-46.

30. *See* text accompanying note 7 *supra.*

31. *See generally* Goolrick, *supra* note 2, at 119-21.

32. 337 F. Supp. 194 (D. Colo. 1972).

33. One commentator characterizes as dictum *Alameda*'s suggestion that less advantageous offers do not require disclosure, observing that the suggestion followed a finding that the offer was not definitive. Wander, *supra* note 17, at 545. Nevertheless, the suggestion appears to be more than dictum with respect to the second offer, which was not described as having been withdrawn.

34. [T]here is no evidence that would support a finding that the value and advantage of that proposal was *so clear* as to impose upon the directors of PCA any obligation

Although neither *Clevite* read broadly nor *Alameda* strikes the best balance between the participation of directors and shareholders in merger decisions,[35] each approach has limited support in other decisions.

Two cases involving fundamental corporate changes provide some support for the broad reading of *Clevite* giving shareholders a primary role in choosing among the alternatives available to the corporation.[36] In *Kohn v. American Metal Climax, Inc.*,[37] the federal district court found proxy materials seeking approval of a plan for externalizing certain assets[38] of a Zambian corporation to be deficient, in part because the proxy materials failed to disclose an alternative method for externalization that the board of directors had considered but rejected in accordance with strong advice from the corporation's financial adviser.[39] Even though the undisclosed alternative seemed clearly undesirable, the court thought it should have been disclosed to the shareholders. Nevertheless, two factors limit the impact of the district court's insistence on the shareholders' right to choose. First, the district court considered full disclosure of both alternatives to be the only way to counteract the likelihood of self-dealing because the recommended method of externalization provided unique benefits for the major corporate stockholder.[40] Second, the Third Circuit on appeal found it unnecessary to decide whether the failure to disclose the alternative method for externalization was material.[41]

In *Robinson v. Penn Central Co.*[42] a federal district court stressed the right of shareholders to choose between an immediate reorganization and the recommended refinancing of debt. The Penn Central proxy materials were found materially deficient because their failure to explain that a likely consequence of the recommended refinancing would be mere postponement of bankruptcy deprived the shareholders of an adequate basis for making an in-

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to repudiate or delay the merger with Ideal Cement for the purpose of submitting the Susquehanna proposal to the stockholders.

337 F. Supp. at 196 (emphasis added).

35. *See* text accompanying notes 56-63 *infra*.

36. *See* Goolrick, *supra* note 2, at 119-21.

37. 322 F. Supp. 1331 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

38. The corporation externalized those assets exempt from the nationalization ordered by the Zambian government.

39. The corporation's longtime investment banker threatened to resign if the corporation adopted this alternative method for externalization. 458 F.2d at 293.

40. 322 F. Supp. at 1354.

41. 458 F.2d at 264.

42. 336 F. Supp. 655 (E.D. Pa. 1971).

formed choice between the available alternatives.[43] Nevertheless, when a stockholder challenged a revised version of the same proxy materials in *Allen v. Penn Central Co.*,[44] the court retreated from the implication in *Robinson* that shareholders should make the primary decision among available alternatives. Rejecting the plaintiff's contention that the revised proxy materials should have included a complete discussion of the immediate reorganization alternative and its consequences,[45] the *Allen* court recognized the need for management to screen alternatives. The court explained that requiring proxy statements to go beyond a full explanation of management's proposal and to provide "a forum for every possible disagreement with the proposed course of action"[46] would produce an incomprehensible "avalanche"[47] of information inconsistent with the purpose of proxy statement regnlation.[48]

The *Alameda* position that a competing merger offer is not material unless clearly advantageous and that the screening of offers by the directors should receive substantial deference finds partial support in *Smallwood v. Pearl Brewing Co.*[49] and *Elgin National Industries, Inc. v. Chemetron Corporation.*[50] In *Smallwood*, Pearl Brewing Company's search for a merger partner yielded one proposal from a newly organized company, which Pearl rejected summarily, and two other proposals, the Aztec and Southdown offers, which were referred to a consulting firm for analysis. The consulting firm reported that either merger would benefit Pearl, but the firm recommended the Aztec proposal as slightly better.[51] Despite this recommendation, Pearl's board of directors decided to pursue the Southdown proposal, and a Pearl-Southdown merger was consummated. The plaintiff challenged Pearl's proxy statement concerning the Southdown merger, citing the failure to disclose the Aztec proposal and the consulting firm's recommendation. The jury's special finding, described but not discussed in the published opinion,[52] that

43. *Id.* at 657; *see* Goolrick, *supra* note 2, at 120.

44. 350 F. Supp. 697 (E.D. Pa. 1972).

45. Brief reference to the alternative of immediate reorganization was found sufficient. *Id.* at 703.

46. *Id.* at 705.

47. *Id. See also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976).

48. 350 F. Supp. at 703.

49. 489 F.2d 579 (5th Cir.), *aff'g* Smallwood v. Southdown, Inc., 382 F.Supp. 1106 (N.D. Tex. 1972), *cert. denied*, 419 U.S. 873 (1974).

50. 299 F. Supp. 367 (D. Del. 1969).

51. The consulting firm opined that the Aztec offer had " 'more upside potential near term.' " 489 F.2d at 585.

52. *Id.* at 588. The primary challenge to the proxy materials was the alleged inadequate disclosure of the power of the Pearl board to waive an underwriting commitment covering shares that the Pearl shareholders received in the merger.

neither omission was material apparently indicates a willingness to defer to the board's business judgment.[53] In *Elgin* shareholders challenged a proxy statement seeking approval of measures designed to make takeovers more difficult for not disclosing prior merger inquiries received by the corporation.[54] Finding that plaintiff had not shown a reasonable likelihood of ultimate success and therefore was not entitled to a preliminary injunction against management's voting of proxies, the court observed that the "wisdom of passing on to stockholders approaches made to management concerning exchange or merger offers lies within the bona fide discretion of the directors."[55]

Despite the partial support provided by these cases, the approaches of both *Clevite,* broadly read, and *Alameda* have substantial disadvantages in the multiple merger proposal context. A *Clevite* per se disclosure requirement could become acutely unworkable when applied to competitive merger offers received after proxy materials have been distributed.[56] Even if management received all definitive offers prior to mailing the proxy materials, disclosure of very low offers would clutter the proxy statement unnecessarily.[57] Moreover, if management received a substantial number of offers, disclosure of all offers could be confusing to the shareholders.[58] On the other hand, the *Alameda* rule[59] that competitive offers need not be disclosed unless clear evidence of the "value and advantage"[60] of any such offer is present does not recognize that some nearly competitive offers may be material to the shareholders' evaluation of the recommended merger. For example, as discussed below, the existence of several slightly less valuable offers may put into perspective a recommended merger offering a premium that otherwise would be viewed as a windfall.[61] In attempting to recognize the role of directors in screening the merger proposals that should be presented to the shareholders, the *Alameda* court seems to make the directors' good faith business judgment as to which offer should be recommended presumptively determinative of the question whether the rejected offers merit any disclosure to the shareholders.[62] Such de-

