

# **NO-SHOP, NO-TALK AND BREAK-UP FEE AGREEMENTS IN MERGER AND TAKEOVER TRANSACTIONS: THE CASE FOR A FRESH REGULATORY APPROACH**

**JAMES MAYANJA** \*

*Merger and takeover transactions have a profound impact of on the interests of shareholders and society in general. For this reason, it is essential that the legal system provide a reliable mechanism for determining the validity of practices that have the potential either to facilitate or inhibit such transactions. This article seeks to demonstrate that the rules currently governing the exercise of directors' powers are ineffective to protect the interests of shareholders and society in general in circumstances involving the use of exclusivity and break-up fee agreements, practices that are fairly new, but which are becoming increasingly common in Australia. The equitable doctrines of fiduciary law against which the validity of these arrangements is determined do not provide clear guidance as to when it is acceptable for directors of target companies to enter into such agreements. There is thus need for reform, so as to promote clarity and predictability of the law in this area. This will enable all interested parties to proceed on reasonable expectations in organizing their affairs whenever these arrangements are involved. In undertaking this reform, policy makers would serve investors and society generally better if they adopted shareholder welfare enhancement as the criterion for adopting the applicable rules in this area. Exclusivity and break-up fee agreements should be permitted where they are designed to maximise shareholder wealth but not otherwise. The article explores ways in which the law could be reformed to achieve this objective.*

**Key words** Directors' duties; mergers; takeovers; corporate control transactions; lock-ups; no-shop; no-talk; exclusivity agreements; break-up fees.

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LL B (Hons)(Makerere); LL M (Lond); Ph D (Monash); Dip LP (Law Dev Centre); Barrister and Solicitor of the Supreme Court of Victoria and the High Court of Australia; Advocate of the High Court of Uganda; Senior Lecturer-in-Law, Faculty of Business, University of Southern Queensland, Toowoomba. I am grateful to Professor Ian Ramsay of the Faculty of Law, University of Melbourne, who encouraged me to look into the issues discussed in this article and two anonymous referees whose incisive comments tremendously assisted in sharpening this analysis. I also thank the Faculty of Business, University of Southern Queensland for its generous financial support which enabled me to take on this project.

## 1 INTRODUCTION

Over the past several decades, Australia has witnessed a noticeable surge in merger and takeover activity. As several commentators have observed, these transactions do have a significant impact on the interests of shareholders and the economic order of society in general. They have the potential to promote efficiency, either by facilitating desirable changes in corporate control<sup>1</sup> or by enabling companies to combine their productive capacities - physical assets or management teams or both.<sup>2</sup> This might enable the merged firm to reap synergistic gains through the elimination of unnecessary production, marketing and distribution costs or the duplication of expenditures on research and development. Apart from assisting the affected firm to become more efficient, a merger (or acquisition) might promote industry rationalisation, to the benefit of the economy as a whole.<sup>3</sup> At the same time, these transactions can also enhance shareholder wealth.<sup>4</sup> In view of the substantial

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<sup>1</sup> Bureau of Industry Economics, Department of Industry, Technology and Commerce, *Mergers and Acquisitions: Issues of Economic Efficiency*, Working Paper No 53, Canberra, 1989, at 15; Department of Trade and Industry, *Mergers Policy: A Department of Trade and Industry Paper On The Policy and Procedures Of Merger Control*, HMSO, London, 1988, para 2.27; A Shleifer, & R W Vishny, 'Value Maximisation And The Acquisition Process' (1988) 2 *Journal of Economic Perspectives* 7 at 11-3; P Holl, 'Control Type and the Market For Corporate Control in Large U S Corporations' in R Posner & K E Scott, *Economics of Corporate Law and Securities Regulation*, Little, Brown and Company, Boston and Toronto, 1980 at 206.

<sup>2</sup> J C Coffee Jr, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review* 1145 at 1221; Bureau of Industry Economics, Department of Industry, Technology and Commerce, *Mergers and Acquisitions: Issues of Economic Efficiency*, Working Paper No 53, Canberra, 1989, at 14; Treasury Department, *Some Economic Implications of Takeovers*, Treasury Economic Paper 12, AGPS, Canberra, 1986 at 7.

<sup>3</sup> Commonwealth of Australia, Parliament, House of Representative Standing Committee on Legal and Constitutional Affairs, *Mergers, Takeovers and Monopolies: Profiting from Competition*, AGPS, Canberra, 1989, para 3.2.15.

<sup>4</sup> F H McDougall, & D K Round, *The Effects of Takeovers and Mergers in Australia*, Research Report No 3, Information Australia for the Australian Institute of Management, Melbourne, 1986 at 83-6; A Mandelbaum, 'Economic Aspects of Takeovers Regulation With Particular Reference To New Zealand' in J H Farrar, (ed) *Takeovers, Institutional Investors and the Modernization of Corporate Laws*, Oxford University Press, Auckland, 1993 at 208; J Franks, & R Harris, 'Shareholder Wealth Effects of UK Take-overs: Implications For Merger Policy' in J Fairburn, & J Kay, *Mergers and Merger Policy*, Oxford University Press, 1987 at 157-59; W Lonergan, *The Valuation of Businesses, Shares and Other Equity*, Longman Professional, Melbourne, 2nd edition, 1994 at 338; R Kraakman,

benefits that they can confer on both private parties and society in general, it is desirable that the law provides a reliable mechanism for determining the legal propriety of practices that have the potential either to facilitate or to inhibit these transactions. Only then can the public interest and the interests of all parties to merger and transfer of control transactions be adequately protected.

This paper considers the use of certain devices designed to improve the chances of success of negotiated mergers and acquisitions of corporate control: no-shop, no-talk (or exclusivity)<sup>5</sup> agreements and break-up fees. These strategies are fairly new,<sup>6</sup> but are becoming increasingly common in corporate control transactions in Australia.<sup>7</sup> Its major premise is that the general legal and equitable doctrines of fiduciary law governing the exercise of directors' powers, which the courts presently apply in determining the validity of these agreements,<sup>8</sup> are ineffective to adequately protect the interests of all parties whose interests may be affected by the use of such strategies. The standard of review provided by these doctrines does not provide a clear and definite guide as to when a decision to enter into an exclusivity agreement or an agreement to pay a break-up fee constitutes a proper exercise of directors' powers.

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'Taking Discounts Seriously: The Implications of "Discounted" Share Prices As An Acquisition Motive' (1988) 88 *Columbia Law Review* 890.

<sup>5</sup> These terms are hereafter used inter-changeably.

<sup>6</sup> See for example Santow J's observation in *Application of Arthur Yates & Co Ltd* (2001) 19 ACLC 529, a recent decision the Supreme Court of New South Wales. There, His Honour acknowledged (at 529) that 'the concept of an exclusivity period during which alternative merger arrangements and their solicitation are constrained' is 'still novel'.

<sup>7</sup> For a detailed account of transactions in which break-up fees have featured see J Mannolini & A Rich, 'Break Fee Agreements in Takeovers' 2001 (19) *C&SLJ* 222 at 245-49.

<sup>8</sup> Other aspects of company law may be relevant in determining the validity of these arrangements. For example, in the context of a takeover, one may need to consider whether entry into either type of agreement is acceptable in terms of s657A of the *Corporations Act* 2001 (Cth). In the case of break-up fees, questions may arise whether these are permissible in view of the provisions relating to transactions affecting share capital, especially *Corporations Act* 2001 (Cth), Part 2J.1 (Share Capital Reductions) and *Corporations Act* 2001 (Cth), Part 2J.3 (Financial Assistance). These matters are not considered here. Interested readers may refer to the following works where these issues are canvassed in detail: Mannolini & Rich, above n 7, at 229-233; W Charnley & B Breslin, 'Break-fees: Financial Assistance and Directors' Duties' (2000) 21 *Company Lawyer* 269.

That standard leaves the courts free to consult the interests either of shareholders or of the company as a commercial entity in deciding whether to uphold or disallow such a measure. This renders it difficult for interested parties to predict with certainty whether or not a legal challenge to such measures will, if mounted, be successful. This uncertainty is undesirable. It has the potential to discourage some aggrieved parties from testing, in court, the propriety of a suspect exclusivity or break-up fee agreement. It also has the potential to serve merely as an instrument of legal maneuvering. In the process, the efficacy of the law in promoting shareholder and social welfare might be reduced. There is thus need to reform the law so as to promote clarity and certainty in this area. This will enable all parties to negotiated merger or acquisition transactions to proceed on reasonable expectations in organizing their affairs whenever the use of these arrangements is contemplated, and very importantly, likely encourage aggrieved parties to more readily challenge questionable no-shop or break-up fee agreements.

To achieve the necessary degree of certainty and predictability, this article recommends the introduction of distinct and specific standards to regulate exclusivity and break-up fee agreements. The new regulatory regime should clearly spell out when it is acceptable for target directors to enter into a no shop / no talk agreement or commit a target to pay a break-up fee. For reasons articulated later on in this article,<sup>9</sup> it is suggested that in undertaking this task, policy makers should adopt shareholder welfare enhancement as the criterion for developing the applicable rules in this area. Thus, an exclusivity clause or a break-up fee agreement should be upheld if it is calculated to promote shareholder welfare, but not otherwise. In the particular case of break-up fee agreements, the governing regime should prescribe clear guidelines on the calibration of the size of the fee payable.

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<sup>9</sup> See Part 4.1 below.

The ensuing analysis is organized as follows. Part 2 identifies some of the problems encountered by prospective merger partners or acquirers of corporate control. It then goes on to describe some strategies – exclusivity clauses and break-up fee agreements - devised by acquirers and their advisers to overcome these problems. Next, Part 3 considers the legal and practical effects of these strategies. While accepting that these arrangements can serve some legitimate and beneficial legal and economic functions, it argues that they are susceptible to abuse. In particular, they can be used to stymie competitive bidding for a company and/or to coerce shareholders to approve an inferior offer. In view of the potential for abuse, the discussion goes on to examine the efficacy of the rules presently applied by the courts in determining the validity of a decision by the directors to enter into such arrangements. The analysis in this part concludes that the current regime is inadequate to deal with the unique problems posed by these arrangements. To minimize the potential for abuse, it is recommended that the law be reformed to exercise more control over the use of exclusivity and break-up fee arrangements. Part 4 sets forth some proposals for reform. Some conclusions follow in Part 5.

