The Legal Effect of Merger and Asset Sale Agreements before Shareholder Approval

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Mr. Ward presents several problems confronting a corporate board of directors which desires to merge the corporation or sell its assets. He points out that the legal effect of the board's merger or asset sale agreements is uncertain because of the common law rule that such agreements are not binding until approved by the shareholders. This uncertainty can lead to serious problems if, before shareholder approval, the board either receives a more attractive offer or desires to abandon or renegotiate the prior agreement for other reasons. Because merger and asset sale legislation has not removed these agreements from "their climate of doubt," the author suggests that the effect of such agreements be clarified by statutory amendment.

BUSINESS CORPORATIONS in the United States, with isolated exceptions, are forbidden by statute to merge or to sell all of their assets without the consent of the holders of a specified percentage of their shares. The statutes which define the procedures for procuring this consent usually state an additional requirement of favorable action by the board of directors, often preceding the shareholder vote. Thus, in the normal course of events both directors and shareholders will act in order to complete the process by which the corporation gives its consent to such a fundamental change. The directors' role in this process is to negotiate a bargain or approve one that the officers have made. The role of the shareholders, in most cases, is to accept or reject the bargain.

Frequently, the directors will enter into or approve a written agreement before shareholder approval. Because merger and consolidation procedures are similar or identical in most states, the references to merger herein will, in most instances, be applicable to consolidations.

See, e.g., DEL. CODE ANN. tit. 8, § 251 (1953).

Since officers have little or no explicit statutory authority independent of that of the board of directors in regard to mergers and sales, the focus herein is mainly upon the effect of legal steps taken by the board of directors and shareholders. Needless to say, director action is frequently in the form of approval of action already taken by officers, and it should not be assumed that action taken by officers in this area is of no legal consequence.
agreement to complete the merger or sale — in form, a contract subject to shareholder approval. Although it is clear enough that the corporation is not thereby committed to complete the transaction until the shareholders act, it often cannot be said with assurance that the agreement, made by the board of directors after deliberation, is until that time a legal nullity. Rather, the question will arise whether the agreement, with such collateral covenants as it may properly have, limits the freedom of the directors to change, cancel, or, as many statutes phrase it, to “abandon” their bargain unilaterally. The answer is to be found in a mixture of statutory corporation law and common law contract doctrines. The proper blend of the two, however, is not readily evident from the statutes themselves or from the oblique and infrequent treatment of the question by the courts.

I. THE NATURE OF MERGER AND ASSET SALE AGREEMENTS

In the case of mergers, the statutes of all but six of the states which have not enacted the Model Business Corporation Act specifically require the execution of an “agreement” of merger approved by the directors before the shareholder vote. The twenty-three states which have enacted the applicable sections of the Model Business Corporation Act provisions provide for a “plan” but do

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4 See text following note 9 infra for a discussion of covenants to maintain the status quo pending a shareholder vote and to submit an agreement to shareholders for their approval.

5 See, e.g., CAL. CORP. CODE § 4112.

6 MODEL BUSINESS CORPORATION ACT, as found in MODEL BUSINESS CORPORATION ACT ANNOTATED (1960) [hereinafter cited as MODEL ACT]. Citations to the Model Act will be taken from volume three of the annotated version.

7 Connecticut, Maryland, Oklahoma, and Vermont do not provide for an agreement. CONN. GEN. STAT. ANN. § 33-364 (1960); MD. ANN. CODE art. 23, § 66 (1957); OKLA. STAT. ANN. tit. 18, § 1.165-166 (1953); VT. STAT. ANN. tit. 11, § 1.161-162 (1958). California and Hawaii do, but do not require board approval to precede shareholder approval. CAL. CORP. CODE § 4108; HAWAII REV. LAWS § 173-4 (1955).

not indicate that an agreement may not be signed, and in these states one often is. Statutory authority for an agreement in the case of sales of assets is not common, and agreements of this sort which have not been approved by shareholders have not met with much success in the courts.\(^9\) Although the principal promise in the agreement — the promise to sell or merge — will perforce be subject to shareholder approval, there may be other promises not so limited which provide that the parties will preserve the status quo pending the shareholder approval, and that management will use its best efforts to secure adoption of the agreement by shareholders. The agreement may also provide for the right of each of the parties unilaterally to abandon the transaction upon specified conditions before or after the shareholder vote, thereby impliedly precluding abandonment except where such conditions prevail. Thus, although the merger or sale is intended to be subject to the approval of shareholders and although the corporation has not bound itself to complete the merger, the agreement may well purport to bind the corporation as to its stance pending the vote.

II. THE CONTEXT OF THE QUESTION

Although the period of time between execution of the agreement and its approval by shareholders is not necessarily a long one, there are numerous circumstances that could cause the directors to consider whether they wish to change the terms of the bargain or withdraw from it altogether before the shareholders act. Antitrust problems, lack of support from holders of large blocks of shares (who may hold power to block the transaction by demanding their appraisal rights), unfavorable action by regulatory authorities, legal action by a discontented minority, or changes in business conditions may cause the directors to inquire about the effect of the agreement. Many agreements will provide for termination or abandonment in certain of these situations. However, it would be unusual to find a purportedly binding agreement which gives one of the parties unilateral power to withdraw on the ground that the agreement has become unfavorable as a business matter. Yet the directors may be confronted with a perplexing dilemma in this regard if they receive a better offer of merger or sale before their agreement is approved by the shareholders.