53. *Id.* at 588.
54. 299 F. Supp. at 370.
55. *Id.* at 371.
56. *See* note 72 and text accompanying notes 132-56 *infra.*
57. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976).
58. *See* note 79 *infra* and accompanying text.
59. *See* note 33 *supra* and accompanying text.
60. 337 F. Supp. at 195.
61. *See* text accompanying notes 83-84 *infra.*
62. The brief *Alameda* opinion consists only of conclusory statements that obscure the

ference to directors infringes on the right of shareholders to make an informed decision on the merger recommendation.[63]

III. A Suggested Approach to Materiality

The tests discussed thus far for determining the materiality of and the need to disclose competing merger proposals[64] or tentative merger inquiries[65] are inadequate. The materiality issue should be resolved by an examination of each merger proposal or inquiry in terms of the specific effect that its disclosure would likely have on the shareholders' evaluation of the recommended merger's desirability.[66]

The precise information that disclosure of other merger inquiries or competing offers will provide varies according to the circumstances surrounding the recommendation of a particular merger. For example, the existence of other firm merger offers comparable to the recommended offer will normally be material to the shareholders' evaluation of the overall fairness of the recommended offer because the other offers indicate the intensity of demand[67] for merger with the shareholders' company. If the recommended merger includes an unusually high premium in light of the book value of the target company's assets or the market value of its stock, disclosure of competing offers with similarly high premiums provides objective evidence that the company's assets are undervalued or its stock values temporarily depressed.[68] Competing offers that put a compellingly attractive merger into perspective are particularly material to shareholder appraisal of the recommended merger.[69] An even stronger presumption of materiality may exist when disclosure of other merger inquiries and competing offers would suggest a fail-

court's reasoning. Nevertheless, the court's findings that the board of directors had exercised good faith, independent judgment in making the merger recommendation and that the evidence of the competing proposal's "value and advantage" was not "so clear" as to require disclosure seem to raise a presumption that competing merger proposals rejected by the hoard do not require disclosure. 337 F. Supp. at 195.

63. *See* text accompanying notes 64-69 *infra* (summarizing significant information that may be provided by disclosure of a competing merger offer).

64. *See* text accompanying notes 29-34 *supra.*

65. *See* text accompanying notes 22-24 *supra.*

66. Goolrick, *supra* note 2, at 126. Goolrick would evaluate disclosure requirements for merger proxy statements based on the disclosure purpose of providing shareholders of the acquired company with all material information concerning the desirahility of investing in the acquiring company and the value of his stock in the acquired company.

67. *See generally* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) ("knowledge of the intensity of demand is essential to determination of a fair price in a market economy.").

68. *See* text accompanying notes 83-84 *infra.*

69. *Id.*

ure by management to use its best efforts to obtain the most advantageous terms available for the company as a whole.[70] Such a situation might arise, for example, if the directors hasten to conclude a merger that is particularly attractive to management.

Distinctions between competitive offers that have only a general impact on the evaluation of a merger's fairness and those that have a more specific impact by evidencing undervalued assets, depressed stock values, or management conflicts of interest might be labelled as academic. Certainly, the safest approach is to resolve any doubt in favor of materiality and to disclose competing offers[71] received before proxy solicitation begins. After the solicitation period begins and as the shareholder meeting date draws closer, however, requiring disclosure of subsequent merger offers becomes increasingly burdensome, particularly if resolicitation of proxies is necessary.[72] Several courts have exhibited a sensitivity to the potential harshness of requiring disclosure and resolicitation for last minute developments.[73] Thus, distinctions in the degree of materiality involved will assist in balancing disclosure policy against business practicalities and in deciding whether a last minute merger offer must be disclosed and, if so, whether complete resolicitation of proxies is necessary. Moreover, in situations uncomplicated by timing problems, defining the specific purpose served by disclosure will aid both in determining the necessary extent of disclosure of competing offers and in deciding whether merger inquiries not rising to the level of firm offers merit disclosure.[74]

A. *Intensity of Demand*

Absent special circumstances,[75] determination of the material-

70. *See* text accompanying notes 87-102 *infra.*

71. *See* text accompanying notes 103-31 *infra* (discussion of the appropriate extent of disclosure).

72. The burdens and risks entailed when post-mailing events must be disclosed include the expense and inconvenience of preparing and distributing a supplement to the proxy statement and of redistributing the original proxy statement if shareholders are likely to have discarded it, any postponement of the shareholders' meeting necessary to allow effective disclosure or resolicitation of proxies, and the possibility that delay in consummation of the merger would jeopardize the effectiveness of a defensive merger or precipitate the other party's withdrawal from the proposed merger and thus substitute for a favorable and almost completed merger the mere possibility of a better bargain. *See* United States Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691 (N.D. Ohio 1968); Scott v. Stanton Heights Corp., 388 Pa. 628, 131 A.2d 113 (1957).

73. *See* text accompanying notes 136-41 *infra.*

74. *See* text accompanying notes 76, 79, 92-93, 125-31 *infra.*

75. Special circumstances may include hidden values in the target company, conflicts of interest, or an inadequate basis for management's recommendation. *See* text accompanying notes 83-102 *infra.*

ity and the appropriate content of disclosures concerning competing merger offers should focus on the information necessary to apprise shareholders of the general attractiveness of their company as a merger partner and should not attempt to provide a complete comparative evaluation of each offer. If the purpose of disclosure is informing shareholders of the intensity of demand for their corporation, mere inquiries that are too casual to establish as a fact[76] the existence of a third party interest need not be revealed. In addition, bad faith offers made only to frustrate consummation of the proposed merger should not be disclosed because such offers are not meaningful indications of the target company's value.[77]

The extent of disclosure required for comparable[78] firm offers should be limited to a summary of terms adequate to show that the competing offers are in the same range of value as the recommended merger. Outlining the terms of several representative offers, with a brief reference to the remaining offers, would demonstrate the intensity of demand more effectively than cluttering[79] the proxy statement with a description of each offer when the target company receives a large number of competing offers. Once the mailing of proxy materials makes disclosure of subsequently received offers more burdensome,[80] consideration of the purposes of disclosing competing offers may reveal critical distinctions in the degree of materiality involved. For example, if the proxy materials disclosed two or more competitive offers, the receipt of another offer during the solicitation period similar in value to those previously disclosed might not be material with respect to the company's general attractiveness as a merger partner.[81] Even if no other competitive offers had been received or disclosed previously, one competitive offer received late in the solicitation period might not be material enough to require disclosure or resolicitation.[82]

76. *See* Richland v. Crandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) (willingness to pay more was not a fact when higher price merely was mentioned during negotiations). *But see* Wander, *supra* note 17, at 547-48. *See generally* R. JENNINGS & H. MARSH, SECURITIES REGULATION 921-26 (4th ed. 1977).

77. *See generally* Ward, *supra* note 6, at 783.

78. Competing offers significantly higher than the recommended merger are discussed in the text accompanying notes 94-98 *infra*.