## **2 DEFINING THE PROBLEM**

Corporate mergers require shareholder<sup>10</sup> and, sometimes, regulatory<sup>11</sup> approval before they can be fully consummated. This creates some particular problems for parties to merger agreements or prospective acquirers. During the period it takes to obtain the approvals required to complete the transaction, which can be several months, circumstances might change. A rival, and perhaps, superior bid might be made for the target. The directors of the

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<sup>10</sup> See *Corporations Act* 2001 (Cth), Part 5.1.

<sup>11</sup> For example, authorisation by the Australian Competition and Consumer Commission may be required if the merger would have the effect, or be likely to have the effect, of substantially lessening competition in a market. See the *Trade Practices Act*, 1975 (Cth) ss 50 and 88(9).

target might simply change their mind and decide not to proceed with the transaction. Or they might decide to seek out a different merger partner.<sup>12</sup>

The occurrence of any of these events can seriously jeopardise the interests of the initial offeror. That bidder may have incurred substantial costs in searching for and identifying a merger partner and making the initial offer. These include the costs of investigating and estimating the value of the target company, lining up financing, complying with governmental regulations and preparing the necessary documentation.<sup>13</sup> That expenditure is certainly bound to be wasted if the transaction is not completed. Another problem faced by the bidder is that during the course of the negotiations with the target board, and while awaiting shareholder approval of the transaction, it might miss out on valuable alternative merger or acquisition opportunities.

In order to protect themselves against such risks, the practice has emerged whereby prospective acquirers require the board of the potential merger partner to agree to an exclusivity (no-shop / no-talk) agreement. Alternatively, the target might be required to reimburse the initial bidder's expenses (break-up fee) if the deal is not consummated.<sup>14</sup> Quite often, both devices are used in tandem with each other.

A typical exclusivity provision enjoins the grantor not to `initiate contact with, solicit, encourage or participate in any way in discussions or negotiations with, or provide

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<sup>12</sup> K J Burgess, `Gaining Perspective: *Directors' Duties in the Context of "No-shop" and "No-Talk" Provisions in Merger agreements*' [2001] *Columbia Business Law Review* 431 at 431-2.

<sup>13</sup> M Kahan & M Klausner, `Lockups and the Market for Corporate Control' (1996) 48 *Stanford Law Review* 1539 at 1547; G V Varallo & S M Raju, `A Process Based Model for Analyzing Deal Protection measures' (2000) *Business Lawyer* 1609 at 1670.

<sup>14</sup> Burgess, above n 12, at 431-2; Varallo & Raju, above n 13, at 1670; L E Strine Jr, `Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements' (2001) 56 *Business Lawyer* 919 at 921-2.

information or assistance to, any third party concerning any acquisition of the company.<sup>15</sup> Under this type of clause, the directors of the target are forbidden from taking any action, such as seeking or considering an alternative, even higher bid, which would render the consummation of the lock-up merger less likely. The intention is clear: to require the target to support a merger between it and the grantee of the option. It has been suggested that exclusivity provisions of this nature are often the most effective method of ensuring success.<sup>16</sup>

In some instances, an exclusivity agreement contains an express 'fiduciary out' clause. Pursuant to that provision, the target's directors agree, either implicitly or explicitly, to support the merger but retain the right to solicit other bids or negotiate with other bidders if their fiduciary duties require them to do so.<sup>17</sup> A variant of the 'fiduciary out' clause is the

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<sup>15</sup> See D J Block *et al*, *The Business Judgment Rule Fiduciary Duties of Corporate Directors*, 5<sup>th</sup> ed 1998, Vol 1, Aspen Law & Business, New York at 939; S M Bainbridge 'Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions' (1990) 75 *Minnesota Law Review* 239 at 243-55. See also Takeovers Panel, *Lock-up Devices Guidance Note*, 2002, available at <http://www.takeovers.gov.au/Content/Policy/lockupdevices.asp> (date of access: 2 February 2002), para 26.

<sup>16</sup> Bainbridge, above n 15, at 246.

<sup>17</sup> The recent case of *Application of Arthur Yates & Co Ltd* (2001) 19 ACLC 529 provides a good illustration of this. The relevant clause in that case provided thus:

Exclusivity

NCE and Yates

- (a) agree that they will co-operate with each other to achieve a merger and during the Exclusivity Period will not have any discussions or dealings with any other person that might relate to or have the result in the merger between NCE and Yates not proceeding;
- (b) agree that clause 8(a) will only impose obligations on Yates to the extent that to cause Yates to fulfil such obligations would not involve a breach of the duties of the directors of Yates or be unlawful on any other basis; and
- (c) acknowledge that clause 8(b) will not be used or claimed by Yates to justify the solicitation of possible purchasers of Yates or its business or the initiation of discussions or dealings with any other person in relation to the possible purchase of Yates or its business unless failure to do so would

'best efforts clause'. This requires the target to employ its best efforts to consummate the agreed merger.<sup>18</sup> According to Vinelott J, an undertaking of this nature is necessarily subject to anything that the directors of the target are required to do pursuant to their fiduciary obligations.<sup>19</sup> The target's board must employ its best efforts to consummate the agreed merger but its right to engage in discussions with, and provide information to competing bidders is successfully preserved. If a rival bidder tops the no-shop bid, the directors must consider it.<sup>20</sup>

As previously pointed out, agreements not to solicit alternative offers or negotiate with rival bidders are frequently, though not always, accompanied by an undertaking by the target to pay a lump sum cash payment to the bidder should a contemplated merger not materialize.<sup>21</sup> This feature is primarily a method for reimbursing the disappointed merger partner for the expenditure incurred in pursuing a transaction.<sup>22</sup> It is intended to entice a party that would otherwise have been unwilling to do so to bid for a company by providing some form of compensation for the risks it is undertaking.<sup>23</sup> This is out of recognition that in some instances 'a "white knight" . . . might only enter the bidding for the target company if it receives some form of compensation to cover the risks and costs involved.'<sup>24</sup> As the courts and several commentators have rightly pointed out, 'some persons are reluctant to commit the

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involve a breach of the duties of the directors of Yates confirmed by Senior Counsel's advice, it being recorded that no such circumstances are presently envisaged.

<sup>18</sup> For a typical best efforts clause see Bainbridge, above n 15, at 243 (fn 10).

<sup>19</sup> See *John Crowther Group Ltd v Carpets International plc* [1990] BCLC 460 at 464.

<sup>20</sup> For a comprehensive analysis of various no-shop provisions and their legal effect, reference may be made to Block *et al*, above n 15, at 939-57.

<sup>21</sup> See further Santow J's observations in *Application of Arthur Yates & Co Ltd* (2001) 19 ACLC 529 at 530; Charnley & Breslin, above n 8, at 269; Burgess, above n 12 at 431-2; Varallo & Raju, above n 13 at 1670; Note, 'Inducement Fees Circumscribed' [2000] *JBL* 59.

<sup>22</sup> Block *et al*, above n 15, at 966; Takeovers Panel, above n 15, para 17.

<sup>23</sup> Mannolini & Rich, above n 7, at 232; Kahan & Klausner, above n 13, at 1540.

<sup>24</sup> *Revlon Inc v MacAndrews & Forbes Holdings* 506 A 2D 173 (1986) at 183. See also *Application of Arthur Yates & Co Ltd* (2001) 19 ACLC 529 at 530 at 531; Charnley & Breslin, above n 8, at 270.

necessary time, effort and expense to make a bid if they believe that it will be used as a “stalking horse” to obtain higher bids.’<sup>25</sup> The following observation neatly summarises the case for break-up fees:<sup>26</sup>

the uncertainty that a merger agreement will be consummated due to the possibility of a competing bid or the failure of shareholders for some other reason to approve the transaction has led many acquirors to insist upon termination or “break-up” fees, pursuant to which the corporation is obligated to pay a specified sum (often amounting to as much as 1 to 3 per cent – or even more – of the aggregate value of a transaction) to the corporation’s merger partner if the transaction is not consummated . . . The promise to pay a termination fee typically is in addition to an expense reimbursement provision requiring reimbursement of all out-of-pocket expenses incurred by a merger partner if the merger agreement is terminated due to a competing bid or is not approved by shareholders for some other reason.

By stimulating an initial bid or persuading other prospective acquirers to enter a bidding contest, a break-up fee agreement can benefit shareholders.<sup>27</sup>

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<sup>25</sup> *Revlon Inc v Macandrews & Forbes Holdings* 506 A 2D 173 (1986) at 183. See further *Arthur Yates & Co Ltd* [2001] NSWSC 40; *Hanson Trust plc v ML SCM Acquisitions Inc* 781 F 2d 264 (1986); at 281; *Jewel Companies Inc v Pay Less Drug Store North West* 741 F 2d 1555 (1984) at 1563; P Davies, *Gower’s Principles of Modern Company Law*, 6th ed 1997, Sweet & Maxwell, London at 786; Bainbridge, above n 15, at 317; Varallo & Raju, above n 13 at 1680; K J Nachbar, ‘Revlon Inc v Macandrews & Forbes Holdings Inc – The Requirement of a Level Playing Field in Contested Mergers, and its Effect on Lock-ups and Other Bidding Deterrents’ [1987] 12 *Delaware Journal of Corporate Law* 473.

<sup>26</sup> *Block et al*, above n 15, at 957; Bainbridge, above n 15, at 246. Indeed, in *Dawson International plc v Coats Paton plc* [1989] BCLC 233, the plaintiffs based part of their claim on the ground that they would not have made an offer at all if the situation was likely to become one of a contested bid – see page 246.

