

ABA Negotiated Acquisitions Committee

Presentation Nuggets¹

**Tortious Interference with
Merger Agreements, Exclusivity Agreements and Letters of Intent
by a Third-Party Bidder**

October 21, 2006

1. Even where there is a fiduciary out, a merger or business combination agreement can be breached, giving rise to third-party liability for the tort of interference with the merger agreement.
2. Even where there is a break-up fee paid to the original bidder, where the merger or business combination agreement was breached, the third-party bidder, in a tortious interference claim, may be liable to the original bidder for damages (whether compensatory or punitive) suffered by it that are not sufficiently covered by the break-up fee. Although payment of the break-up fee by the target may mitigate, in part, a claim for compensatory damages, it may not be sufficient, and it is not likely to cover a claim for punitive damages.
3. When a non-binding letter of intent includes, or is accompanied by, a binding exclusivity agreement and an obligation to negotiate in good faith, it binds the parties to undertake good faith negotiations within the scope of the letter of intent. A higher third-party bid, however, may expand the permissible scope of good faith negotiations. This is useful not only because the target can ask for significantly higher price from the original bidder in consideration of the higher third-party bid, but also because it announces to potential third party bidders that they may gain an advantage by making a higher offer to the target and legitimately usurping the original bidder, or ultimately making the deal more expensive for the initial bidder—a possible competitor—by increasing the target's bargaining power.
4. Merely sending a better offer to the target company will not, in most cases, be sufficient to trigger the liability of the third-party bidder, so long as its intent is to do the deal, and not simply to scuttle the other parties' deal. Whether an outside bidder can be held to have induced the breach will ultimately depend on the reasonableness and fairness of its conduct, particularly in light of business standards and ethics in the community. A third-party bidder is liable if its conduct amounts to an intentional and improper interference with the letter of intent or exclusivity agreement.

¹ These presentation nuggets prepared by Arman J. Kuyumjian of McCarthy Tétrault LLP and John F. Cermak, Jr., of Jenkins & Gilchrist, LLP, are qualified in their entirety by, and are intended to be read in conjunction with, the memorandum dated August 3, 2006, presented by the authors to the Judicial Interpretations Working Group of the Negotiated Acquisitions Committee of the American Bar Association.

Memorandum

August 3, 2006

To: Judicial Interpretations Working Group of the Negotiated Acquisitions Committee
From: Arman J. Kuyumjian, McCarthy Tétrault LLP
John F. Cermak, Jr., Jenkens & Gilchrist, LLP
Re: Liability of a Third Party Bidder for Tortious Interference with Provisions in Merger Agreements, Exclusivity Agreements and Letters of Intent

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1. The Issue, Its Role in The Acquisition Process, and Practical Considerations

Exclusivity agreements, most acquisition/merger agreements and some letters of intent include “deal protection” provisions to protect the purchaser from unsolicited competitive bids for the target. These provisions come in a variety of forms, including no-shop clauses, no-talk provisions, best efforts covenants, break-up fee provisions and lock-out clauses. No-shop clauses, which limit the ability of a seller to solicit or respond to competing bids, are a common feature of acquisition agreements. Third-party bidders, however, sometimes enter the scene in an effort to compete for ownership of a target company in spite of that company’s existing

agreement with the original bidder and any exclusivity arrangements contained in such agreement. The target company's board of directors will, in most cases, have an obligation to consider the new bidder because of its fiduciary duties to the company's shareholders. An often negotiated "fiduciary out" exception to the deal protection provision enables the target's board to terminate the agreement if its duties require it to accept a higher bid.

While the breach of an exclusivity agreement may subject the target company to a potential suit for breach of contract, the victorious outside bidder which succeeds in acquiring the target company may also be at risk of being sued by the disgruntled first bidder for the tortious interference with contractual relations. The tort provides relief for intentionally and improperly taking away the contractual rights of another without justification, outside of the bounds of fair competition. According to the Restatement (Second) of Torts, "[o]ne who intentionally and improperly interferes with the performance of a contract (except a contract to marry) between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract." Restatement (Second) of Torts § 766 (1979).

The basic elements of a cause of action for tortious interference with contractual relations are: (1) the existence of a valid contract between the plaintiff and a third party; (2) awareness of the contract by the defendant; (3) the defendant's intentional and unjustified inducement of a breach of the contract; (4) a subsequent breach by the third party, caused by the defendant's wrongful conduct; and (5) damages suffered by the plaintiff as a direct result of the defendant's actions. The contract must actually be breached in order for there to be a finding of liability.

A defendant in an action for tortious interference will not be held liable if the defendant possesses a privilege or justification for its actions. Although there is no clear list of available privileges, recognized privileges include protection or assertion of a legal right or interest, advice given to the breaching party based on a confidential relationship, freedom of speech under the First Amendment and taking action in the public interest. 1-11 Business Torts § 11.04 (2005). In most jurisdictions, the defendant has the burden of showing privilege or justification.