79. If all 20 inquiries received by Clevite had ripened into definitive offers, each of 20 separate descriptions of these offers would probably not have "assumed actual significance in the deliberations of the reasonable shareholder." *See generally* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

80. *See* note 72 *supra*.

81. *See generally* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). In contrast, if the purpose of disclosing competing merger offers was to give shareholders a primary role in choosing among the available alternatives, the subsequent offer would require disclosure. *See* text accompanying notes 36-43 *supra*.

82. *See* text accompanying notes 151-56 *infra*.

B. *Hidden Value*

When particular circumstances such as undervalued assets or temporarily depressed stock values make appreciating the attractiveness of a company more difficult for its shareholders, competing merger offers may become more material than usual. Courts have recognized that outside offers to purchase a corporation's assets at prices substantially above book value are sufficiently objective and reliable, in contrast to appraisals by management, to merit disclosure whenever the value of the corporation's assets is material in a matter requiring shareholder approval.[83] Similarly, if a recommended merger contains an unusually high premium in light of book value or stock prices, disclosure of competing merger proposals offering comparable premiums would provide reliable evidence that the corporation has some hidden value. A competing merger proposal becomes significantly more material if both it and the recommended merger contain premiums approximately thirty percent over the market price of the target company's stock, as opposed to the typical fifteen percent merger premium.[84]

Most of the considerations discussed above[85] with respect to competing merger offers that indicate a company's general attractiveness as a merger partner apply equally when hidden values account for part of that attractiveness. As noted previously, when the untimeliness of a competing proposal significantly increases the burdens and risks attached to supplemental disclosure, the purpose served by such disclosure becomes significant. For example, an untimely offer that puts into perspective a recommended merger that shareholders predictably viewed as a windfall would be more material than if the shareholders believed the recommended offer included only a typical merger premium. In the former situation, the competing offer would significantly alter "the 'total mix' of information" relevant to the shareholder's decision.[86]

C. *Conflicts of Interest and Inadequate Basis for Recommendation*

Disclosure of other merger inquiries or competing merger offers may inform shareholders that self-interest or other inappropriate

83. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294-95 (2d Cir. 1973) (well-reasoned dictum by Judge Friendly); Madonick v. Denison Mines, Ltd., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,550 (S.D.N.Y. 1974).

84. *See, e.g.,* United States Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,039 (N.D. Ohio 1968) (referring to 15% as a typical merger premium).

85. *See* text accompanying notes 76-79 *supra.*

86. *See generally* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

factors interfered with management's search for the merger terms most advantageous to the corporation. When this purpose is used to evaluate the need to disclose circumstances surrounding the directors' recommendation, the materiality of such circumstances depends upon the directors' good faith performance of their fiduciary duties.[87] This good faith standard relates not to disclosure decisions[88] but to the directors' substantive decisions in recommending a merger and in responding to the other merger inquiries and competing merger proposals.[89] The board's recommendation of a particular merger encompasses an implied representation that a reasonable basis exists to support the directors' judgment that the recommended merger is the best alternative available to the corporation.[90] This implied representation makes material any circumstances revealing that factors compromising the directors' business judgment tainted the merger recommendation.[91]

Several significant consequences attach when disclosure of the circumstances surrounding a merger recommendation reveals an inadequate basis for or a compromise of the directors' independent judgment. First, as *Clevite* suggests, tentative merger inquiries that have not ripened into facts indicative of the corporation's attractiveness as a merger partner[92] nevertheless should be disclosed if management, motivated by self-interest, has rebuffed such inquiries and prevented them from developing into firm proposals.[93] Second, if a competing merger offer contains a premium significantly higher than that contained in the previously received and recommended

87. *See* [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,050-51 (N.D. Ohio 1968).

88. A negligence standard applies under rule 14a-9 to disclosure decisions in connection with proxy solicitations. *E.g.*, Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-1301 (2d Cir. 1973).

89. *See* [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,050-51 (N.D. Ohio 1968).

90. Jacobs, *What Is a Misleading Statement or Omission Under Rule 10b-5?*, 42 FORDHAM L. REV. 243, 280-86 (1973); *see* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 803 (2d Cir. 1969). *See also* SEC v. Fruit of the Loom, Inc., Civ. No. 61-640 (S.D.N.Y. 1961), *discussed in* SEC, TWENTY-SEVENTH ANNUAL REPORT 92-93, H.R. Doc. No. 269, 87th Cong., 2d Sess. (1962); Klink, *Management's Role in Recommending for or Against an Offer*, 25 BUS. LAW. 845, 848 (1970); Krasik, *Tender Offers: The Target Company's Duty of Disclosure*, 25 BUS. LAW. 455 (1969).

91. *See* Alameda Oil Co. v. Ideal Basic Indus., Inc., 337 F. Supp. 194 (D. Colo. 1972); United States Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691 (N.D. Ohio 1968).

92. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691 (N.D. Ohio 1968).

93. Goolrick, *supra* note 2, at 120. *Cf.* SEC v. Parklane Hosiery Co., 422 F. Supp. 477, 485 n.5 (S.D.N.Y. 1976), *aff'd*, 558 F.2d 1083 (2d Cir. 1977) (negotiations concerning profitable cancellation of a lease held material although deal not consummated by time of suit; SEC investigation may have prompted decision not to close the deal).

merger, the materiality of that offer must be measured not only by the offer's impact on the shareholder's evaluation of his company's attractiveness as a merger partner,[94] but also by the degree to which the offer impeaches the implied representation that the directors' recommendation reflects independent business judgment supported by a reasonable basis. Although courts recognize that business expediency sometimes justifies quick decisions,[95] a merger recommendation made in seemingly justified haste could be found unsupported by a reasonable basis if a subsequent competing offer reveals a clear inadequacy in the terms of the recommended merger.[96] As the discrepancy narrows between the premiums contained in the recommended merger and a subsequent competing offer, the impeachment of management's recommendation lessens, but still may be significant if self-interest provided part of the impetus for the haste in making a merger recommendation.[97] For example, if management hurriedly negotiates a defensive merger to avoid takeover by a corporation perceived as hostile to management as well as undesirable for the shareholders, the self-interest of inside directors imposes a stricter duty to justify their recommendation, and makes their recommendation more vulnerable to impeachment.[98]

Finally, a competing offer that omits certain perquisites for management contained in the recommended offer may have special materiality, whether or not the premium for shareholders is higher than that of the recommended merger. Competing offers assume more significance because self-interest imposes upon inside directors a higher duty to justify their recommendation.[99] Moreover, the particular danger that the recommended merger diverts to management an unjustified portion of the premium commanded by the company makes comparative information about offers with premiums that are free of this aspect of self-interest more important to the shareholders.[100] Competing merger offers that omit perquisites

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94. *See* text accompanying notes 75-77 *supra.*

95. *E.g.*, Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

96. *Compare* U.S. Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691 (N.D. Ohio 1968) *and* Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974), *with* Richland v. Crandall, 262 F. Supp. 538(S.D.N.Y. 1967).