<sup>27</sup> There is a vibrant debate on the benefits and costs of auctions. A detailed discussion of this issue is beyond the scope of this paper. For representative literature on this subject reference may be made to R Gilson, ‘A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers’ (1981) 33 *Stanford Law Review* 819 at 868-875; R Gilson, ‘Seeking Competitive Bids Versus Pure Passivity In Tender offer Defense’ (1982) 35 *Stanford Law Review* 51; G R Andre, ‘Tender Offers For Corporate Control: A Critical Analysis And Proposals For Reform’ (1987) 12 *Delaware Journal of Corporate Law* 865 at 905-906; L A Bebchuk, ‘The Case For Facilitating Competing Tender Offers’ (1981-82) 95 *Harvard Law Review* 1028 at 1039-41; L A Bebchuk, ‘The Case For Facilitating Competing Tender Offers: A Reply and Extension’ (1982) 35 *Stanford Law Review* 23; M Gillen, ‘Economic Efficiency And Takeover Bid Regulation’ (1986) 24 *Osgoode Hall Law Journal* 919 at 931-939; J C Coffee Jr, ‘Regulating The Market For Corporate Control: A Critical Assessment of The Tender Offer’s Role in Corporate Governance’ (1984) 84 *Columbia Law Review* 1145 at 1280 et

### 3 THE CONCERN WITH NO-SHOP AND BREAK-UP FEE AGREEMENTS

Exclusivity and break-up fee agreements reduce the risk that the merger between the target and the grantee will not proceed. Whilst they may be beneficial in this important respect, these arrangements do present problems of their own. For example, a no-shop agreement commits the target's directors to support a particular bidder. As a consequence, the target is prevented from co-operating, or dealing, with rival bidders. This has the potential to discourage some prospective acquirers from coming forward,<sup>28</sup> to the possible detriment of shareholders, who are thereby denied the benefit of an auction for their shares. Another major potential problem is that the directors may agree to a no-shop clause in furtherance of their own parochial interests, in conflict with their duty to act in best interests of the company.<sup>29</sup> They might, for instance, do so to facilitate the company to be acquired by a bidder that promises not oust them from their positions after the merger, or to confer on them extra side benefits, rather than one offering the best terms.<sup>30</sup> Again, this may deny shareholders a higher return on their investment or frustrate a more strategic merger. More seriously, the ability to influence the outcome of a bidding contest, by ensuring that the company is acquired by a party that will not penalise them, has the potential to diminish the disciplinary effect of corporate control transactions on corporate management. It may also subvert the public interest by preventing corporate assets from passing to their highest

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seq; R A Ragazzo, 'The Legitimacy of Takeover Defense in The '90s' (1992) 42 *DePaul Law Review* 689 at 707-10; F H Easterbrook, & D R Fischel, 'Corporate Control Transactions' (1982) 91 *Yale Law Journal* 698; F H Easterbrook, & D R Fischel, 'Auctions and Sunk Costs' (1982) 35 *Stanford Law Review* 1.

<sup>28</sup> Kahan & Klausner, above n 13, at 1552-53; Burgess, above n 12 at 439; M Lebovitch & P B Morrison, 'Calling a Duck a Duck: Determining the Validity of Deal protection Provisions in Merger of Equals Transactions' 2001] *Columbia Business Law Review* 1 at 45.

<sup>29</sup> This matter is treated in more detail in the next Part of this article.

<sup>30</sup> Bainbridge, above n 15, at 272-75; Lebovitch & Morrison, above n 28 at 13-4

valued uses. This may have serious implications for the efficient functioning of the economy generally.<sup>31</sup>

Break-up fees also give rise to similar concerns. In particular, a termination fee, especially if it is large enough, can make a transaction more expensive. This might reduce the target firm's value and, in the process, discourage competing bidders.<sup>32</sup> As Kahan and Klausner have elucidated:<sup>33</sup>

the outcome of a bidding contest depends on the maximum prices bidders are willing to pay for a target – their “reservation prices.” A bidder's reservation price depends on the profit it expects to gain if it acquires the target at a certain price, and on its opportunity costs of acquiring the target (in a sense its “profits” if it fails to acquire the target). Bidders will bid up to the price at which these amounts are equal. For example if Alpha Corp values Targetcorp at \$800 million, and has no opportunity cost of acquiring Targetcorp, it will bid up to, but not beyond \$800 million (the point at which its profits from the acquisition would equal zero).

If a target grants a lockup to one bidder, the lockup will effectively constitute a liability to another bidder (a “locked-out” bidder) that succeeds in acquiring the target. The lockup reduces the profit the locked-out” bidder obtains from acquiring the target at any given price by a sum equal to the value of the lockup.

In addition to their potential effect on the incentives of prospective bidders, break-up fee arrangements are hazardous in another important respect. As the payment of such a fee is triggered if shareholders reject a merger proposal, there is potential for directors to use a break-up fee as a strategy to coerce shareholders into approving a bid favoured by them. They

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<sup>31</sup> Kahan & Klausner, above n 13, at 1559-60; P Regan, ‘Great expectations? A Contract Law Analogy for Preclusive Corporate Lockups’ (1999) 21 *Cardozo Law Review* 1 at 5.

<sup>32</sup> Takeovers Panel, above n 15, paras 18-9.

<sup>33</sup> Kahan & Klausner, above n 13, at 1544 (notes omitted).

could do this by agreeing to pay an unconscionably large termination fee to their white knight if it loses.<sup>34</sup>

Because of their potential to stifle unwelcome acquisition bids and allied problems,<sup>35</sup> it is clear that no-shop and break up fee arrangements can diminish shareholder and social welfare.<sup>36</sup> Although current law attempts to exercise some control over their use, it is presently difficult to predict when a court will rule that the implementation of such measures is or is not permissible. This diminishes the efficacy of the law in protecting the interests of shareholders and society in general. Hence the need to reform the law so as to remove the present uncertainty. Before canvassing possible reforms, however, it is essential first to establish the deficiencies of current law. That forms the task of discussion in the next part.

### **3.1 CHALLENGING SUSPECT LOCK-UP AGREEMENTS: CURRENT LAW**

It is now beyond doubt that where the responsibility for managing the company is, by its constitution, vested in the directors,<sup>37</sup> they enjoy the general power to make all decisions

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<sup>34</sup> See generally Block *et al*, above n 15, at 960; Lebovitch & Morrison, above n 28, at 45-6; Varallo & Raju, above n 13, at 1680; Takeovers Panel, above n 15, para 20.

<sup>35</sup> Mannolini & Rich, above n 7, at 232. Indeed, in one American case, the court found that the directors agreed to a break-up fee just as part of an overall plan to thwart a rival bidder. See *Revlon Inc v Macandrews & Forbes Holdings Inc* 506 A 2D 173 (1986) at 184.

<sup>36</sup> See further Note, above n 21, at 59-60.

<sup>37</sup> This is ordinarily the case under modern commercial practice. Most, if not all, companies usually have a by-law similar to s198A of the *Corporations Act*. That section relevantly provides that:

The business of a company is to be managed by or under the direction of the directors.

The directors may exercise all the powers of the company except any powers that this Law or the company's constitution (if any) requires the company to exercise in general meeting.

On the legal effect of this and similar provisions see *Automatic Self Cleansing Filter Syndicate Company v Cunningham* [1906] 2 Ch 34; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; *National Roads and Motorists Association v Parker* (1986) 4 ACLC 609.

(other than those reserved to shareholders in general meeting) on behalf of the company.<sup>38</sup>

This includes the power to decide whether the company should enter into an agreement, and the terms of any such contract. In the context of the present discussion, the directors have the authority to initiate and negotiate the terms of a merger for approval by shareholders.<sup>39</sup>

However, it is also common knowledge that in exercising their management powers, the directors are subject to some restraints. These limitations, which are imposed by the equitable doctrines of fiduciary law, seek to minimize the potential for directors to act in abuse of the immense managerial powers conferred on them.<sup>40</sup> Foremost amongst these is the directors' duty of loyalty to the company.<sup>41</sup> This requires every exercise of the directors' discretionary powers to be in good faith, for the benefit of the company as a whole.<sup>42</sup> The same duty further enjoins the directors to exercise their powers for proper purposes,<sup>43</sup> not to fetter their discretion<sup>44</sup> and to avoid any conflict of interest.<sup>45</sup>

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<sup>38</sup> H A J Ford *et al*, *Ford's Principles of Corporations Law*, 10<sup>th</sup> ed 2000, Butterworths, Sydney, para 7.110 (at 217).

<sup>39</sup> See text accompanying note 10 above.

<sup>40</sup> *Mills v Mills* (1938) 60 CLR 150 at 185-186; *Ampol Petroleum Limited v R W Miller (Holdings) Limited* [1972] 2 NSWLR 850 at 856.

<sup>41</sup> Ford *et al*, above n 38, para 8.010 (at 302-3)

<sup>42</sup> *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 217; *Re Smith & Fawcett Limited* [1942] 2 Ch 304 at 306; *Pergamon Press Limited v Maxwell* [1970] 2 All E R 809 at 813.

<sup>43</sup> *Re Smith And Fawcett Limited* [1942] 1 Ch 306; *Allen v Gold Reefs Of West Africa Limited* [1900] 1 Ch 656, 671; *Greenhalgh v Ardene Cinemas Limited* [1950] 2 All ER 1120 at 1126; *Pergamon Press Limited v Maxwell* [1970] 2 All ER 809 at 813; *Mills v Mills* (1938) 60 CLR 150 at 185; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923 ) 33 CLR 199 at 217; *Hindle v John Cotton Limited* (1919) 56 Sc L R 625 at 630.

These general equitable obligations have now been adopted by the Parliament and codified into statutory obligations. See *Corporations Act* 2001 (Cth), s 181(1) which provides that:

a director . . . of a corporation must exercise their powers and discharge their duties

(a) in good faith in the best interests of the corporation; and

(b) for a proper purpose.