In such a situation the directors' loyalties to the shareholders

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\(^9\) See, e.g., Masonic Temple, Inc. v. Ebert, 199 S.C. 5, 18 S.E.2d 584 (1942). See also text accompanying notes 77-79 infra.
and their duties, legal or moral, to the other party to the transaction will be placed in potential conflict. Merger or asset sale negotiations are often protracted and in the case of a large company may require extensive evaluation of properties and financial analyses, as well as very substantial expenditures of money. Different proposals on different terms may have been evaluated, and the directors may have made hard decisions as to which offer is best and which is least likely to be derailed by unfavorable shareholder action, antitrust difficulties, and so on. Accordingly, after the agreement is signed, both parties may wish to have the matter proceed to a vote on the scheduled date. Yet what are the directors of the selling corporation to do upon receipt, before the shareholder vote, of an offer that is or might be higher than the one which they have just accepted? Whatever their view of the ethics of the matter, they may well feel obliged to inquire whether they are bound by the agreement, or whether they must seize the opportunity to procure a better bargain for their shareholders.

The problem of the board in this respect may be complicated by doubt as to whether the offer is intended merely as a diversion to break up the pending deal. Since there is frequently no practical way to assure that the new offer will be held open, the directors are obliged to consider whether it will evaporate after they have scuttled the pending transaction. The board may also face difficult problems in evaluating the competing offers where simple cash transactions are not involved. Every merger offer requires the offeree to evaluate the future of its proposed merger partner, and the same is true of asset purchases where stock forms the consideration. The two offers may also be difficult to compare because they involve securities which have no ascertainable market values, or because of a host of other business reasons involving certainty and value.

Difficult problems regarding the stance toward their shareholders and the other party will confront the directors upon receipt of a higher offer. They may be required by the proxy rules of the Securities and Exchange Commission to inform their shareholders of the new offer, even though the agreement requires them to use their best efforts to procure the approval of the first offer. They may make a recommendation regarding the second offer to their shareholders, but it is unclear to what degree they may denigrate the offer that they have accepted in favor of the higher offer.

If they do throw cold water on the offer that they have accepted and cause its rejection, they will run the risk that the other offer may be reduced or withdrawn before it can be approved.

That the dilemma caused by receipt of a higher offer after execution of an agreement is a real one, and that it involves a risk of liability, will be evident from a brief review of the litigation involving competing offers in asset sale situations. In Smith v. Good Music Station, Inc., the directors were confronted with a two-offer situation, although the second offer followed shareholder approval. Without deciding whether the agreement, claimed by the plaintiff to be of no effect, was binding, the court upheld the action of the directors in submitting the first offer to shareholders. The directors were justified in taking no action on the second offer because, among other reasons, it was contingent upon reaching an agreement on various matters and ambiguous as to amount. "[A] different situation would be presented," the court said, "if, other things being substantially equal, the board of directors accepted the lower of the two bona fide cash offers."

Although the case is of no aid in determining the effect of the agreement before shareholder approval, the court's assiduous avoidance of that question at least suggests the need for care in this area. The chancellor made it fairly plain, however, that where the corporation is not technically bound it is obliged to give serious attention to higher cash offers which are unconditional. No guidelines were suggested for the situation where the two offers present some difficulty of comparison.

Shortly thereafter, in Abelow v. Midstates Oil Corp., the Supreme Court of Delaware endorsed the chancellor's ruling in the Good Music Station case and indicated that in some situations the doctrine that matters of business judgment will not be judicially

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11 No significant case involving competing offers and a merger agreement appears to have been reported.
12 36 Del. Ch. 262, 129 A.2d 242 (Ch. 1957).
13 Id. at 267, 129 A.2d at 245.
14 Id. at 268, 129 A.2d at 245.
15 Id. at 273, 129 A.2d at 248. The court referred to Robinson v. Pittsburgh Oil Ref. Corp., 14 Del. Ch. 193, 126 Atl. 46 (Ch. 1924), where the court, in considering a complaint that an unfavorable offer had been accepted in preference to a better one said: "Where the standard of comparison is the absolute one of dollars in hand for the same identical thing, a discretion which would choose the smaller amount will be so manifestly abused as to convict itself of fraud." Id. at 200, 126 Atl. at 49.
16 Ibid.
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reviewed would shelter the board where the comparison of offers not purely for cash is questionable.\(^{18}\) The court declared:

As for the Pan American offer, it is to be noted that it was not firm, that it proposed only a relatively small cash payment, and that it would have created problems for Midstates in respect of its debt. It cannot be regarded as comparable with the Tennessee offer . . . In the light of these facts, we cannot say that the directors’ decision to prefer the Tennessee offer was a breach of trust as respects Midstates stockholders. It appears to us to be nothing more than an exercise of judgment.\(^{19}\)

However, in *Wilmington Trust Co. v. Coulter*,\(^{20}\) the Delaware Supreme Court suggested that the business judgment doctrine cannot be relied upon to foreclose liability simply because the two offers present some difficulties of comparison.\(^{21}\) In that case the Wilmington Trust Company and one Gladson were co-trustees of a trust which owned eighty-two percent of the stock of the Toledo, Peoria & Western Railway Company (the T.P. & W.). The trust company and the officers of the Pennsylvania Railroad Company and the Atcheson, Topeka & Santa Fe Railroad Company signed an agreement whereby the two railroads would purchase a controlling block of the stock at one hundred dollars per share. The agreement was expressly made subject to the approval of the boards of directors of the purchasing railroads and of the co-trustee. Before this approval was granted, the trust company received from the Minneapolis & St. Louis Railway Company (the M. & St. L.) an offer of $133 per share, which was, like that of the Santa Fe and the Pennsylvania, subject to approval of the Interstate Commerce Commission, but was also subject to the approval of the shareholders of the M. & St. L. In comparing the two offers, then, the trustees had to consider the likelihood of the necessary approvals being obtained and also (or so it was argued) the economic pressure that the Pennsylvania and Santa Fe could bring to bear on the T.P. & W. In the court’s view, however, no difficulty was posed by the “agreement” because the Pennsylvania and Santa Fe boards had not approved it and because Gladson’s written consent had not been received.\(^{22}\) Therefore, the trust com-