97. *See* Richland v. Crandall, 262 F. Supp. 538, 546 (S.D.N.Y. 1967).

98. *See generally* Klink, *supra* note 90, at 847.

99. *Id.*

100. According to one commentator, most mergers divert to management of the acquired company part of the premium that the acquiring company is willing to pay for corporate control. An offer affirmatively competing with management's recommendation, however, would pay the full premium to the shareholders. Manne, *Some Theoretical Aspects of Share Voting,* 64 COLUM. L. REV. 1427 (1964).

for management indicate the premium that the corporation itself commands. If the recommended merger contains a smaller premium for the shareholders than competing offers, a strong likelihood exists that the perquisites offered to management constitute a diversion of the corporate premium. On the other hand, if the recommended merger contains a comparable or higher premium for the shareholders, then the competing offers provide evidence that the special perquisites constitute a legitimate effort to retain unique managerial talents.[101] To the extent that disclosure of competing merger offers, tentative merger inquiries, and management's responses would undermine the directors' recommendation of a particular merger, such information has special materiality, particularly when deciding whether last minute developments require disclosure and resolicitation of proxies.[102]

IV. Extent of Disclosure Required

Practical considerations prevent including in a proxy statement all the information necessary for shareholders to make a fully informed choice among several competing merger offers. An evaluation of competing merger offers requires an examination of synergistic and long-range considerations that make the choice highly complex. A proxy statement that had to provide detailed business and financial information for each competing merger offeror would be potentially confusing and thus might violate securities laws.[103] Employing a comparative analysis deduced from the raw data about each offer would be equally unworkable. The court in *Allen v. Penn Central Co.*[104] recognized that when a corporation must choose between complex alternatives, any attempt to provide a thorough analysis of each alternative would "drench the shareholder with a flood of information," defeating the purpose of proxy statement disclosure.[105] The *Allen* court also observed that management could properly omit disclosure of the consequences of an immediate reorganization because predicting the consequences would be overly speculative.[106]

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101. *Cf.* Smith v. Good Music Station, Inc., 36 Del. Ch. 262, 129 A.2d 242 (1957) (asset sale agreement was fair; payments under consulting agreements with president and his wife were in exchange for consideration only the individuals could supply, not for corporate assets).

102. *See* text accompanying notes 147-56 *infra*.

103. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976); Allen v. Penn Cent. Co., 350 F. Supp. 697, 703 (E.D. Pa. 1972); Richland v. Crandall, 262 F. Supp. 538, 553 (S.D.N.Y. 1967).

104. 350 F. Supp. 697 (E.D. Pa. 1972).

105. *Id.* at 703 (quoting Doyle v. Milton, 73 F. Supp. 281, 285 (S.D.N.Y. 1947)).

106. *Id.*

In *Union Pacific Railroad Co. v. Chicago & North Western Railway Co.,*[107] an exchange offeror attempting to defeat a competing merger distributed to the shareholders of the target company an investment banker's letter predicting the future workout values of both offers and concluding that the exchange offer was "far more attractive."[108] Finding that the letter violated rule 14a-9, the court explained that the comparison of future values misled investors by suggesting a degree of "competence and authority" with respect to "the mysteries of finance" that cannot exist.[109] Therefore, an attempt to present more than management's subjective reasons for the recommendation by providing shareholders with an objective discussion of the advantages and disadvantages of each competing merger offer probably would be impermissibly speculative.[110]

The limitations upon thorough disclosure of information concerning competing offers indicate that management, not shareholders, must make the primary choice between alternatives because shareholders denied both raw data and a complete comparative analysis of each competing offer lack an adequate basis to make the primary decision. Nevertheless, difficulties in defining the extent of required disclosure remain even when the purpose of disclosure is only to provide a basis for an informed decision on the particular merger recommended by management.[111] For example, when a proxy statement lists the current market value of the securities offered under the recommended merger and under any outstanding competing proposals, the extent to which management must monitor relative changes in the market values of the different offers and supplement the proxy statement when significant changes occur is unclear. *SEC v. Parklane Hosiery Co.*[112] found nondisclosure materially misleading when a situation developed during the solicitation period[113] that had a substantial likelihood of affecting the validity of an appraiser's report that the cash price offered to the minority shareholders in a freeze-out merger was fair. The *Parklane* court

107. 226 F. Supp. 400 (N.D. Ill. 1964).

108. *Id.* at 408.

109. *Id.* at 409.

110. In order to provide an adequate basis for shareholders to make a primary choice among alternatives, such analysis would need to include specific predictions and would be distinguishable from the *Allen* and *Smallwood* opinions discussed in the text accompanying notes 123-25 *infra.*

111. *See* text accompanying notes 66-70 *supra.*

112. 422 F. Supp. 477 (S.D.N.Y. 1976), *aff'd,* 558 F.2d 1083 (2d Cir. 1977).

113. Despite the proxy statement's assertion that no present negotiations were underway concerning a possible lease cancellation that might result in a substantial cash payment to the company, Parklane made no supplemental disclosure when the stalled negotiations resumed during the solicitation period.

cautioned, however, that the materiality of the same post-mailing development would be more difficult to determine if the shareholders' decision had addressed the desirability of an ongoing investment rather than the fairness of a cash-out price.[114] One commentator has suggested that relative changes in the market values of competing offers may require supplemental disclosure,[115] but adds that justifying a fairness opinion or management recommendation in terms of long-range considerations may diminish the need to provide such supplemental disclosure.[116] Absent extreme shifts in the values of competing offers, any benefit from supplemental disclosure is outweighed by both the practical difficulties of updating[117] and the danger of causing even greater fluctuations in the stock values of all companies involved.[118]

A second area of uncertainty is the extent to which management must disclose the existence of any objective opinions[119] favoring an offer other than the one recommended by management. In *Union Pacific*[120] the court strongly condemned an exchange offeror's distribution of an investment banker's report supporting the exchange offer over the recommended merger offer.[120] Nevertheless, the specificity of predictions included in the investment banker's opinion[121] and the partisan purpose for which the exchange offeror obtained the report[122] provide possible bases for distinguishing truly objective opinions that do not contain specific predictions. The *Allen* court[123] recognized that the specific consequences of an immediate reorganization were too speculative for management to predict but held that an objective opinion opposing the alternative recommended by management should have been disclosed to the shareholders.[124] The objective opinion was that of a distinguished judge

114. 422 F. Supp. at 484-85.

115. Klink, *supra* note 90, at 851-52.

116. *Id.*

117. Because changes in the relative values of competing offers could occur indefinitely and are not within the target company's control, postponement of the merger is not feasible in this situation as a solution to the mechanical difficulties of constantly updating the proxy materials. *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1297 n.15 (2d Cir. 1973).

118. *See, e.g.,* Elgin Nat'l Indus., Inc. v. Chemetron Corp., 299 F. Supp. 367, 371 (D. Del. 1969); Quirke v. Norfolk & W. Ry., [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,645, at 95,405 (S.D.N.Y.), *appeal dismissed,* 367 F.2d 864 (2d Cir. 1966) (need for extreme care to avoid undue market fluctuations caused by premature disclosure of merger plans).