For an erudite discussion of the legal effect of the codification of the directors' fiduciary obligation to act in the interest of the company see Ford *et al*, above n 38, para 8.065 at 315; B S Butcher,

The effect of the duty of loyalty is to render invalid any action of the directors that is not motivated by considerations of good faith concern for the interests of the company. To this extent, the equitable doctrines of fiduciary law go some way in protecting the interests of the company.<sup>46</sup> These principles are, however, not always helpful to shareholders wishing to test the legal propriety of either a no-shop, no-talk or break-up fee agreement which they consider to be detrimental to their interests, for example one that is likely to chill an auction for the company.

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*Directors' Duties: A New Millennium, A New Approach?* 2000, Kluwer Law International, London, at 141.

<sup>44</sup> *Thorby v Goldberg* (1965) 112 CLR 597. This matter is explored in more detail in Part 3.1.2 below.

<sup>45</sup> See for example *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1; *Consul Developments Pty Ltd v D P C Estates Pty Ltd* (1975) 49 ALJR 74; *Furs Limited v Tomkies Limited* (1936) 54 CLR 583; *Phipps v Boardman* [1967] 2 AC 46; *Bray v Ford* [1896] AC 44; *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461; [1843-60] All ER Rep 249.

There is a substantial volume of literature on the directors' duty of loyalty. As a starting point, the following works may prove quite helpful: Ford *et al*, above n 38, at 315-60; Davies, above n 25, at 599-623; Butcher, above n 43, at 95-127; J H Farrar & B M Hannigan, *Farrar's Company Law*, Butterworths, London, 4th ed 1998 at 377-391; R C Nolan, 'The Proper Purpose Doctrine and Company Directors' in B Rider (ed), *The Realm of Company Law*, 1998, Kluwer Law International, London, at 1-35; S Worthington, 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *MULR* 121 at 122-5; L S Sealy, "'Bona Fides" and "Proper Purposes" in Corporate Decisions' (1989) 15 *Mon ULR* 265.

<sup>46</sup> The fiduciary duty of loyalty is supplemented by the duty of care. This has, as its principal aim, to protect the company by ensuring that directors do not shirk their responsibilities. As it is not directly relevant to the issues considered here, the duty of care is not discussed in this paper.

As to the scope and dictates of the duty of care see generally *Daniels t/a Deloitte Haskins & Sells v AWA Ltd* (1995) 37 NSWLR 438; *Re City Equitable Fire Insurance Company Limited* [1925] Ch 407; *Re Brazilian Rubber Plantations* [1911] 1 Ch 425 at 435; *Re Denham* (1884) 25 Ch D 752; *The Overend & Gurney Co v Gibb* (1871-72) LR 5 HL 480.

For an illuminating analysis of the duty of care see by way of example only Ford *et al*, above n 38, at 349-360; P Lipton & A Herzberg, *Understanding Company Law*, The Law Book Company Limited, Sydney, 10th ed 2001, at 338-343; A S Sievers, 'Directors' Duty of Care: What is the New standard?' (1997) *C&SLJ* 392; J Cassidy, 'An Evaluation of Corporations Law s 232(4) and the Directors' Duty of Care, Skill and Diligence' (1995) 23 *Australian Business Law Review* 184.

### 3.1.1 The 'best interests of company' test

To determine the legality of an impugned no-shop or break-up fee agreement, a court is required to ascertain, amongst other things, whether it was implemented bona fide, in the interest of the company as a whole.<sup>47</sup> In theory this test is not controversial at all. However, its application presents a major difficulty. This is so primarily because the edict that 'directors must act bona fide for the benefit of the company as a whole' is, as Dixon J famously observed in *Mills v Mills*,<sup>48</sup> "an indefinite phrase."<sup>49</sup> As interpreted and applied by the courts, the concept of 'company' currently admits of different meanings.<sup>50</sup> In some instances, this duty is said to be an obligation to act bona fide for the benefit of the company as a separate legal entity. In others, it is formulated as a duty to act bona fide for the benefit of the shareholders.<sup>51</sup> Because 'company as a whole' is an ambiguous term,<sup>52</sup> it is difficult to predict with certainty whether or not a court will sustain a challenge to a lock-up device which threatens the interests of shareholders, for example, a no-shop agreement which curtails the chances of competing bids being made for a company.

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<sup>47</sup> See for example *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *Mills v Mills* (1938) 60 CLR 150; *Ampol Petroleum Limited v R W Miller (Holdings) Limited* [1972] 2 NSWLR 850.

<sup>48</sup> (1938) 60 CLR 150.

<sup>49</sup> *Ibid* at 188.

<sup>50</sup> On the possible different meanings of the term 'company' see Ford *et al*, above n 38, para 8.090 at 318; Farrar & Hannigan, above n 45, at 570-71; J D Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (ed), *Equity and Commercial Relationships*, 1987, The Law Book Company Limited, Sydney at 120-26; G Nicoll, 'The Changing Face of the "Company as a Whole" and Directors' Responsibilities to Members in the Exercise of management Powers' (1994) 4 *Aust Jnl of Corp Law* 187 at 289-303; F G Rixon, 'Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association' (1986) 49 *Modern Law Review* 446 at 448.

<sup>51</sup> Heydon, above n 50, at 120.

<sup>52</sup> On this see *Re Halt Garage Ltd* [1982] 3 All E R 1016 at 1035 where Oliver J poignantly observed that this term is not always used in the same sense.

**3.1.1(a) Acting in the ‘best interests of company’ as a duty to act in the interests of shareholders.**

There is a view that the term ‘company as a whole’ means nothing but the general body of corporators.<sup>53</sup> This idea has been propounded in a number of leading cases. For example, in *Ngurli Limited v McCann*<sup>54</sup> the High Court of Australia, applying the principle set out in the English case of *Greenhalgh v Ardenne Cinemas Limited*,<sup>55</sup> postulated that:<sup>56</sup>

the phrase ‘the company as a whole’, does not mean the company as a commercial entity, distinct from the corporators: it means corporators as a general body.

According to these cases, the obligation imposed on directors to exercise their powers bona fide for the benefit of the company as a whole is a duty to consult the interests of the shareholders to the exclusion of those of the separate legal entity, the corporation.<sup>57</sup> In other words, a reflection of the interests of the company is to be found in the interests of the shareholders.<sup>58</sup>

We are instructed by the authors of the influential Australian treatise *Ford’s Principles of Corporations Law*, that the term shareholders, when used in this context, is usually equated with current shareholders.<sup>59</sup> The same learned authors also maintain that the obligation to act in the best interest of shareholders as used in this context is taken to mean maximising the

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<sup>53</sup> *Greenhalgh v Ardenne Cinemas Limited* [1951] 1 Ch 286 at 291; *Peter’s American Delicacy Company Limited v Heath* (1939) 61 CLR 457 at 512; *Parke v Daily News* [1962] 2 All E R 929 at 948.

<sup>54</sup> (1954) 90 CLR 425.

<sup>55</sup> See [1951] 1 Ch 286 at 291.

<sup>56</sup> (1954) 90 CLR 425 at 438.

<sup>57</sup> *Ford et al*, above n 38, para 8.095 at 319; *Davies*, above n 25, at 603; *Nicoll*, above n 50, at 291-7.

<sup>58</sup> *Heydon*, above n 50, at 123.

<sup>59</sup> *Ford et al*, above n 38, para 8.090 at 318.

wealth of shareholders.<sup>60</sup> On this view then, it can be argued that the actions of directors must be guided by no consideration other than the maximization of the wealth of current shareholders. If this is accepted, then, it is arguable that in merger transactions and other transactions involving the transfer of corporate control, it is the duty of the directors of the target company to take all reasonable steps to obtain the best price for the shareholders. To do otherwise would be a breach of the duty of loyalty. On this view, it can be argued that shareholders can successfully challenge the validity of lock-up arrangements that preclude directors from dealing with rival bidders, especially if the later bid is superior to the no-shop bid. It is also arguable that transactions which makes it more difficult for alternative bids to be mounted could be attacked as not being in the interests of shareholders.

**3.1.1(b) Acting in the ‘best interests of company’ as a duty to act in the interests of the commercial legal entity.**

Although the previous analysis is quite compelling, there is a distinct possibility that an action by shareholders challenging the validity of a no-shop or break-up fee arrangement may not be successful. There is a countervailing view to the concept of company just discussed. This posits that the powers of directors `are conferred and are exercisable for the benefit of the company as a separate corporate entity, and the duty is owed to that entity and not to the individual shareholders whether assembled in general meeting or not.’<sup>61</sup>

From this perspective, the obligation to act in the best interests of the company calls for a concentration on the interests of the company as a corporate commercial entity distinct from

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<sup>60</sup> *Id.*

<sup>61</sup> B H McPherson, ‘Duties of Directors and the Powers of Shareholders’ (1977) 51 *ALJ* 460 at 468. See also Nicoll, above n 50, at 297-300; G F K Santow, ‘Defensive Measures Against Company Take-overs’ (1979) 53 *ALJ* 374.

the interests of the corporators.<sup>62</sup> On this view, directors are free to enter into a no-shop or related agreement provided they have acted on an informed basis and honestly believe it to be for the benefit of the company as a commercial entity.<sup>63</sup> Such an agreement will be upheld so long as it was not entered into for 'purposes foreign to the company's operations, affairs and organisation.'<sup>64</sup> The decisive test is whether the directors exercised their powers in good faith and for a proper purpose.<sup>65</sup> According to this view, a court will interfere with a no-shop agreement only if it is so unreasonable that no 'intelligent and honest person in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the [transaction was] for the benefit of the company.'<sup>66</sup>

In the particular context of corporate control transactions, the view that actions of directors are valid if they are for the benefit of the company as a commercial entity finds judicial support in several cases. For example, in *Darvall v North Sydney Brick & Tile Company Limited* (No 2),<sup>67</sup> a cash takeover offer of \$10 per share was made for all the issued shares in the capital of the respondent company. The last recorded trading price of the subject shares prior to this bid was 87 cents. The offer thus represented 'a tenfold increase in the value of the shares over their last sale.'<sup>68</sup> Nonetheless, the target directors opposed the offer. To

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<sup>62</sup> *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294 at 1305; Heydon, above n 50, at 122.