\(^{18}\) Id. at 150-51, 189 A.2d at 678.
\(^{19}\) Id. at 150, 189 A.2d at 678.
\(^{20}\) 41 Del. Ch. 548, 200 A.2d 441 (Sup. Ct. 1964). See also the interesting and thorough opinion of the chancellor in *Pennsylvania Co. v. Wilmington Trust Co.*, 40 Del. Ch. 567, 186 A.2d 751 (Ch. 1962).
\(^{21}\) 41 Del. Ch. at 557-58, 200 A.2d at 446.
\(^{22}\) Id. at 564, 200 A.2d at 450.
pany could "presumably" have "withdrawn from the . . . agreement with impunity" and have accepted the M. & St. L. offer. 23

The trust company did not withdraw, however, until after the requisite board approval was obtained and the co-trustee had consented in writing to the sale. It then arranged to sell all of the stock to the Santa Fe for $135 per share and settled the Pennsylvania's suit on the rejected agreement for $500,000, for which it was surcharged in the cited case.

The court's comment regarding the duties of trustees, which differ not greatly from those of corporate directors, 24 confirms that care is required in evaluating conflicting considerations of certainty and worth:

While ordinarily speaking, when selling trust assets a Trustee is required to obtain the best price obtainable, he necessarily, however, must do so in the light of the overriding consideration of safety of the trust assets. Thus, it is, we conceive, that under some circumstances a Trustee is not negligent in accepting the lower of two offers when the higher offer is of such character as to justify the belief that its consummation is doubtful, and that the refusal of the lower offer would damage the trust. When all is equal, however, it is plain that the Trustee is bound to obtain the best price obtainable. 25

The trust company argued that all was not equal and that it could not be sure of the higher offer because of the doubtfulness of Interstate Commerce Commission and M. & St. L. shareholder approval and because the Pennsylvania and the Santa Fe were in a position to "affect the prosperity" of the T.P. & W. should their offer be rejected. 26 Nonetheless, the court held the trust company negligent in not withdrawing from its tentative agreement while it had the chance. 27

"At the very least," the court said, tacitly suggesting that the trust company was not really confronted with a black-and-white choice between a safe low offer and a risky high one, "the appre-

23 Id. at 558, 200 A.2d at 446.
24 In Delaware trustees are required to act "as other reasonable businessmen would have acted under the same circumstances." Pennsylvania Co. v. Wilmington Trust Co., 40 Del. Ch. 567, 575, 186 A.2d 751, 756 (Ch. 1962). The precise degree of care required of directors — who are, like trustees, fiduciaries — varies from state to state, but it is often formulated, as with trustees, with reference to the ordinarily prudent man or director managing his own or company affairs. See Feuer, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 13-23 (1961).
25 Id. at 564, 200 A.2d at 450.
26 Id. at 566, 200 A.2d at 451.
ciably higher offer should have caused the Trust Company to go back to the Pennsylvania and Santa Fe, as it finally did, and try to negotiate a higher price from them." The court also discussed and rejected, without meeting the point, the argument that the agreement was binding before board approval as an exchange of promises — the trust promising to keep the offer open until board action and the railroads promising to submit the matter to their boards. Moreover, it ruled out the suggestion that the trust company could or did grant a binding option by entering into the agreement.

*Scott v. Stanton Heights Corp.* reflects a somewhat different approach to the question of fiduciaries' responsibilities and business dealings. The corporation entered into an agreement, expressly subject to shareholder approval, to sell all of its assets. Just as the shareholders were to vote on the agreement, a higher offer, which had been received earlier in oral form, was submitted. The shareholders who were present at the meeting were apprised of the higher offer, but on advice of counsel the lower offer was submitted and approved, in part by votes under authority of proxies from shareholders who did not know of the higher offer. Although the court had other grounds on which to refuse the requested injunction of the sale and although it regarded, for reasons known only to itself, the unapproved agreement as binding, its general view seems to allow directors the discretion to place more weight on extralegal factors than was allowed the trust company in the *Wilmington* case.

The court stated:

> The violation of the "reasonable business man" standard of which appellant complains seems to be based on the fact that the board of directors refused to breach an apparently legitimate written agreement, properly executed, because of a "better offer" received almost three weeks after execution of that agreement. This is a remarkable conception of the prudence exercisable by a reasonable business man.

> While it would seem unnecessary to go further in reaching our decision, we note that although generally the price in dollars is a prime indicator of the relative worth of an offer, there can be no question but that in a given case other considerations — certainty and promptness of payment; financial responsibility; established legitimate business relationships; the performance of valid legal

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28 *Id.* at 564, 200 A.2d at 450.
29 *Id.* at 565, 200 A.2d at 450-51.
30 *Id.* at 570, 200 A.2d at 453.
32 See *id.* at 655, 131 A.2d at 116.
obligations; tax consequences; as well as business ethics, especially as they apply to accepted business practices such as sealed bids or conduct at open auctions — may weigh much more significantly in the appraisal of the offer which the ordinarily prudent business man would accept than money price alone.38

III. MERGER AND ASSET SALE LEGISLATION

The foregoing discussion should be sufficient to demonstrate that corporate directors are generally well advised to consider seriously a higher offer if they are not technically bound by an agreement to accept a lower one. Their difficulty will arise in determining if and when they are bound. It is a mistake to regard the efficacy of their agreement as a simple matter of contract law, for merger and asset sale legislation as well as other principles of corporate law may or at least should have an effect upon the result. As a starting point, then, the bearing of the legislation establishing procedures for merger and sale upon the question of when such agreements become effective should be considered.