119. *See* note 110 *supra* and accompanying text.

120. 226 F. Supp. at 408.

121. Specific dollar "work-out values" were predicted. *Id.* at 409.

122. The competing exchange offeror solicited the report to support its offer.

123. 350 F. Supp. 697 (E.D. Pa. 1972).

124. The requested remedy was denied, however. *See* text accompanying notes 138-41 *infra.*

who, petitioned for advice by a trustee shareholder, instructed the trustee to vote against the recommended refinancing. The result in *Smallwood v. Pearl Brewing Co.*[125] lies between the holdings in *Union Pacific* and *Allen.* According to the *Smallwood* jury, the failure to disclose that a consulting firm, hired by the target company to evaluate two competing proposals, had recommended the proposal not ultimately recommended by management was not material. The consulting firm's opinion in *Smallwood,* however, possessed objectivity similar to that reflected in the judge's opinion in *Allen,* which, according to the *Allen* court, should have been disclosed. Although the jury verdict in *Smallwood* lacks significant precedential value, the contrasting results indicate the absence of consensus on this disclosure question.

In addition to these specific disclosure problems, target companies must determine the general scope of disclosure required for each competing offer. Resort to general principles of disclosure is necessary to supplement judicial directives that some information about competing merger offers must be disclosed, but that the proxy statement need not serve as a forum for detailed discussions supporting each alternative to management's recommendation.[126] Management must present enough information to enable stockholders to make a fully informed decision, yet the presentation must be comprehensible by unsophisticated investors, and some selectivity in disclosing relevant facts is necessary to keep proxy statements manageable.[127] Professors Jennings and Marsh suggest that there may even be a duty to interpret the facts for unsophisticated investors.[128] Any attempt to interpret facts, however, must avoid specific predictions about such speculative matters as future workout values or long-range consequences of competing offers.[129] The proxy statement should highlight any conflicts of interest suggesting a compromise of management's independent judgment concerning the relative merits of competing offers.[130] Drafters of proxy

125. 489 F.2d 579 (5th Cir. 1974).

126. Allen v. Penn Cent. Co., 350 F. Supp. 697, 705 (E.D. Pa. 1972); United States Smelting, Ref. & Mining Co. v. Clevite Corp. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691 (N.D. Ohio 1968); *see, e.g.,* Richland v. Crandall, 262 F. Supp. 538, 553 (S.D.N.Y. 1967).

127. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1297 (2d Cir. 1973); Robinson v. Penn Cent. Co., 336 F. Supp. 655, 657 (E.D. Pa. 1971).

128. JENNINGS & MARSH, *supra* note 76, at 928-29.

129. Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400, 409 (N.D. Ill. 1964); *see* Allen v. Penn Cent. Co., 350 F. Supp 697 (E.D. Pa. 1972).

130. Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), *cert. denied,* 409 U.S. 874 (1972). *See also* JENNINGS & MARSH, *supra* note 76, at 928.

materials should also be guided by the purpose to be served in disclosing a particular competitive offer. The summary disclosure that may be appropriate when a competing proposal indicates nothing more than another company's willingness to offer a typical merger premium should be expanded when conflicts of interest are evident.[131]

V. Special Problems Caused by Untimely Receipt of Competing Merger Offers

Receipt of a competing merger offer after the target company begins solicitation and after its board of directors has agreed to use best efforts to obtain shareholder approval of the proposed merger presents special, interrelated problems in complying with disclosure, fiduciary, and contractual obligations. In discussing these interrelated problems, this Note focuses first on federal law and then on state law.

A. *A Realistic Approach to Disclosure of Competing Offers Received After Distribution of Proxy Materials*

When an event occurring after the mailing of proxy materials and prior to the shareholders' meeting[132] causes the proxy statement to become materially misleading, the proxy rules[133] generally require supplemental disclosure and, in many cases, cancellation of existing proxies followed by a complete resolicitation. This requirement can impose an extreme burden. For example, in a proposed merger in which time is a critical factor,[134] the delay necessary for resolicitation could destroy the proposed transaction, wasting substantial expenditures and extensive preparation.[135] Although supplemental disclosure and resolicitation have been ordered when deemed necessary for fair shareholder suffrage, several courts have recognized that the expense and inconvenience entailed justify a realistic and flexible approach to disclosure of developments during the solicitation period.

131. Professors Jennings and Marsh describe the nearly total correlation between cases in which courts bave considered transactions unfair to the shareholders and cases in which courts have found disclosure deficiencies in the proxy materials. Jennings & Marsh, *supra* note 76, at 929.

132. Althougb tbis section focuses on material events that occur during the solicitation period, material events that occur after the shareholder meeting but before the formal closing of a merger also may require disclosure. *See* SEC v. National Student Marketing Corp., 360 F. Supp. 284 (D.D.C. 1973).

133. Rule 14a-9, *supra* note 2, has been construed to require that proxy statements be updated to reflect material cbanges after the proxy statements are distributed. Jacobs, *supra* note 90, at 262.

134. A defensive merger is one example.

135. *See* Ward, *supra* note 6, at 783.

In *General Time Corp. v. Talley Industries, Inc.*,[136] plaintiff sought to invalidate proxies solicited by an independent stockholders' committee, arguing that supplemental disclosure of an SEC decision rendered three days before the scheduled meeting was necessary. The SEC had held that the organizers of the committee violated the Investment Company Act by not obtaining prior approval of their joint arrangement to acquire General Time stock. Judge Friendly refused to adjourn the meeting and require supplemental disclosure and resolicitation by the stockholders' committee. He explained that this remedy, while authorized by rule 14a-9, was "strong medicine" requiring "a correspondingly strong showing of materiality,"[137] which had not been made by plaintiff.

The court in *Allen v. Penn Central Co.*[138] applied *General Time*'s flexible approach in considering management's failure to disclose a judge's order issued nine days before the shareholders' meeting that instructed a trustee shareholder to vote against the refinancing plan recommended by management.[139] Although finding the omission material, the court denied the particularly harsh remedy sought by plaintiff of appointing a special receiver for the Penn Central. The *Allen* decision suggests that the court might have ordered supplemental disclosure and resolicitation had those remedies been sought,[140] yet it expressly acknowledged the need to weigh practical considerations when implementing disclosure policies. Admonishing defendants that expense and inconvenience cannot provide a complete justification for failing to provide supplemental disclosure of material events occurring during the solicitation period, the court nevertheless observed that "the remedy for the omission of a material fact must vary with the circumstances."[141]

Other courts, however, have been less flexible in requiring management to cure defects arising when a proxy solicitation becomes misleading because of material developments during the solicitation period. Finding that a material development required resolicitation, not just supplemental disclosure coupled with an opportunity to revoke existing proxies, the court in *Central Foundry Co. v. Gondelman*[142] reasoned that placing "the onus of obtaining restitution upon the misled stockholders" was inappropriate.[143] *Cooke v.*

136. 403 F.2d 159 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969).
137. *Id.* at 163.
138. 350 F. Supp. 697 (E.D. Pa. 1972).
139. *See* text accompanying notes 123-24 *supra.*
140. 350 F. Supp. at 705.
141. *Id.*
142. 166 F. Supp. 429 (S.D.N.Y. 1958).
143. *Id.* at 446.