<sup>63</sup> See *Darvall v North Sydney Brick & Tile Company Limited* (No 2) (1989) 7 ACLC 659 at 708 and 714 respectively; *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294 at 1304; *Ashburton Oil No Liability v Alpha Minerals No Liability* (1971) 45 ALJR 162 at 163.

<sup>64</sup> Heydon, above n 50, at 122; *Winthrop Investments Limited v Winns Limited* (1978-80) 4 ACLR 1; *Ngurli Limited v McCann* (1954) 90 CLR 425 at 438; *Mills v Mills* (1938) 60 CLR 150 at 186.

<sup>65</sup> *Howard Smith Limited v Ampol Petroleum Limited* [1974] A C 821 at 834; *Winthrop Investments Limited v Winns Limited* (1978-80) 4 ACLR 1; *Harlowe's Nominees Proprietary Limited v Woodside (Lakes Entrance) Oil Company N L* (1968) 42 ALJR 123 at 125; P Little, *Law of Company Takeovers*, Law Book Company, Sydney, 1997 at 535.

<sup>66</sup> *Charterbridge Corporation Limited v Lloyd's Bank Limited* [1970] 1 Ch 62 at 74. See also *Wayde v New South Wales Rugby League Limited* (1987) 5 ACLC 799 (High Court of Australia).

<sup>67</sup> (1989) 7 ACLC 659.

<sup>68</sup> *Ibid*, at 665.

frustrate it, they caused the target to transfer its crown jewel, a large parcel of land, to a wholly owned subsidiary. The subsidiary then entered into a joint venture agreement with a third party to develop the land.

There can be no doubt that these actions were prejudicial to the interests of the offerees who wished to accept the offer and reap the substantial premium offered by the bidder. All the same, the majority of the New South Wales Court of Appeal upheld the impugned transactions. According to the majority, the directors acted to promote the interests of the company as a commercial entity. Those actions were thus a valid exercise of directors' powers.<sup>69</sup>

On the basis of this and similar cases,<sup>70</sup> it is apparent that, prima facie, a challenge by a shareholder to a lock-up involving either a no-shop clause or break-up fee will be not be successful if the device can be shown to have served some proper corporate purpose. In such a case, there will be a basis for the directors to argue that they believed the agreement was in the interests of the company. The agreement will stand even if it is shown not to be for the benefit of the aggrieved shareholders.<sup>71</sup>

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<sup>69</sup> *Ibid*, at 708 and 712.

<sup>70</sup> See, for example, *Harlowe's Nominees Proprietary Limited v Woodside (Lakes Entrance) Oil Company N L* (1968) 42 ALJR 123; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199; *Allen v Gold Reefs of West Africa Limited* [1900]1Ch 656; *Sidebottom v Kershaw, Leese & Co* [1920] 1 Ch 154; *Dafen plate Tinsplate Co v Llanley Steel Co* [1920] 2 Ch 124; *Shuttleworth v Cox & Brothers Co (Maidenhead)* [1927] 2 K B 9; *Dawson International plc v Coats Paton plc* [1989] BCLC 233.

<sup>71</sup> See for example *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294 at 1304; *Ashburton Oil No Liability v Alpha Minerals No Liability* (1971) 45 ALJR 162 at 163

### 3.1.2 Fetters on directors' discretionary powers

The principles of fiduciary law governing directors' duties provide an additional restraint on the use of no-shop and break-up fee arrangements. This is through the obligation imposed on directors not to fetter their discretion.

High authority has established that the 'powers given to directors must be exercised for the benefit of the company. Consequently there is no authority for directors to give an undertaking . . . that they will not exercise those powers.'<sup>72</sup> In view of this, some might argue that it is not permissible for directors to agree, on an informed basis, to a no-shop or break-up fee agreement, especially if that arrangement would have the effect of restricting their ability to exercise their powers in the future.<sup>73</sup> It could be argued that if directors committed themselves to support a particular bid, thereby precluding their right to consider a later (and possibly superior) offer if one is made, such an agreement would constitute a fetter of directors' discretion. Consequently, the agreement would amount to a breach of directors' fiduciary duty and would be unenforceable. For, 'an undertaking or any other transaction made by directors in breach of any of their fiduciary duties is voidable and therefore unenforceable against the company.'<sup>74</sup>

This argument is certainly respectable. However, it appears that, as presently applied, the rule against fettering discretion is also not likely to be very helpful in curbing suspect no-shop or break-up fee agreements. Directors' actions can easily pass muster under this test now. All that directors need to do is to show that after fully appraising all relevant

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<sup>72</sup> *Ashburton Oil No Liability v Alpha Minerals No Liability* (1971) 45 ALJR 162 at 163; *Thorby v Goldberg* (1965) 112 CLR 597 at 605.

<sup>73</sup> See discussion in Part 2.1 above.

<sup>74</sup> *Bamford v Bamford* [1970] Ch 212; *Wilton Group plc v Abrams* [1991] BCLC 315. For an illuminating discussion of this and related issues see A Griffiths, 'The Best Interests of Fulham F C: Directors' Fiduciary Duty in Giving Contractual Undertakings' [1993] *Journal of Business Law* 576 at 577.

considerations, they genuinely believed that the interest of their company would be best served if it merged with, or was acquired by the grantee of the no-shop option or break-up fee. To meet this test, the directors and/or their advisers could undertake a perfunctory search and claim that no bidder had indicated any interest. After that, they could enter into a merger agreement with a favoured bidder and undertake not to solicit other bids. Or, they could agree to pay a break-up fee to that bidder. They could even do both and argue that they acted as they did so as to entice the grantee to make an offer for the company. In these circumstances, it is probable that a court would uphold those actions as a permissible exercise, and not a fetter, of the directors' discretion. This is so notwithstanding that the effect of the undertaking would be to limit the scope for exercising their powers in the future.

A review of the major cases in this area lends considerable support to this view. For example, in *Thorby v Goldberg*<sup>75</sup> the parties entered into an agreement concerning the financing of the construction of a building on a property then owned by the appellants, and the sharing of office space in that building. To give effect to that agreement, the appellants undertook to take steps to procure the happening of certain events, including the amendment, in a specified way, of the articles of association of their company. The appellants repudiated the agreement, upon which the respondents successfully sued for damages for breach of contract. On appeal, it was contended on behalf of the appellants that the agreement sued upon was void as it bound the directors to act in a fixed manner, in breach of their duties not to fetter their discretion. The High Court of Australia rejected this argument, with Kitto J succinctly observing:<sup>76</sup>

there are many kinds of transactions in which the proper time for the exercise of the directors' discretion is the time of the negotiation of a contract, and not the time at which the contract is to be performed. . . . If the at the former time they are bona

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<sup>75</sup> (1965) 112 CLR 597.

<sup>76</sup> *Ibid*, at 606 (per Kitto J).

fide of opinion that it is in the interests of the company that the transaction should be entered into and carried into effect, I see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board.

Another decision worthy of note in this connection is *Fulham Football Club Ltd v Cabra Estates Ltd*,<sup>77</sup> a decision of the English Court of Appeal. There, the Court was concerned with certain undertakings given by the directors of Fulham Football Club Ltd to support the respondent in its efforts secure planning permission to re-develop its property which had previously served as Fulham's home ground. In return, Cabra promised to pay certain sums of money to the club (Fulham), which agreed to vacate the property.

Subsequent to this agreement, however, the directors of Fulham determined that the planned re-development would not serve the club's interest and sought to withhold its support for Cabra's proposals. To this end, it commenced proceedings seeking a declaration that it was not bound by the undertakings given by its directors to Cabra. This was on the grounds, inter alia, that the directors could not fetter the exercise of their discretionary powers through any contractual undertaking. The Court of Appeal disagreed, holding:<sup>78</sup>

it is trite law that directors are under a duty to act bona fide in the interests of their company. However, it does not follow from that proposition that directors can never make a contract by which they bind themselves to the future exercise of their powers in a particular manner even though the contract taken as a whole is manifestly for the benefit of the company.

As these cases clearly show, the courts will not always treat an agreement seeking to bind directors to exercise their powers in a certain way in the future as necessarily improper. On the contrary, the courts appear to have accepted the view put forward by some commentators that `denying directors the power to give undertakings or obliging them to keep their options

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<sup>77</sup> [1992] BCLC 863.

<sup>78</sup> *Ibid* at 875 (per Neill L J).

would prejudice the interests of companies in general.<sup>79</sup> Indeed, in the *Fulham Football Club case* just discussed, Neill LJ tersely remarked that 'such a rule could well prevent companies from entering into contracts which were commercially beneficial to them.'<sup>80</sup> So, on current authority, it appears that an undertaking whereby directors bind themselves not to solicit rival bids or to pay a break-up fee will be upheld if it can be shown that at the time of giving it, the directors believed that it was in the interest of their company to do so, which will not be difficult if the agreement serves some rational business purpose. This will be treated by the courts as an exercise of directors' discretion, not a fetter of it.<sup>81</sup>

### **3.1.3 Interim conclusion**

The legal scheme which currently regulates the exercise of directors' powers is, at a conceptual level, fundamentally flawed and consequently inadequate to handle the special problems arising in connection with the use of exclusivity and break-up fee agreements. The governing general legal and equitable principles of fiduciary law permit the directors in some circumstances to concentrate on the interests of the separate legal/economic entity, and in others on the interests of shareholders.<sup>82</sup> This creates considerable uncertainty in determining whether or not a decision to enter into these agreements constitutes a proper exercise of directors' powers. Because of this uncertainty, shareholders are likely to be loath to challenge suspect no-shop / no-talk or break-up fee agreements. In the result, directors are left relatively free to use these devices to manipulate corporate control either by impeding competing bids or by facilitating control of a company to pass to parties favourable to them. This is undesirable. It has the potential to diminish both shareholder and social welfare.