A. Legislative Purposes

The general purport of this legislation is to make merger or sale possible upon a vote of the holders of less than all of the stock and, as an ancillary matter, to regulate the procedure by which such transactions are initiated and submitted to a vote. The statutes were enacted for the most part in order to change, not codify, the law applicable to mergers and sales of assets. At the time of their enactment, such matters were governed by the fundamental principle that a corporate charter is a contract to which all of the shareholders and the state are parties. This contract, like any other, was not subject to abrogation without the unanimous consent of the parties, unless by virtue of reserved powers of the legislature. The result of this principle in regard to the matter at hand was clearly stated in Feld v. Roanoke Inv. Co.:34

The officers of a corporation cannot, against the wishes of its

38 Ibid. The chancellor in Pennsylvania Co. v. Wilmington Trust Co., 40 Del. Ch. 567, 186 A.2d 751 (Ch. 1962) made the following comment about business ethics: "A moral commitment, as opposed to a legal one, is generally not a legally sufficient reason for a trustee to neglect his overriding duty to sell at the maximum price." Id. at 607, 186 A.2d at 774.

34 123 Mo. 603, 27 S.W. 635 (1894). See also Butler v. New Keystone Copper Co., 10 Del. Ch. 371, 93 Atl. 380 (Ch. 1915); Voigt v. Remick, 260 Mich. 198, 244 N.W. 446 (1932); Mayor of the City of Knoxville v. Knoxville & O.O.R.R., 22 Fed. 758, 763 (E.D. Tenn. 1884), appeal dismissed, 136 U.S. 642 (1889).
stockholders or any one of them, sell and transfer the entire property from which it derives its emoluments or which forms the basis of its business operations. To do so would be to commit a breach, if not of the express terms of the contract, of its implied terms by which the general objects defined in its charter would be diverted and in effect destroyed. With respect of the management of the business affairs of a corporation, such matters are confided to a board of directors or managers, who are endowed with full power to do whatever they may think for the best interest of those whom they represent within the scope and meaning of the charter under which they act; but, when it comes to a final disposition of the corporate property for the purpose of forming another and different corporation for an entirely different and distinct enterprise, it can only be done by the unanimous consent of all of its stockholders. . . . Nor can the stock of such new corporation be forced upon the dissenting stockholders in payment of their stock in the original company, who are entitled to payment in money.35

Thus, although sales of all of the assets apparently did not require the state's consent, they did constitute acts inconsistent with the corporate charter and required consent of the shareholders, who were the parties to the contract. Since the directors were not parties, their consent was not required.

Absent charter authority, mergers and consolidations were likewise regarded as outside the scope of the shareholders' contract, but statutory approval was also generally necessary. In Clearwater v. Meredith,36 the Supreme Court of the United States commented on the power to merge and consolidate:

The power of the legislature to confer such authority cannot be questioned, and without the authority, railroad corporations organized separately could not merge and consolidate their interests. But in conferring the authority, the legislature never intended to compel a dissenting stockholder to transfer his interest, because a majority of the stockholders consented to the consolidation. Even if the legislature had manifested an obvious purpose to do so, the act would have been illegal, for it would have impaired the obligation of a contract. There was no reservation of power in the act under which the [railway in question] was organized, which gave authority to make material changes in the purposes for which the corporation was created, and without such a reservation, in no event could a dissenting stockholder be bound.37

In short, although the directors might have negotiated the sale or merger, its approval rested completely in the hands of the shareholders as the parties to the charter. Until directors were given

35 123 Mo. at 613-14, 27 S.W. at 637.
36 68 U.S. (1 Wall.) 25 (1863).
37 Id. at 39. See also Rath v. Rath Packing Co., 136 N.W.2d 410, 415 (Iowa 1965).
by statute a formal role to play in the preparation of the transaction, it was difficult to see how they could be said to have had the power to give the requisite corporate consent. Their function was to manage the corporation's business within the confines of its charter, and mergers and asset sales were typically outside of those confines. Their agreements would thus seem to have been entitled to little weight. At the same time, it was plain that, particularly with companies having numerous shareholders, the function of the directors in managing the affairs of the business quite naturally encompassed the arrangement of most of the things necessary to effect a sale or merger.

Against this background the legislation in question appears clearly focused upon the problem of facilitating mergers and sales by removing the need for unanimity of shareholders. But its secondary purpose of establishing the role of the board of directors in effecting such fundamental changes was significant. What was this role? Where director action was specifically required, was it a *sine qua non* for the transaction or a mere formality? What was the effect of the directors' statutory “agreement” to merge? Were the directors to act simply as scouts for the shareholders, presenting them with the best sale or merger possibility that they could find and inviting their decision, or was their exercise of judgment and approval of the transaction a necessity on the theory that in most cases they would be best able to evaluate the bargain? Whatever the answers to these questions, the legislation to be discussed appeared to bring the directors into a position of legal prominence which they did not occupy when the matter was governed solely by principles applicable to charters.