Teleprompter Corp.[144] recognized that shareholder inertia substantially undercuts the effectiveness of giving shareholders an opportunity to revoke as an alternative to voiding proxies executed prior to distribution of supplementary disclosure material. Nevertheless, because the post-mailing event[145] at issue in *Cooke* was apparently well-publicized by the news media, the court voided only those proxies dated before or on the day that the event occurred. The court held that a right to revoke was adequate for proxies dated after that time because the shareholders submitting those proxies knew or should have known of the material event.[146]

Rejecting the adequacy of supplemental disclosure with an opportunity to revoke existing proxies, the *Clevite* court ordered a complete resolicitation.[147] Because this result seems consistent under the circumstances with an equitable approach to the appropriate remedy, *Clevite* illustrates factors relevant in deciding whether resolicitation should be required. First, the *Clevite* proxy materials were deficient from the outset for failing to disclose the first Gould offer. Mere supplemental disclosure was inadequate because it could not cure this initial defect as well as to provide sufficient disclosure of the post-mailing offer.[148] Even in the absence of a pre-mailing Gould offer that should have been disclosed, four factors would have justified requiring resolicitation: first, the strikingly higher terms offered by Gould evidenced the inadequate basis for the directors' initial recommendation; second, numerous mailings and publicity concerning the proposed merger created an "atmosphere of great confusion;"[149] third, the company did not redistribute the initial proxy statement with the supplemental disclosure, so that comparison was no longer possible for many shareholders; and last, insufficient time was available to evaluate and react to the supplemental disclosure prior to the scheduled meeting.[150]

Absent a "strong showing of materiality"[151] or other factors justifying resolicitation, both of which were present in *Clevite*, receipt of a competing merger offer during the solicitation period should not

144. 334 F. Supp. 467 (S.D.N.Y. 1971).

145. The corporation and one of its officers were convicted of bribery.

146. 334 F. Supp. at 474.

147. [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,054 (N.D. Ohio 1968).

148. *Id.* at 99,053.

149. *Id.* at 99,054.

150. The other factors making resolicitation necessary outweighed the special difficulty, recognized by the court, that delay presented in consummation of the defensive merger. *Id.*

151. General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 163 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

require more than supplemental disclosure and an opportunity to revoke existing proxies.[152] Furthermore, a balancing of disclosure policy against business exigencies should be employed in defining the underlying duty to disclose, and not merely the manner of disclosure. As both the burdens of supplemental disclosure and the legitimate business reasons for nondisclosure increase, the underlying duty to disclose untimely merger offers should be conditioned upon "a correspondingly strong showing of materiality."[153] For example, requiring disclosure of a second merger proposal made a few days before the scheduled meeting and revealing only an additional company's willingness to offer a typical merger premium seems unjustified if the delay required to make such disclosure and to provide sufficient time for shareholders to respond[154] would jeopardize consummation of a legitimate defensive merger arranged to avoid takeover by an unreliable company.[155] The potential harm caused by demanding disclosure in such circumstances outweighs the possible benefit to be gained.[156]

B. *Potentially Conflicting Obligations Under State Law*

Another problem confronting the directors of the target company is determining the time at which they or their corporation becomes contractually bound to proceed with the negotiated merger without being free to negotiate with subsequent offerors for better terms. Under state corporate law, customary procedure calls for the board of directors of each company to approve an initial plan or agreement of merger and then to submit the proposed merger to their shareholders for approval.[157] The directors of each company typically promise to use their best efforts to obtain shareholder approval of the merger.[158] The legal effect of this promise, however, is unclear. One writer argues that business exigencies, the parties' desires, and the intent of modern merger statutes to give directors an important role in the merger process require that the directors be authorized to enter a binding agreement to proceed with the merger, subject to shareholder approval.[159] Nevertheless, the author-

152. *See* Jacobs, *supra* note 90, at 289.

153. 403 F.2d at 163.

154. Even if resolicitation were not required, adequate time for shareholders to digest the disclosure and take action to revoke existing proxies would be necessary; otherwise the disclosure would not serve any useful purpose.

155. *See* note 150 *supra* (indicating the *Clevite* court's recognition of this problem).

156. The cost-benefit analysis applied in defining materiality in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976), is equally appropriate here.

157. *See* Ward, *supra* note 6, at 780.

158. *See id.* at 782.

159. Ward, *supra* note 6.

ities do not agree on the legal effect of merger and similar agreements prior to the statutorily required approval of the shareholders. If such agreements are legally binding, they must be harmonized with the Federal disclosure requirements concerning competing merger offers and the directors' fiduciary duty to obtain for the shareholders the best merger terms available. Since very little authority specifically addresses merger agreements and when they become binding, the applicable principles must be derived primarily from cases arising from analogous transactions that also require shareholder approval such as the sale of substantially all of a corporation's assets.

(1) Contractual Obligations

Viewing shareholder action as an essential ingredient of the corporation's consent to entering a contract, several courts have held that agreements requiring shareholder approval have no binding legal effect until management obtains that approval.[160] For example, in *Finklea v. Carolina Farms Co.*,[161] plaintiff sought specific performance of an agreement, executed by the corporation's president and made subject to shareholder approval, giving plaintiff an option to purchase all of the corporation's land. When informed by the president that another party had made a higher offer after the signing of the option agreement with plaintiff, the shareholders rejected plaintiff's tender of the purchase price. The court denied relief, holding that the option agreement could not bind the corporation without shareholder approval and that the agreement had not preempted the president's fiduciary obligation to advise the shareholders of the higher offer.[162] In *Smith v. Good Music Station, Inc.*[163] and *Masonic Temple, Inc. v. Ebert*,[164] asset purchase agreements signed by the proposed purchasers and executive officers of the proposed sellers were characterized as constituting, prior to approval by the proposed sellers' shareholders, mere offers by the proposed purchasers. Having reached this conclusion, the *Masonic Temple* court allowed the proposed purchaser to withdraw his "offer" without liability prior to its "acceptance" by the proposed seller's shareholders.[165]

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160. *See id.* at 792.

161. 196 S.C. 466, 13 S.E.2d 596 (1941).

162. The court also rejected any personal liability of the president under the contract. *Id.* at 471, 13 S.E.2d at 598.

163. 36 Del. Ch. 262, 129 A.2d 242 (1957).

164. 199 S.C. 5, 18 S.E.2d 584 (1942).

165. *Id.* at 12, 18 S.E.2d at 587.