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<sup>79</sup> Griffiths, above n 74, at 578.

<sup>80</sup> [1992] BCLC 863 at 875.

<sup>81</sup> See *Thorby v Goldberg* (1965) 112 CLR 597 at 617-8 (per McTiernan J and Windeyer J).

<sup>82</sup> *Richard Brady Franks Limited v Price* (1937) 58 CLR 112 at 143 (per Dixon J).

Also, it provides fertile ground for tactical maneuvering, legal posturing and skirmishing which can be exploited by malcontents, to the potential detriment of shareholders and society in general. Hence the need for reform of the law in this area. Some proposals for reform are set out in the next part.

## 4 PROPOSALS FOR REFORM

### 4.1 Validity

There is need to promote certainty as to when a decision by directors to enter into no-shop, no-talk and break-up fee agreements is acceptable. To achieve this, a new standard for reviewing the validity of these agreements should be introduced in lieu of the present ‘benefit of the company’ test. As presently applied, this term is, as Dr Rixon once bluntly put it, ‘a Delphic term employed by different judges in different circumstances to signify different things.’<sup>83</sup>

In undertaking the proposed reform, policy makers would serve the investing community and society generally well if they adopted shareholder welfare enhancement as the criterion for developing the applicable standards in this area. An approach focussing on shareholder welfare has a lot to commend it. In the first place, it recognises that shareholders are the

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<sup>83</sup> Rixon, above n 50, at 454. To compound this difficulty, it is sometimes argued that directors owe an independent duty to outside constituencies, for example creditors, employees, customers etc. To protect these interests, it is suggested that the directors’ duty to act in the interests of the company should be relaxed so as to give directors more discretion to look after these constituencies. See for example *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 ACLR 395; *Jeffree v National Companies and Securities Commission* (1989) 7 ACLC 556; *Sydlow Pty Ltd v Melwren Pty Ltd* (1994) 13 ACSR 144. This issue will not be canvassed here. For a more detailed discussion of this matter, interested readers may refer to Nicoll, above n 50, at 291—3; Heydon, above n 50, at 120 et seq; R Baxt, ‘Do Directors Owe Duties to Creditors – Some Doubts Raised by the Victoria Court of Appeal’ (1997) 15 *C&SLJ* 373 at 374-5; J J Mannolini, ‘Creditor’s [sic] Interests in the Corporate Contract: A Case for the reform of Our Insolvent Trading Provisions’ (1996) 6 *Aust Jnl of Corp Law* 14 especially at 22-3; L S Sealy, ‘Directors’ “Wider” Responsibilities - Problems Conceptual, Practical and Procedural’ (1987) 13 *Mon U L R* 164.

“owners of the company”,<sup>84</sup> they being the people who have risked their capital in the hope of gain.<sup>85</sup> In any case, as Hansmann and Kraakman have argued, there now appears to be a consensus among the academic, business, and governmental elites in leading jurisdictions . . . that . . . the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders’<sup>86</sup> and that other constituencies such as creditors, employees, suppliers and customers should have their interests protected by contractual and regulatory means rather than participation in corporate governance.’<sup>87</sup>

In view of this, it would make eminent sense to require directors to act primarily in the interests of shareholders in these circumstances. This will likely have the added advantage of promoting greater accountability of directors, which is bound to be impaired if directors are at liberty to consider other diffuse interests. For, as Professor Sealy once observed, if in the discharge of their duties directors may relevantly consider:<sup>88</sup>

potentially opposed interests, the duty imposed on them bifurcates and fragments so that it amounts ultimately to no more than a vague obligation to be fair; . . . If the law does this, it abandons all effective control over the decision-maker.

By helping to assure greater accountability of directors, the suggested approach will likely assist to improve the efficiency of companies. This will benefit not only shareholders. Aggregate social welfare might thereby be enhanced.

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<sup>84</sup> See *Corporations Act* 2001 (Cth), Part 1.5 para 1.9. See also *Caparo Industries plc v Dickman* [1990] 1 All E R 568 at 579 (per Lord Bridge).

<sup>85</sup> Ford *et al.*, above n 38, para 8.095 at 319. See also I A Renard, ‘Commentary’ in P D Finn (ed), *Equity and Commercial Relationships*, 1987, The Law Book Company Limited, Sydney at 140.

<sup>86</sup> See H Hansmann & R Kraakman, ‘The End of History for Corporate Law’ Harvard Law School, John M Olin Center for Law, economics and Business, Discussion Paper No 280, available at [http://www.law.harvard.edu/programs/olin\\_center/](http://www.law.harvard.edu/programs/olin_center/) (accessed 11 February 2002) at 2-3.

<sup>87</sup> *Id.*

<sup>88</sup> Sealy, above n 83, at 175.

A further advantage of adopting shareholder welfare enhancement as the guiding criterion for testing the validity of an exclusivity or break-up fee agreement is that it promotes 'a more precise, concrete, material inquiry.'<sup>89</sup> This is likely to promote certainty and predictability. With the object of the law clearly enunciated, all parties concerned – directors, shareholders, prospective acquirers and judges - know the parameters of permitted conduct. This enables all participants in merger / takeover transactions to organise their affairs on reasonable expectations. The resulting certainty and predictability may encourage interested parties to more readily challenge welfare diminishing lock-ups. The role of the law in promoting shareholder and social welfare might thereby be enhanced.

Therefore, the law should be amended to provide that directors may agree to a no-shop / no-talk clause or break-up fee only if it is for the benefit of shareholders. As the benefit of shareholders is usually equated with shareholder wealth maximisation,<sup>90</sup> it should ordinarily be permissible for directors to enter into such an agreement only if it is calculated to secure the best reasonably obtainable offer for shareholders. An example of this is an agreement that is likely to induce an initial bid, where none has been forthcoming, or one that is likely to 'entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit.'<sup>91</sup> Measures (usually taken in response to an acquisition bid not favoured by incumbent directors or in anticipation of such a bid<sup>92</sup>) which end an active auction, foreclose further bidding or make it more difficult for a potential competing bid to succeed should not be permitted. They operate to the detriment of shareholders.<sup>93</sup> By discouraging competing bids, they not only deny shareholders a higher

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<sup>89</sup> Heydon, above n 50, at 123

<sup>90</sup> See discussion accompanying notes 56-57 above.

<sup>91</sup> *Revlon Inc v Macandrews & Forbes Holdings Inc* 506 A 2D 173 (1986) at 182. See also *Hanson Trust plc v ML SCM Acquisitions Inc* 781 F 2d 264 at 274 (1986).

<sup>92</sup> These are popularly referred to as 'second bidder' and 'anticipatory' lock-ups respectively. See generally Kahan & Klausner, above n 13, at 1563.

<sup>93</sup> See further *Revlon Inc v Macandrews & Forbes Holdings Inc* 506 A 2D 173 (1986) at 183.

premium for their shares. They also potentially whittle down the allocative role of transfer of corporate control transactions, which might adversely affect the efficient functioning of the economy generally.<sup>94</sup> Indeed, in recognition of their deleterious effects, the Takeovers Panel, the agency vested with primary responsibility for the resolution of takeover disputes in Australia<sup>95</sup> has signaled its opposition to the use of these measures in takeover transactions.<sup>96</sup>

For the avoidance of doubt, the governing rule should expressly state that the acceptance of a no-shop / no-talk provision, whether it contains a fiduciary-out clause or not, does not in any way affect the directors' obligation to continue to act in the best interest of shareholders. Under the proposed rule, the directors would be free to agree not to shop for competing bids if they have seriously shopped around, have bargained as hard as they can and are satisfied, on available credible information, that the no-shop bidder is offering the best price at the time of the agreement. This is beneficial to all parties. It protects the bidder's investment in researching and negotiating the merger. At the same time, it assures the target shareholders of a committed and seriously negotiated agreement.<sup>97</sup> However, directors would still have a duty to receive and consider information from rival bidders, if any should be forthcoming. Directors are under a fiduciary duty to act in the best interest of the company and to exercise due care in managing the affairs of their company.<sup>98</sup> To discharge these obligations effectively, it is imperative that they take into account all information reasonably available. Information from potential rival bidders could provide new insights regarding the value of the company. Disregarding that information could prevent the board from learning about a potentially superior proposal.<sup>99</sup> This could hurt the interests of shareholders.

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<sup>94</sup> See further Kahan & Klausner, above n 13, at 1563-64.

<sup>95</sup> See *Corporations Act* 2001 (Cth), Part 6.10, Division 2.

<sup>96</sup> See Takeovers Panel, above n 15, paras 18-20 and 28-30.

<sup>97</sup> See further Burgess, above n 12, at 469-70.

<sup>98</sup> See discussion in Part 3.1 above.

<sup>99</sup> Burgess, above n 12, at 470; Lebovitch & Morrison, above n 28 at 19-20.

In addition, directors would also be required to consider an unsolicited rival bid that tops the no-shop bid if one is subsequently made. In that eventuality, the directors would be required to negotiate with the rival bidder for the best value reasonably available to the shareholders, provide relevant information to the rival bidder, if necessary, and accept the rival bid if it is superior to the no-shop bid.<sup>100</sup>

This proposal, which significantly enjoys the support of the Takeovers Panel,<sup>101</sup> serves some important functions. First and foremost, it sets a realistic check on the ability of directors to implement measures which may have the effect of nullifying the shareholders' statutory power to approve or reject merger transactions. Secondly, it preserves the auction process. This is likely to enhance both shareholder and social welfare. An auction can assist shareholders to receive an alternative and possibly better offer for their shares.<sup>102</sup> Further, as the success of a competing offer does not depend on the target directors' co-operation,<sup>103</sup> the potential problem of management self-interest discussed before<sup>104</sup> is overcome. And, to the extent it facilitates the re-allocation of corporate resources to their highest valued uses,<sup>105</sup> the auction process is likely to benefit society generally.