**B. The Model Business Corporation Act**

For present purposes, attention should be focused on current statutes, most of which directly descended from those which changed the common law. The most widespread pattern in regard to mergers is that of the Model Business Corporation Act, largely identical versions of which prevail in twenty-two states and the District of Columbia.\(^8\) Section 65 of the act provides that "any two or more domestic corporations may merge into one of such corporations pursuant to a *plan* of merger approved in the manner provided in this

\(^8\) See statutes cited note 8 *supra.*
Without mentioning an agreement, the section goes on to provide that "the boards of directors of each corporation shall, by resolution adopted by each such board, approve a plan of merger," which is to contain much the same thing that agreements of merger contain pursuant to statutes in other states. 40

Included in the plan are the "terms and conditions" of the merger and, affording considerable latitude, "such other provisions with respect to the proposed merger as are deemed necessary or desirable." 41

Section 67 of the act provides that "the board of directors . . . upon approving [the plan], shall, by resolution, direct that the plan be submitted to a vote at a meeting of shareholders . . . ." 42 The same section provides: "After . . . approval by a vote of the shareholders of each corporation, and at any time prior to the filing of the articles of merger . . . , the merger . . . may be abandoned pursuant to provisions therefor, if any, set forth in the plan of merger . . . ." 43 It will be noted that no reference is made in the statute to abandonment at a time prior to the approval of the shareholders of both of the merging corporations. If the plan is approved and not abandoned, the officers of the corporation execute and file "articles of merger" pursuant to section 68 of the act; and section 69 provides that upon the issuance of the certificate of merger by the appropriate state office, "the merger . . . shall be effected." 44

Plainly, the Model Act gives no strong sanction to a director agreement, since it makes no mention of one. It is provided that the "plan" shall be submitted to a shareholder vote, once adopted, 45 but this without more is hardly a clear indication that the directors are foreclosed from reopening negotiations. Some weight might be attached to the fact that abandonment is provided for only after the shareholder vote. 46 This could mean that the power to abandon is assumed to be there as a matter of course before the vote or, to the contrary, that no abandonment is permitted before the vote, in which case the plan might be regarded as binding.

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39 *Model Act* § 65. (Emphasis added.)
40 Ibid.
41 *Model Act* § 65 (e).
42 *Model Act* § 67. (Emphasis added.)
43 Ibid.
44 *Model Act* § 69.
45 *Model Act* § 67.
46 Ibid.
It might be argued that the only reason for abandonment of power after the vote is because the plan is otherwise binding and that it becomes so upon adoption by both parties. This does not, however, seem to be the intent of the act. It is more likely that the provision was intended to save directors from the obligation to seek further consent of the shareholders for abandonment after their approval has been granted. If this is so, there is no need for an abandonment provision prior to the shareholder vote. The matter of abandonment is between the shareholders and directors and does not enlarge or diminish the parties' rights under their agreement.

However, the Model Act provisions are far from inconsistent with a rule that would uphold director agreements, particularly those requiring the directors to maintain the status quo after adoption of a plan and to use their best efforts to secure its adoption. Directors are given broad authority by the act. They are charged with finding the merger partner and negotiating the terms of the merger. They may reject substantial offers of merger without shareholder approval. A highly respectable interpretation of the statute is that without their approval, no merger can be consummated. They thus occupy a position of high responsibility and are far more than mere brokers who submit propositions to shareholders. Having been given such responsibility, which they did not have at common law, can it truly be said that they may not, by specific terms, commit the corporation for a reasonable time to maintain the status quo and proceed with its own internal processes for securing the approval of a merger by a shareholder vote?

Although this question deserves a negative answer, it cannot be given with assurance. As will appear in the subsequent discussion of asset sale agreements, whatever statutory implications there may be are in danger of being outweighed by the contract law doctrine that would require shareholder action as a part of the corporate consent to the formation of a contract. The possibility of a valid subcontract to hold the offer open and submit it to the

47 Model Act § 65.
48 The contrary has been suggested as a possibility. See 64 Colum. L. Rev. 1427, 1437 n.28 (1964).
49 See text accompanying notes 63-83 infra.
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shareholders remains, of course, a possibility, although untested in the courts.61

C. Other Types of Legislation

The implication that the directors' agreement is legally binding, whether or not specific language in the agreement so provides, is stronger in states which have not enacted the Model Act. All but four of these states actually require an "agreement" of merger.62 In Delaware and several other states, the agreement is to contain the "terms and conditions of the merger," the "mode of carrying the same into effect," and "such other details and provisions as are deemed necessary," thus affording an opening for covenants to submit the agreement to shareholders.63 The resemblance of the statutory agreement to a binding contract is emphasized by the fact that generally it is "entered into" by the directors, signed, and sealed before the shareholder vote. Florida and Montana also allow a majority of the shareholders to enter into the agreement.64 Some states require an agreement but do not provide for it to be signed before shareholder approval.65 The states which follow the Delaware pattern provide that the signed agreement shall be submitted to shareholders, as in the Model Act,66 creating some implication that the directors' action gives rise to a corporate obligation to hold itself in readiness to merge should the shareholders consent.

Abandonment provisions are not common, being absent from the Delaware-pattern states and others. California allows abandonment by the directors "in their discretion . . . at any time before the merger . . . has been completed" but "subject to the rights of

61 But see Finklea v. Carolina Farms Co., supra note 50.
66 See text accompanying notes 42, 45 supra.
third parties under any contracts relating thereto." Whether "third parties" includes the merger partner and whether "contracts" includes the merger agreement does not seem clear. Although this provision, like that of the Model Act, seems aimed at the directors' duties to shareholders who have approved the merger, if the provision as to the rights of third parties does not protect the merger partner, it would appear that a merger agreement is never binding in California.