In *American Cyanamid v. Elizabeth Arden Sales Corp.*,[166] the court held that an asset sale agreement was not a mutually binding contract prior to the consent of the purchaser's full board of directors, which was required by both the agreement and the purchaser's bylaws.[167] Before the buyer's board of directors could act, the seller gave notice of its withdrawal from the transaction and proceeded to accept a better offer received after the first agreement was signed. Although the seller's potential liability for impermissibly withdrawing an irrevocable offer made summary judgment for the corporate defendants inappropriate, the *American Cyanamid* court held that liability could not be premised on the existence of a binding, bilateral contract because the buyer was not bound until its board acted. The court did grant summary judgment in favor of the individual defendants who signed the agreement as officers of the seller corporation and as executors of the estate that owned all of the seller's stock.[168] Finding no malice or fraud to justify imposing liability on these agents who clearly acted in a representative capacity, the court noted that as fiduciaries, the agents were in a "difficult position" because of the better offer and their obligation to act for the estate's best interest.[169]

Under *Finklea, Smith, Masonic Temple,* and *American Cyanamid,* a merger agreement executed by the target company's board of directors presents no contractual obstacles to compliance with either the directors' fiduciary obligations or federal securities law.[170] Prior to shareholder approval and absent any malice or fraud on the part of the directors,[171] neither the target company nor its directors will be liable if the directors advise shareholders of subsequent, more attractive merger offers, causing the shareholders to reject the earlier proposal. According to this line of cases, liability will not accrue even if the directors, in response to a higher offer, withdraw their promised recommendation of the proposed merger.

Other cases suggest, however, that contractual obligations may arise prior to shareholder approval, thus presenting a potential conflict between contractual liabilities and securities and fiduciary obligations.[172] In *Itek Corp. v. Chicago Aerial Industries, Inc.*,[173] Itek

166. 331 F. Supp. 597 (S.D.N.Y. 1971).

167. Execution of the agreement had been authorized only by the purchaser's executive committee.

168. 331 F. Supp. at 607. A trustee of the bank that was one of the estate's executors also served as president and chief executive officer of the corporation.

169. *Id. See* text accompanying notes 193-94 *infra.*

170. *See* text accompanying notes 187-89 *infra.*

171. *See* 331 F. Supp. at 607.

172. *See* text accompanying notes 187-89 *infra.*

173. 248 A.2d 625 (Del. 1968).

and Chicago Aerial Industries (CAI), with the approval of each corporation's board of directors, executed a letter of intent outlining the basic terms of an exchange of CAI assets for Itek stock. Each corporation undertook to use reasonable efforts to reach and formalize a final agreement, subject to approval by the CAI shareholders. Despite the letter of intent and without giving Itek an opportunity to revise the offer, CAI abandoned the proposed sale when it revived the earlier interest of another party, which then made a more attractive offer to purchase the stock of the principal CAI shareholders for cash. In a suit against CAI and the individuals who represented CAI and its controlling shareholders[174] in the negotiations, Itek alleged that failure to negotiate in good faith constituted a breach of contract. The Delaware Supreme Court affirmed summary judgment for the individual defendants but remanded the question of CAI's liability.[175] Without discussing the possibility that shareholder approval was a prerequisite for binding CAI, the court instructed the trial court to determine the legal effect of the preliminary letter based upon the intent of the parties.[176]

Even though the Delaware court ultimately found the *Itek* letter unenforceable,[177] the decision in *Mid-Continent Telephone Corp. v. Home Telephone Co.*[178] reemphasizes the significance of the parties' intent. Two controlling officers of the primarily family-owned Home Telephone Company signed a preliminary letter conditionally agreeing to a tax-free exchange of Home's assets for Mid-Continent stock.[179] Home abruptly terminated negotiations toward a final agreement after receiving a more attractive offer from Union Telephone Company to purchase all of Home's common stock for cash. After Union purchased Home's common stock, Mid-Continent sued Home and the two controlling officers for breach of contract and sued Union for tortious interference with a contract. Examining

174. The controlling shareholders owned approximately 50% of the CAI stock. Thus their informal consent to the agreement with Itek would not have been sufficient to create a binding contract under the reasoning of Mid-Continent Tel. Corp. v. Home Tel. Co., 319 F. Supp. 1176 (N.D. Miss. 1970). *See* text accompanying notes 181-82 *infra*.

175. In granting summary judgment, the trial court relied solely on the letter's provision releasing the parties from further obligation if they failed to execute a formal contract. The Delaware Supreme Court found, however, that release under this provision was conditioned upon a good faith attempt to reach a final agreement. 248 A.2d at 629.

176. *Id.*

177. Itek Corp. v. Chicago Aerial Indus., Inc., 274 A.2d 141 (Del. 1971).

178. 319 F. Supp. 1176 (N.D. Miss. 1970).

179. Those conditions included obtaining a favorable ruling from the IRS and reaching a mutually satisfactory employment contract for one of the two controlling officers of Home. The court found that these contingencies were conditions precedent to performance of the contract and not conditions precedent to formation of a binding contract. *Id.* at 1190.

all the circumstances to determine the parties' intent,[180] the court concluded that the letter agreement was a binding contract. Rejecting the defendants' contention that the letter agreement could not bind the corporation without formal stockholder approval, the court explained that the informal approval of the common stockholders, all members of the president's family, was sufficient.[181] Failure to notify or obtain even informal consent from the nonfamily preferred shareholders did not trouble the court, apparently because the preferred shareholders lacked sufficient votes to block the transaction.[182] Although the decision in *Mid-Continent* to bind a corporation without formal shareholder approval may have been conditioned upon the existence of a sufficient concentration of stock ownership to allow informal shareholder consent, the *Itek* court relied upon the parties' intent without requiring even informal approval.

The multiple liabilities imposed in *Mid-Continent* indicate the need for caution in deciding whether to make merger agreements binding prior to shareholder approval. Although the individual officers escaped liability to Mid-Continent,[183] the court assessed damages against Home for breach of contract and against Union for tortious interference with the contract.[184] In a subsequent suit, however, the court held the individual officers liable to Home, then owned primarily by Union, for breaching their fiduciary duties and tortiously defaulting as officers.[185] The officers' liability resulted from their causing Home to breach the Mid-Continent agreement without a corporate business purpose and solely for the family's personal gain.[186]

(2) Fiduciary Obligations

Even if execution of a preliminary plan or agreement of merger

180. Among the circumstances important to the court's conclusion were the actual signing of the preliminary letter under the word "accepted" and the Home officers' refusal to accept the third party's offer without first obtaining an opinion of counsel that the Mid-Continent agreement was not binding. *Id.* at 1191.

181. *Id.* at 1195. *But see* Smith v. Good Music Station, Inc., 36 Del. Ch. 262, 129 A.2d 242 (1957) (not mentioning possibility that informal consent might suffice).

182. *See* 319 F. Supp. at 1193-94.

183. The court found that the individuals signed solely in a representative capacity. *Id.* at 1199.

184. The court found that Union acted recklessly and deliberately in inducing the breach of an agreement that it knew or should have known was binding. *Id.* at 1200. In American Cyanamid v. Elizabeth Arden Sales Corp., 331 F. Supp. 597 (S.D.N.Y. 1971), however, the court rejected a claim for tortious interference with a contract because the subsequent offeror concluded reasonably that no binding contract existed.