These proposals are susceptible to attack on the ground that they focus primarily on the interests of existing shareholders. There is a view in some quarters that directors ought not to

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<sup>100</sup> This approach is, indeed, consistent with that taken by the courts in some overseas jurisdictions. See for example *Dawson International plc v Coats Paton plc* [1989] BCLC 233; *John Crowther Group Ltd v Carpets International plc* [1990] BCLC 460. Significantly, the Delaware Supreme Courts, one of the most influential courts on matters of corporate law in the United States has expressed its disapproval of provisions in merger agreements which have the effect of preventing directors from considering all reasonably available information. See for example *Paramount Communications v QVC Network* 637 A 2d 34 at 49 (1993); *Ace Ltd v Capital Re Corp* 747 A 2d at 106 (1999); *Phelps Dodge Corp v Cyprus Amax Minerals Co* 1999 WL 1054255.

<sup>101</sup> See Takeovers Panel, above n 15, paras 31-2.

<sup>102</sup> Kahan & Klausner, above n 13, at 1563-64.

<sup>103</sup> *Ibid*, at 1564; Bainbridge, above n 15, at 273-75 and 318.

<sup>104</sup> See discussion accompanying note 27 above.

<sup>105</sup> Kahan & Klausner, above n 13, at 1563-64.

be guided solely by the interests of current members, but should also relevantly endeavour to promote the long-term interests of the company, including its future shareholders.<sup>106</sup>

While this course may be justified in some circumstances, it is, with respect, not altogether appropriate in merger and corporate control transactions. Where control of a company is bound to change, there is no reason for the directors to concern themselves with the future of the company. As the full English Court of Appeal rightly observed in *Heron International Ltd v Lord Grade, Associated Communications Corp PLC*,<sup>107</sup> after a change in control, the future of the company lies with the new controller. The directors owe no duty to the new controller or the company after it has passed to the new controller. The new controller can look after himself.<sup>108</sup> So, where a change of corporate control is involved, the proper concern of the directors should be to maximise the welfare of existing shareholders. This means obtaining the best available price for these shareholders. As, in substance, the economic consequences of a merger are the same as those of a transaction involving a transfer of corporate control,<sup>109</sup> this same rule should also apply in merger transactions not involving a change of control.

It is worth noting here that the Delaware Supreme Court, a court whose decisions on matters of corporate law are very much respected in the United States of America, has also taken a similar approach on this matter. In *Revlon Inc v Macandrews & Forbes Holdings Inc*,<sup>110</sup> that court ruled that 'where a change of corporate control is involved, the duty of the board changes from the preservation of the company to the maximization of the company's value at

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<sup>106</sup> See for example Counsel's opinion cited in Davies, above n 25, at 606 (fn 38).

<sup>107</sup> [1983] BCLC 244.

<sup>108</sup> *Ibid* at 265. On this see further Lebovitch & Morrison, above n 28, at 36-9.

<sup>109</sup> As Vice Chancellor Leo Strine Jr has reminded us each of these transactions represents the final opportunity for the target shareholders to be afforded payment for their now exclusive ownership of the target company. See Strine Jr above n 14, at 928-930.

<sup>110</sup> 506 A 2D 173 (1986).

a sale for the stockholders' benefit.'<sup>111</sup> It restated the same principle in *Paramount Communications v QVC Network*.<sup>112</sup> There it held that in circumstances involving a transfer of corporate control,<sup>113</sup>

the directors must focus on one primary objective – to secure the transaction offering the best value reasonably available for the stockholders. The board must act in a neutral manner to encourage the highest possible price for shareholders.

This point was re-emphasised later on in the same judgment, with the court declaring that 'when a corporation undertakes a transaction which will cause . . . a change in corporate control or . . . a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available for the stockholders.'<sup>114</sup>

Structural changes in the world economy and developments in technology are fast rendering national markets irrelevant. Capital and securities markets are now becoming increasingly international. In these circumstances, Australian policy makers would be well advised to reform its law to accord investors in local companies the same protection as their counterparts overseas. If Australian law does not guarantee shareholders adequate protection, Australian companies might find it difficult to raise capital in the world's financial markets.<sup>115</sup>

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<sup>111</sup> *Ibid*, at 182

<sup>112</sup> 637 A 2d 34 at 49 (1993).

<sup>113</sup> *Ibid*, at 44.

<sup>114</sup> *Ibid*, at 48.

<sup>115</sup> See further J Mayanja, 'Reforming Australia's Takeover Defence Laws: What Role for Target Directors? - A Reply And Extension (1999) 10 *Aust Jnl of Corp Law* 162 at 191; M Kirby, 'Corporate Governance, Corporate Law and Global Forces' in I Ramsay (ed), *Corporate Governance and the Duties of Company Directors*, Centre for Corporate Law and Securities Regulation, The University of Melbourne, Melbourne, 1997 at 51-52. An interesting discussion of some of the challenges and problems posed to Australia by the internationalisation of securities markets can be found in L Masel, 'The Growing Internationalisation of Securities Markets - Implications For Australia' in *Countertrade, Protectionism, Deregulation And Arbitration in Australia-Asia-The Pacific*, Asian Law Centre, Melbourne, July 1985 at 101 et seq; S Sporkin, 'Securities and Financial Market Regulation in the 1990s' (1991) 18 *Securities Regulation Law Journal* 414.

## 4.2 Calibration of break-up fees

To minimise the potential for abuse, it is prudent to regulate the size of break-up fees. Because these arrangements can serve some beneficial functions,<sup>116</sup> the relevant rules should permit their use, in accordance with the principles discussed above, but ensure that the agreed fee is within the range of reasonableness, and is fully disclosed to the shareholders.

The principal aim of break-up fees is to entice a potential merger partner or acquirer either to make an initial bid, or to enter a bidding contest, for the target. The need for such an incentive is particularly evident in those circumstances where a prospective bidder is reluctant to expend considerable sums to attempt an acquisition if it is not confident of recovering those costs if the company is, ultimately, acquired by another party. In light of this, the rules adopted should explicitly make clear that the object of a break-up fee agreement is to induce a bid and to compensate the grantee for out-of-pocket expenses.<sup>117</sup> As such, any amount in excess of bid costs should be disallowed. Such costs are not necessary to induce bids. The agreement should not be used to confer a gratuitous benefit upon the grantee should the anticipated merger fail. This would amount to a waste of corporate resources.<sup>118</sup> Nor should it be entered into simply to make it more difficult for potential competing bids to succeed or to penalize shareholders for not approving a merger.

As a break up fee is, in effect, an advance estimate by the parties of the loss likely to be suffered by the grantee if the merger is not approved by the shareholders,<sup>119</sup> it should be

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<sup>116</sup> As to these see discussion in Part 2 above especially text accompanying notes 21-26.

<sup>117</sup> This view is shared by the Takeovers Panel. See Takeovers Panel, above n 15, paras 8, 17. See further Annexure to Guidance Note, paras 1-3.

<sup>118</sup> In this connection, see *Plaut v Steiner* (1989) 5 BCC 352 at 364 and *Barclays Bank v British and Commonwealth Holdings plc* (1996) 1 BCLC 1 at 41 for dicta suggesting that in cases involving break fees, any amount which exceeds the bidder's wasted expenditure may well amount to a gift, and possibly unlawful. See also Takeovers Panel, above n 15, Annexure to Guidance Note, para 7.

<sup>119</sup> See Bainbridge, above n 15, at 245.

treated as a liquidated damages clause. Ordinarily, therefore, it should be upheld if it is reasonable in light of the bidder's costs and the magnitude of the transaction.<sup>120</sup> Conversely, the clause should be treated as a penalty, and disallowed, if the amount involved appears to be unconscionable or is not rationally related to the damage likely to be sustained by the bidder as a result of the failure by shareholders to approve the merger.<sup>121</sup>

To determine whether or not the agreed fee is reasonable, guidance should be sought from the principles accepted by the courts for analysing the award of damages in the law of contract. Current learning teaches that 'the object of an award of damages is to give the plaintiff compensation for the damage, loss or injury he has suffered.'<sup>122</sup> Indeed, in *Robinson v Harman*,<sup>123</sup> which is widely acknowledged as the leading authority on the measure of damages in contract,<sup>124</sup> Parke B held that:<sup>125</sup>

where a party sustains a loss by reason of a breach of contract, he [or she] is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed.

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<sup>120</sup> On this see generally Block *et al*, above n 15, at 966 and the cases cited therein; Kahan & Klausner, above n 13, at 1565-66.

<sup>121</sup> On penalties see further N C Seddon & M P Ellinghaus, *Cheshire & Fifoot's Law of Contract*, Seventh Australian Edition 1997, Butterworths, Sydney para 23.35 (at 801-2) and the cases cited there.

<sup>122</sup> H McGregor, *McGregor on Damages*, 15th ed 1988, Sweet & Maxwell, London, para 9 (citations omitted). See further S Jacobs, *Damages in a Commercial Context*, 2000, LBC Information Services, Sydney, at 51-61; S M Waddams, 'The Principles of Compensation' in P D Finn, *Essays On Damages*, The Law Book Company, Sydney, 1992 at 1; A McInnes, *Handbook On Damages*, The Law Book Company Limited, Sydney, 1992 at 7-10.

<sup>123</sup> [1848] 1 Ex 850.

<sup>124</sup> See McGregor, above n 122, para 9 (at 8-9); Jacobs, above n 122, paras 5.17 (at 54).

<sup>125</sup> [1848] 1 Ex 850 at 855 (parenthesis added). The same principle is applied in Australia. See for example *The Commonwealth Of Australia v Amman Pty Ltd* (1991) 174 CLR 64 at 80; *Gates v City Mutual Life Assurance Society Ltd* (1986) 160 CLR 1 at 11-12; *McRae v Commonwealth Disposals Commission* (1951) 84 CLR 377.