Connecticut has a similar provision which is expressed simply in terms of "rights of other parties" without specifying the source of those rights. This seems broad enough to protect the other party to the merger, except that doubt is created by the fact that Connecticut provides for a "plan" rather than an agreement. The Connecticut provision is also interesting in that it confirms, by its stipulation that abandonment "shall not require further action or approval of shareholders ... unless the plan ... otherwise provides," that it is specifically aimed at the problem of directors' duties to shareholders.

Maryland, which has "articles of merger" in lieu of a plan or agreement, provides that if the merger is abandoned, "no legal liability shall arise under the articles of ... merger or transfer [of all of the assets] but no such action shall, in any event, prejudice the rights of any person under any other contract made by a corporation party to the proposed articles in connection with the proposed ... merger or transfer." If this provision were not sui generis, it would yield some support for an argument that merger agreements in general are never binding. On the other hand, since the provision does not call for an agreement, the language could be explained by positing the existence of an agreement of merger separate from the articles and governed by ordinary contract principles, if such is not precluded by the statute.

The statutes of the states which do not have the Model Act provisions afford no definite answer as to the effect of the directors' merger agreement. They contain the implications already noted in regard to the Model Act. Further, the procedure which they establish — the orderly negotiation and execution of an agreement

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57 CAL. CORP. CODE § 4112.
59 Ibid. CONN. GEN. STAT. REV. § 33-368(b) (1958).
60 Ibid.
61 MD. ANN. CODE art. 23, § 66 (1958). (Emphasis added.)
by the boards of directors followed by a required submission of
the agreement to shareholders — may well be taken to contemplate
an agreement that cannot be broken before the shareholders act.
The statutes should be held to intend a procedure that is in accordance
with conventional business practice and that is responsive to
the needs of the parties. The difficulties that may be caused by
unreliable merger agreements have already been noted, and
generally the parties will wish to be able to rely upon their effectiveness. It may be that such agreements should not be held binding
unless they specifically contain promises to maintain the status quo
and to procure a shareholder vote, but no strong policy forbids
the interpretation of the term "agreement" in the statutes to mean
a binding agreement subject to shareholder approval.

D. Statutory Regulation of Asset Sales

Asset sale statutes are less obviously relevant to the question
whether agreements to sell are binding before shareholder approval
because, except in rare instances, they do not specifically require
an agreement. Section 72 of the Model Act provides that sales
or other dispositions of all or substantially all the assets of a cor-
poration, not in the regular course of business, may be authorized
as follows: "The board of directors shall adopt a resolution recom-
mending such sale . . . and directing the submission thereof to a
vote at a meeting of shareholders . . . ."63 The notice to share-
holders "shall state that the purpose . . . of such meeting is to
consider the proposed sale."64 The shareholder "may fix, or may
authorize the board of directors to fix, any or all of the terms and
conditions thereof and the consideration to be received by the corpo-
ration therefor."65 It is also provided that after the shareholder
authorization, "the board of directors nevertheless, in its discretion,
may abandon such sale . . . subject to the rights of third parties under
any contracts relating thereto, without further action or approval
by shareholders."66

The Model Act provision is drafted in such a way that the
directors may either recommend a specific transaction with a partic-
ular buyer or secure general authority for the sale and then con-

63 See text accompanying notes 9-11 supra.
64 MODEL ACT § 72(b).
65 MODEL ACT § 72(c).
66 MODEL ACT § 72(d).
summate an agreement without further shareholder action. No explicit mention is made of an agreement or a plan, but the reference in the abandonment provision to contracts suggests that one may be contemplated. However, these provisions indicate only that an agreement or contract would be binding after shareholder approval. Favorable director action is stated as a requirement of sale, and shareholders may grant the directors broad discretion in advance regarding whether to sell and upon what terms. As noted in regard to merger agreements, if this great discretion is granted to the board, it would be incongruous to forbid the board's committing the corporation to hold itself ready to sell pending the approval of an agreement.

As to the states which have not enacted the Model Act provisions, some, including Delaware, provide simply that the directors may "sell, lease or exchange all of . . . [the corporation's] property . . . when and as authorized by the affirmative vote" of the requisite percentage of the corporation's stock. Other statutes provide simply that the assets may be sold upon authorization of the shareholders, and contain no reference to any director action. The latter, therefore, seem to adhere to the traditional position that the matter is one for the shareholders and, to the extent that an implication is to be found in the statutes, suggest that agreements will be given little weight before shareholder approval.

In New York, there has been a tendency, springing perhaps in part from the fact that mergers and sales traditionally were purely within the shareholders' realm, for director agreements to be regarded as contrary to statutory law and as an impediment to the free exercise of shareholder judgment. In Wegman v. Levinson Shoe Mfg. Co., the court was concerned with section 20 of the

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67 MODEL ACT § 72.
68 MODEL ACT § 72(d).
69 MODEL ACT § 72.
70 Ibid.
71 See text following note 48 supra.
72 DEL. CODE ANN. tit. 8, § 271 (1953); GA. CODE ANN. § 22-1870 (1965); KAN. STAT. ANN. tit. 17, § 3801 (1963); MICH. COMP. LAWS § 450.57 (1948); MINN. STAT. § 301.36 (1961); N.J. REV. STAT. § 14:3-5 (1937); TENN. CODE ANN. § 48-509 (1964); W. VA. CODE ANN. § 3076 (1961).
73 See, e.g., IDAHO CODE ANN. § 30-145 (1965); KY. REV. STAT. § 271.415 (1963).
New York Stock Corporation Law\textsuperscript{76} which did not require or forbid director action but provided that shareholder approval should be obtained before a "sale." The court considered a contract to sell to be a "sale" and stated:

There is no authority for making an agreement by the officers in advance of the consent of the stockholders. A proposal, which if legally accepted becomes binding, is the contemplated procedure. The stockholders are entitled to have the proposed sale submitted to them without prior commitments or complications which may forestall independent action. If there is to be a sale of the company, it must be made in accordance with the statute, so that no undue or unlawful advantage may be taken of minority stockholders.\textsuperscript{76}

The Appellate Division overruled the \textit{Wegman} case in \textit{Neponsit Holding Corp. v. Ansorge}.\textsuperscript{77} There, an action was brought for specific performance of a contract, section 20 again being applicable. The contract provided that it was "subject to the consent and approval of shareholders," but also that "the seller hereby agrees to cause a special meeting of the stockholders of the seller to be called" by a certain date to consider the sale.\textsuperscript{78}

It was argued that section 20 required shareholder consent to precede the contract of sale and that since the consent had followed the execution of the contract (though it preceded the consummation of the sale), the entire transaction was invalid. The court, holding that no sale had occurred within the meaning of the law until after the shareholder vote, approved the following statement of the trial court:

To give section 20 . . . the construction urged by the defendant, would mean stockholders could not ratify the act of the corporate officer, and therefore that a good bargain could not be made by an officer of a corporation tentatively. Such officer, if the construction sought is correct, would be obliged to run the risk of losing the bargain by first going to the necessary stockholders for consent.\textsuperscript{79}

The Appellate Division appeared to switch back to the view of

\textsuperscript{76} N.Y. Corp. Laws § 20.
\textsuperscript{77} 195 N.Y. Supp. at 536.
\textsuperscript{79} Id. at 372, 214 N.Y. Supp. at 92.
the *Wegman* case in *Gottfried v. Gottfried Baking Co.*, where it interpreted section 20, without citation of authority, as forbidding the execution of contracts to sell the assets before shareholder approval. The court stated:

> Presenting stockholders with the opportunity of ratification of a fait accompli is not the same as giving them the opportunity of advance consideration and determination. We have no hesitancy in saying, therefore, that officers and directors undertaking to act without proper approval are answerable for any damages resulting to the corporation from unauthorized action.

Of course, the reference to a “fait accompli” is misleading, since the agreements could be rejected by shareholders.

The weight of these cases is diminished by the fact that the New York statute did not at that time provide for director action. Nevertheless, there remains the possibility that, in accordance with the common law view, shareholders will be regarded as the sole depositaries of corporate power to merge or sell all of the assets and that the director action will be regarded as merely advisory. It has been suggested that the shareholder proposal rule of the Securities and Exchange Commission might be available to test the question whether director action is a mere formality. The

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80 1 App. Div. 2d 994, 151 N.Y.S.2d 583 (1956). *But see* Mattiello v. Flagg, 178 N.Y.S.2d 179 (Sup. Ct. 1958), where a shareholder tried to invalidate a resolution of shareholders giving directors authority to sell all of the corporation’s assets on such terms as they should determine. The court said: “It is the plaintiff’s contention that the stockholders cannot give advance consent in general terms to a disposition of the corporate assets on terms to be determined by the directors.” *Id.* at 180. It concluded: “Were this Court to adopt the view urged by the plaintiff it would be tantamount to requiring that each transaction be submitted to the stockholders for approval, in which case it would either deprive the corporation of an advantageous sale or impose upon it tremendous inconvenience and expense.” *Ibid.*

81 1 App. Div. 2d at 994, 151 N.Y.S.2d at 583.

82 *Id.* at 994, 151 N.Y.S.2d at 584.


84 64 COLUM. L. REV. 1427, 1437 n.28 (1964). *See also* Curtin v. Salmon River Hydraulic Gold Mining Ditch Co., 130 Cal. 345, 351, 62 Pac. 552, 554 (1900), where 1897 Cal. Stat. 96 provided: “It shall not be lawful for the directors of any mining corporation to sell, lease, mortgage, or otherwise dispose of the whole or any part of the mining ground owned or held by such corporation . . . unless such act be ratified by” two thirds of the shareholders. The court stated:

> This section does not confer upon the stockholders any power to mortgage the property of the corporation, or to authorize the directors to mortgage it, and it is a familiar rule that ratification cannot give effect to an unauthorized or invalid act, unless the person or body making the ratification could in the first instance have authorized the act. The corporate power and business of the corporation must be exercised by the board of directors . . . and the stockholders cannot, by their own act, mortgage its property . . . The stockholders are thus made a component part of the power to make a mortgage effective, but cannot by any act of their own, make a mortgage, or validate
proper answer, however, seems clear. Virtually every aspect of a merger or sale involves action and the exercise of judgment by the directors. The negotiation of such a transaction is naturally within their sphere. It would be unwise not to allow them the additional supplementary power to secure the results of their negotiation by entering into a binding agreement subject to shareholder approval.

IV. AGREEMENTS IN THE COURTS

The agreements which have been considered by the courts, which appear to be limited to asset sale agreements, have been tested mainly with reference to contract principles. This is understandable because of the fact that asset sale legislation generally makes no mention of an "agreement," although it is disappointing that a greater effort has not been made to probe the relevance of corporate law to the question. At least two cases, Neponsit Holding Corp. v. Ansorge and Finklea v. Carolina Farms Co., involved agreements to submit offers to the shareholders, but nothing was decided on the point in Neponsit, and in Finklea the agreement, although it appeared to lack consideration and was not signed by the board, was rejected on the ground that only stockholders could take such action.