185. Home Tel. Co. v. Darley, 355 F. Supp. 992 (N.D. Miss. 1973), *aff'd*, 489 F.2d 1403 (5th Cir. 1974).

186. *Id.* at 999.

creates a binding legal obligation, the directors of the target company cannot rely on that contractual obligation to justify complete disregard of competing merger offers subsequently received. A preliminary agreement, prior to shareholder approval, cannot eliminate the target company's obligation under the federal securities law to disclose competing merger offers.[187] Similarly, a preliminary agreement cannot suspend the fiduciary obligations of the officers and directors to protect the interests of the shareholders. Overlapping with the federal proxy regulations, these fiduciary obligations prevent management from obtaining shareholder approval of a merger without disclosing higher offers.[188] In addition, management's fiduciary obligation to investigate alternative merger offers[189] may survive an agreement to merge with a particular company and may require abandonment of that agreement if the terms of a subsequently received offer are better.

In *Scott v. Stanton Heights Corp.*,[190] the court rejected the contention that the directors' fiduciary duty should be extended to require breach of an enforceable agreement in order to accept a better offer received after execution of the agreement. This general observation is undercut, however, by the *Scott* court's finding that under any standard the directors had acted reasonably in the particular circumstances involved[191] and by the *American Cyanamid* decision.[192] The *American Cyanamid* fiduciaries were the chief executive officer of Elizabeth Arden Sales Corporation and the executors of the Arden estate, which owned all of the corporation's stock. The court held that despite the corporation's possible liability for withdrawing an irrevocable offer in order to accept a better deal, the fiduciaries who controlled the corporation could not be liable. The court's explanation that the duty to act for the best interest of the shareholder estate put these fiduciaries "in a difficult position . . . because of the higher offer"[193] suggests that in certain circumstances fiduciaries may have an obligation to breach an existing agreement

187. United States Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,053 (N.D. Ohio 1968). As noted above, the extent of this obligation is unclear.

188. Finklea v. Carolina Farms Co., 196 S.C. 466, 13 S.E.2d 596 (1941); *see* American Cyanamid v. Elizabeth Arden Sales Corp., 331 F. Supp. 597 (S.D.N.Y. 1971).

189. Wander, *supra* note 17, at 549.

190. 388 Pa. 628, 131 A.2d 113 (1957).

191. The court pointed out that price is not the sole determinant of the worth of an offer, noting the following relevant considerations: "certainty and promptness of payment; financial responsibility; established business relationships; [and] the performance of valid legal obligations." *Id.* at 635, 131 A.2d at 116.

192. 331 F. Supp. 597 (S.D.N.Y. 1971).

193. *Id.* at 607.

in order to accept a more advantageous offer. A breach effected to fulfill legitimate fiduciary obligations is distinguishable from the improper breach in *Mid-Continent,*[194] which the board effected to allow the president and his family to benefit from a higher offer at the expense of the corporation and its preferred shareholders. The breach was therefore a violation, rather than an appopriate exercise, of management's fiduciary obligations.

C. *Defining Management's Obligations*

A rule that no binding contractual obligations exist prior to shareholder approval of a merger makes the commitment of time and money necessary to investigate a merger partner and prepare a merger proxy statement unnecessarily risky. Business ethics alone are insufficient limitations on the right to abandon a proposed merger prior to shareholder approval. Nevertheless, imposing contractual liability on a corporation for action taken by management in a good faith response to its obligations under federal securities law or state fiduciary principles is also undesirable.[195]

Ideally, the preliminary merger plan or agreement should have contractual force, with shareholder approval as a condition subsequent, and should by express terms reconcile the contractual obligations with the obligations imposed by securities law and fiduciary principles. Absent an express term, however, the courts should respond to business needs by recognizing contractual obligations prior to shareholder approval, subject to an implied condition permitting any action taken in good faith to comply with the federal securities law or state fiduciary principles. Thus a corporation should not be contractually liable if the required disclosure of a competing merger offer causes the shareholders to reject a recommended merger. Even if management withdraws a recommendation, postpones the shareholders' meeting pending investigation of a competing merger offer, or completely repudiates an existing agreement, prior to shareholder approval, to pursue an offer more advantageous to the corporation, no liability should result. Contractual liability should attach if, as in *Mid-Continent,* the corporation abandoned the proposed merger to pursue an offer more advantageous only to certain controlling persons or if the original merger partner had no opportunity to match a subsequent offer by modifying the original terms.[196]

194. Home Tel. Co. v. Darley, 355 F. Supp. 992 (N.D. Miss. 1973), *aff'd,* 489 F.2d 1043 (5th Cir. 1974); Mid-Continent Tel. Corp. v. Home Tel. Co., 319 F. Supp. 1176 (N.D. Miss. 1970).

195. *But see* 331 F. Supp. 597 (S.D.N.Y. 1971).

196. Unless the advantages of the second offer derive from intangible factors, such as

Furthermore, the extent of the directors' obligation to abandon an existing bargain in order to pursue a competing merger offer that may be more favorable must be defined. A number of nonprice factors, such as capabilities of the offeror's management, quality of the offeror's business history, and synergistic advantages to be gained from a particular business combination, make competing merger offers difficult to compare.[197] Absent clear evidence of abuse, a court should not reverse management's good faith business judgment that competing merger offers do not merit serious negotiation.[198] Requiring management to pursue a slightly better merger offer received shortly before the shareholders' meeting would jeopardize a nearly completed, favorable merger without assurance that the second offer would result in a final agreement or that the first offer could be revived if the second were later withdrawn.[199] Thus management must be accorded considerable discretion to reject the particular risks involved in pursuing untimely merger offers.

VI. Conclusion

Uncertainty concerning the appropriate extent of shareholder participation in a corporation's decision to merge underlies the complex and interrelated problems confronting a corporation that receives multiple offers. This Note has urged that management should have the primary role in making a merger decision.[200] The fiduciary nature of that role, however, should be emphasized in defining both disclosure requirements and the legal effect of a merger agreement prior to shareholder approval. By giving management the primary role in making merger decisions while stressing the fiduciary nature of that role, problems facing corporations that receive competing merger offers can be solved realistically without compromising the interests of shareholders.

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the identity of the second offeror, and not merely from a more favorable price, bad faith appears to be the only possible motivation for abandoning a pending merger without affording an opportunity to meet the competition. Modification of an existing agreement clearly would be easier and cheaper than negotiating an entirely new agreement with the second offeror.

197. *See* note 191 *supra*.

198. *See* United States Smelting, Ref. & Mining Co. v. Clevite Corp., [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,691, at 99,047 (N.D. Ohio 1968).

199. *See* Scott v. Stanton Heights Corp., 388 Pa. 628, 131 A.2d 113 (1957).

200. Merger agreements recommended by management are rarely rejected. Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 Calif. L. Rev. 1 (1969). This fact suggests that shareholders lack the initiative to make an independent evaluation of a merger proposal.