In attempting to achieve this, the courts may award either 'expectation' damages or 'reliance' damages.<sup>126</sup> The object of awarding expectation damages is to protect a party against loss of profits. As Fuller and Purdue elucidated in their seminal 1936 article, in the event of a breach contract:<sup>127</sup>

we may seek to give the promisee the value of the expectancy which the promise created. We may in a suit for specific performance actually compel the defendant to render the promised performance to the plaintiff, or, in a suit for damages, we may make the defendant pay the money value of this performance. Here our objective is to put the plaintiff in as good a position as he would have occupied had the defendant performed his promise. The interest protected in this case we may call the expectation interest.

On the other hand, reliance damages enable the victim to recoup wasted expenditure. To return to Fuller and Purdue:<sup>128</sup>

we may award damages to the plaintiff for the purpose of undoing the harm which his reliance on the defendant's promise has caused him [or her]. For example, the buyer under a contract for the sale of land has incurred expense in the investigation of the seller's title or has neglected the opportunity to enter other contracts. Our object is to put him [or her] in as good a position as he was in before the Promise was made. The interest protected in this case may be called the *reliance interest*.

For the purposes of determining whether or not a break-up fee is reasonable, it would appear that the 'expectation damages' analysis, which seeks to compensate for lost profits, is not apposite. Ordinarily, it would be a fairly difficult task for a bidder to establish that a proposed merger would have resulted in a profit, let alone the level of that profit. The

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<sup>126</sup> See generally *The Commonwealth of Australia v Amman Pty Ltd* (1991) 174 CLR 64 at 82; Jacobs, above n 122, paras 5.16-5.41.

<sup>127</sup> Fuller & Purdue, 'The Reliance Interest in Contract Damages' (1936) 46 *Yale Law Journal* 52 at 54. See further Seddon & Ellinghaus, above n 121, para 23.20 (at 788); *The Commonwealth Of Australia v Amman Pty Ltd* (1991) 174 CLR 64 at 82.

<sup>128</sup> Fuller and Purdue, above n 127 at 54 (words in parentheses not in original). See also Regan, above n 29, at 34-35.

realization of benefits from a merger is not fully within the control of a successful bidder. Several other variables come into play. For example, there is the possibility that the bidder would not have won in the market, operating costs, levels of competition and so on. In these circumstances, therefore, it is advisable that the enquiry focus, relevantly, on the expenditure rendered futile by non-consummation of the merger.<sup>129</sup> So, the 'reliance damages' analysis should be applied. A break-up fee clause should be upheld if it is a reasonable forecast of the actual expense incurred by a frustrated bidder.<sup>130</sup>

This approach is in keeping with that adopted by the High court of Australia in assessing damages in cases of breach of contract where damages for future loss of profit cannot be readily ascertained. For example, in the leading case of *The Commonwealth of Australia v Amman Pty Ltd*,<sup>131</sup> the respondent entered into a contract with the Commonwealth to undertake aerial surveillance of the northern coastline of Australia for the purposes of detecting unauthorized landings. The respondent experienced delays in procuring the necessary number of properly fitted and equipped aircraft, as a result of which it was unable to perform its contract immediately. In consequence, the Commonwealth served on the respondent notice of termination of the contract. The respondent sued for damages for breach of contract.

The trial judge found for the respondent but awarded damages for lost profits, which were far below the amount expended by the respondent in preparation for the performance of the contract. On appeal, the award was augmented to take into account the respondent's wasted expenditure. The Commonwealth appealed to the High Court where it argued, inter-alia, that it was wrong to award damages where it could not be established that the respondent would

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<sup>129</sup> See generally McGregor, above n 122, paras 49 (at 29) and 58-9 (at 35-6); M Owen, 'Some Aspects of the Recovery of Reliance Damages' (1984) 4 *Oxford Journal of Legal Studies* 393 at 395-99.

<sup>130</sup> See further Seddon & Ellinghaus, above n 121, para 23.35 (at 801-2).

<sup>131</sup> (1991) 174 CLR 64.

have made a profit on the contract. This argument was comprehensively rejected by the High Court. Of particular significance, Mason C J and Dawson J held, in a joint judgment, that:<sup>132</sup>

where it is not possible for a plaintiff to demonstrate whether or to what extent the performance of a contract would have resulted in a profit for the plaintiff, it will be open to a plaintiff to seek to recoup expenses incurred, damages in such a case being described as reliance damages or damages for wasted expenditure.

The High court also took a similar approach in the earlier case of *McRae v Commonwealth Disposal Commission*.<sup>133</sup>

It is worthy of note at this stage that the need to regulate break-up fee agreements has been recognised by the Takeovers Panel, a key business regulatory agency in Australia. In response to the increasing popularity of lock-up devices in Australia, the Panel has issued a Guidance Note setting out its view as to the circumstances in which it considers the use of these arrangements acceptable. Quite significantly, the Panel makes clear in that guidance note that it frowns upon the use of break-up fees simply to confer a windfall gain on the counter-party,<sup>134</sup> to stifle competing bids<sup>135</sup> or coerce shareholders to accept a particular offer.<sup>136</sup> The Panel sees the role of break-up fees as being to enable the bidder to recoup its wasted expenditure and reasonable opportunity costs.<sup>137</sup>

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<sup>132</sup> *Ibid*, at 81. See also the separate judgments of Deane J (at 127-8) and Toohey J (at 135).

<sup>133</sup> (1951) 84 CLR 377. For an insightful commentary on reliance damages in Australia see Jacobs, above n 122, para 5.33.

<sup>134</sup> See Takeovers Panel, above n 15, Annexure, para 7.

<sup>135</sup> Takeovers Panel, above n 15, paras 8 and 19.

<sup>136</sup> *Ibid*, para 20.

<sup>137</sup> *Ibid*, especially para 7 and Annexure, paras 2 - 3.

The Panel counsels that when used, a break-up agreement should have a `clear dollar or percentage cap. In this regard a cap of 1% of the value of the bid is a reasonable guide for bids.<sup>138</sup>

The Panel's guidelines mirror the rules adopted by the City Panel on Takeovers and Mergers, a self-regulatory body responsible for the regulation of takeover and merger activity in the United Kingdom, to address concerns regarding the use of break-up fees in that jurisdiction. The City Panel's rule, which seeks to provide some safeguards for shareholders whenever it is proposed to pay a break-up fee provides, relevantly, that:<sup>139</sup>

- the fee must be de minimis (normally no more than one per cent of the offer value) and the offeree company board and its financial adviser must confirm to the London Takeovers Panel in writing that, inter alia, they believe the fee to be in the best interest of shareholders. Any fee arrangement must be fully disclosed in the announcement made under Rule 2.5 [ie the press release announcing the offer] and in the offer document. Relevant documents must be put on display . . .; and
- the Panel must be consulted at the earliest opportunity.

This rule was introduced out of the City Panel's concern to ensure that:<sup>140</sup>

the interests of the offeree shareholders are not adversely affected by inducement fee arrangements. The payment of such fees will necessarily reduce offeree shareholders' funds, and in cases where the offeree board has received an approach from another party, there are concerns that a bona fide offer may be frustrated by reason of these arrangements.

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<sup>138</sup> *Ibid*, para 14.

<sup>139</sup> *City Code on Takeovers and Mergers*, Rule 21(2), introduced July 2000. Reproduced in CCH, *British Company Law and Practice*, para 65-800.

<sup>140</sup> City Panel on Takeovers and Mergers, *Inducement Fees*, Statement 1999/10, 16 July 1999.

There is no doubt that objective of these initiatives is to ensure that break-up fees are kept within the bounds of reasonableness. This is a positive step in the protection of shareholders for which these regulators should be congratulated.

However, in its Guidance Note, the Takeovers Panel, while recognising that 'reimbursement of opportunity costs is a difficult area,'<sup>141</sup> has left the door open to such claims.<sup>142</sup> According to the Panel, such fees 'will only be acceptable in relation to the reasonable opportunity costs to the bidder in making its bid, and will not be acceptable where they are to reimburse profit expected on the success of the proposed bid.'<sup>143</sup> So, it appears that while disallowing claims for lost profits, the Panel will be prepared to entertain claims for losses incurred in not pursuing alternative merger/acquisition opportunities. This is problematic. Because of the difficulty of ascertaining the value of foregone opportunities, a difficulty which the Panel itself has recognised,<sup>144</sup> the allowance of this head of claim is likely to introduce much uncertainty in determining whether a particular break-up fee is reasonable. This is undesirable. To remove this uncertainty, it is advisable to restrict recoverable costs to the bidder's actual total pre-and post-bid costs - its reliance damages in contract terms, in accordance with the principles discussed above.<sup>145</sup>

## **5 CONCLUSION**

The current legal scheme for regulating the use of no-shop / no-talk and break-up fee agreements is not satisfactory. Under the present regime, interested parties cannot safely predict whether or not a decision by the directors to enter into any of these arrangements will

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<sup>141</sup> Takeovers Panel, above n 15, Annexure, para 4.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> See text accompanying notes 128-133 above.

be upheld by the court, if challenged. This resultant uncertainty has the potential to diminish the protection of the interests of shareholders. It can also potentially discourage some parties from entering into what might otherwise be value creating merger transactions.

In order to promote shareholder and social welfare to the fullest extent possible, the law should be reformed to define more explicitly the obligations of directors in relation to the use of exclusivity provisions and break-up fee arrangements. In undertaking this task, policy makers should adopt shareholder welfare enhancement as the criterion for developing the rules applicable in this area. Under these rules, only no-shop agreements and break-up fee arrangements that entice bidders or promote an auction for the company should be permitted. Arrangements that unfairly favour one party, repel other potential bidders or prevent directors from receiving or considering alternative bids should be disallowed. These proposals, if accepted, are likely to lead to a relatively clear and predictable regulatory framework.