The difficulty that the courts have faced where no such covenant is involved is that of corporate consent to the contract. Since shareholder approval is required, how can it be said that a contract has come into being until they act? No question of a contract subject to a condition of shareholder approval can arise until the corporation has properly given its consent to the contract, and this it is obliged to do by action of the shareholders. Thus, the court in Scott v. Stanton Heights Corp. stands almost alone in holding

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86 Wegman v. Levinson Shoe Mfg. Co., 195 N.Y. Supp. 535 (Sup. Ct. 1922) and the other New York cases discussed supra are an exception in their reliance on corporate law principles. See also Finklea v. Carolina Farms Co., 196 S.C. 466, 13 S.E.2d 596 (1941).


87 196 S.C. 466, 13 S.E.2d 596 (1941).

89 Id. at 471, 13 S.E.2d at 598.

88 Id. at 471, 13 S.E.2d at 598.

that asset sale agreements are binding before shareholder approval, and it gives no reason for this result.

The more common view is stated in Masonic Temple, Inc. v. Ebert, where the defendant, who had agreed to purchase all the plaintiff's assets, abandoned the transaction before plaintiff's shareholders had approved the contract. The court asserted:

To constitute a valid contract of sale in the circumstances here the consent of the stockholders was necessary. Until that consent was given, the signing of the contract by Ebert was only in the nature of an offer [by Ebert], which could be made effective by the acceptance of stockholders.

Thus, Ebert was able to withdraw his offer before it was accepted.

In the earlier case of Finklea v. Carolina Farms Co., relied upon in Ebert, one Walker wrote to Brown, the president of the defendant corporation, asking for an option to buy all of the corporation's assets and enclosing a check for one thousand dollars. The company's lawyer replied that no option could be granted until the shareholders had approved the option and that the corporation would "proceed with all facility to obtain" the approval. After the meeting had been called but before the shareholders had voted, a higher offer was received and, upon being informed of this fact, the shareholders voted against Walker's option proposal. The trial court's opinion, adopted by the supreme court, stated:

Stripped to its essence it would appear that the plaintiff's contention is based upon the theory that Mr. Brown, as president of the company, and Mr. Dargan as attorney for the company, were under some obligation to procure the approval of the stockholders, and that hence they should not have submitted the later and higher offer. But even if these representatives of the Company as individuals had been under such an obligation, which I do not think is true, obviously they could not thereby make a contract for the company, for under the law only stockholders could do that in a case of this kind.

The court went on to say that it was clearly the duty of Brown

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90 199 S.C. 5, 18 S.E.2d 584 (1942).
91 Id. at 12, 18 S.E.2d 587. See also Wilmington Trust Co. v. Coulter, 41 Del. Ch. 548, 200 A.2d 441 (Sup. Ct. 1964); Smith v. Good Music Station, Inc., 36 Del. Ch. 262, 129 A.2d 242 (Ch. 1957), where the court said that the agreement could not have "any ultimate binding legal effect [on the corporation] . . . until it received the requisite statutory approval." Id. at 267, 129 A.2d at 245.
92 Ibid.
93 196 S.C. 466, 13 S.E.2d 596 (1941). The statute in question did not contain any provision for director action.
94 Id. at 468-69, 13 S.E.2d at 597-98.
95 Id. at 471, 13 S.E.2d at 598. (Emphasis added.)
and Dargan to submit the higher offer: “Granting that ordinarily the trust relationship of officers is to the corporation rather than to the stockholders yet where, as in this case, the corporation must act through its stockholders there is no distinction.”

V. CONCLUSION — A NEED FOR STATUTORY AMENDMENT

In summary, neither merger nor asset sale agreements will ordinarily be held binding under conventional contract principles because shareholder approval is a necessary component of corporate consent to the contract. Further, since shareholders might arbitrarily reject the contract (if it were such), it is questionable whether there would be any consideration for the promise of the corporation made by the directors. The effort to render such agreements binding until the shareholder vote by making a covenant to that effect could and should succeed. However, the attitude of the courts in the Wegman, Gottfried, and Finklea cases makes reliance on such a covenant dangerous. Even where statutes specifically call for an agreement of merger, one cannot be certain that a court will not rule the agreement a mere proposal for consideration of shareholders. The common law role of directors as mere advisors in such situations is deeply rooted in tradition.

This uncertainty is not desirable. The problem of competitive offers and other business exigencies make it imperative that the directors of a corporation know when they have foreclosed themselves from considering other offers or from renegotiating the bargain. Consequently, there is a need for statutory amendments to remove such agreements from their climate of doubt. As a starting point for discussion, it is worth considering an authorization to the directors to put in the agreement, if they wish, a binding provision that the offer of sale or merger will be held open for a limited period of time and will be submitted to shareholders within that period, with a corresponding covenant on the part of the other party. In other areas it has been found wise to facilitate business transactions by modifying the requirement of consideration for con-

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98 Ibid.
100 See, e.g., CAL. CORP. CODE § 4103, which speaks of the “proposed agreement.”
tracts, and here there is little risk of injury to shareholders from a similar change. The directors will have no great ability to prejudice the interests of the corporation, for the shareholders may still retain the power to reject an unfavorable bargain and may profit from the ability of the board legally to accept an offer that might otherwise be withdrawn before the vote.

101 Section 2-205 of the Uniform Commercial Code allows merchants to specify that their offers to buy or sell goods will be irrevocably held open for three months. See also RESTATEMENT, CONTRACTS § 90 (1932).