Tortious interference is different from causing a party to exercise a termination right contained in an agreement or causing a condition not to be satisfied. Rather, the tortious interference with contract involves causing a party to breach its contract with the plaintiff. A competing offer does not, by itself, create liability for tortious interference. In analyzing a tortious interference claim, courts must undertake the difficult task of weighing the predictability of contractual rights against the interest in free competition. As noted by one court, the tort "impl[ies] a balancing of societal values: an individual has a general duty not to interfere in the business affairs of another, but he may be privileged to interfere, depending on his purpose and methods, when the interference takes a socially sanctioned form, such as lawful competition." *Belden Corp. v. InterNorth, Inc.*, 413 N.E.2d 98, 101 (Ill. App. Ct. 1980) (further discussed below).

In view of the potential liability for tortious interference, an outside bidder must proceed with caution in injecting itself into another's transaction. If the circumstances fit a cause of action for tortious interference and liability is found, the potential liability can be significant. See *Texaco, Inc. v. Pennzoil, Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987) (further discussed

below). The outside bidder cannot necessarily take comfort in the fact that the original bidder has received a termination fee from the target under their original merger agreement, as the remedies awarded for tortious interference with a merger agreement can be significantly greater than compensatory damages.

2. Common Formulations

Exclusivity provisions come in various forms, but are all aimed at providing the prospective buyer with protections against competition. Section 5.6 of the ABA Model Asset Purchase Agreement (the “Model APA”) contains the following “no negotiation” provision that prohibits solicitation and negotiation with other prospective buyers:

Until such time as this Agreement shall be terminated pursuant to Section 9.1, neither Seller nor either Shareholder shall directly or indirectly solicit, initiate, encourage or entertain any inquiries or proposals from, discuss or negotiate with, provide any nonpublic information to or consider the merits of any inquiries or proposals from any Person (other than Buyer) relating to any business combination transaction involving Seller, including the sale by Shareholders of Seller’s stock, the merger or consolidation of Seller or the sale of Seller’s business or any of the Assets (other than in the Ordinary Course of Business). Seller and Shareholders shall notify Buyer of any such inquiry or proposal within twenty-four (24) hours of receipt or awareness of the same by Seller or either Shareholder.

A “fiduciary out” clause acts as an exception to an exclusivity provision by allowing the target company’s management to do something not otherwise permitted by the provision if required to do so by its fiduciary duties to shareholders. The best efforts clause in *ConAgra, Inc. v. Cargill, Inc.*, 382 N.W.2d 576 (Neb. 1986), a case that is further described below, included the following fiduciary out:

[N]othing herein contained shall relieve either Board of Directors of their continuing duties to their respective shareholders. *Id.* at 582.

As discussed below, liability for tortious interference depends in part on the enforceability of the exclusivity provision in light of the board of director’s fiduciary duties.

3. Analysis of the Case Law

The following are summaries of the case-law and our analysis relating to the elements of tortious interference with contracts in the context of a third-party competitive bid. We cover the breach of deal protection provisions in merger agreements that are subject to fiduciary outs, and exclusivity agreements and letters of intent with binding exclusivity provisions. Of the elements of the tort, we address with particular emphasis the breach of binding exclusivity terms, knowledge by the third party of the agreement, inducement by the third party and damages.

(a) Analysis of the Claim for Tortious Interference With Contractual Relations in the Context of a Competitive Third-Party Bid

(i) *Breach of Contract*

A. Effect of Fiduciary Out of the Target Company

A deal protection provision will not relieve a company's board of directors from carrying out its fiduciary duties to its shareholders. A target company's consideration of a competing bid pursuant to the board of directors' fiduciary duties and entry into another agreement does not necessarily result in a breach of the target company's agreement with the original bidder. As a result, the making of an offer by a third party in the absence of a breach of contract will not lead to a finding of liability for tortious interference. As discussed below, there are, however, cases where the target company's behavior, notwithstanding a fiduciary out, results in a breach of the deal protection provision, which may give rise to third party liability for tortious interference with the agreement. The following are a few cases where the fiduciary out/breach of contract issues are weighed by the courts in the context of claim for tortious interference with contract.

In *Belden Corp. v. InterNorth, Inc.* on appeal from the Circuit Court of Cook County, Illinois, the plaintiff, Belden, Inc. ("Belden") brought a cause of action for tortious interference with contractual relations against the defendant, InterNorth, Inc. ("InterNorth") after the merger agreement between Belden and Crouse-Hinds, Inc. ("Crouse") fell apart. In the Belden-Crouse merger agreement, the board of directors for each entity promised to present the proposed merger to their respective shareholders and to recommend approval. While aware of the Belden-Crouse agreement, InterNorth made a tender offer for Crouse's shares. In the advertisement announcing its offer, InterNorth stated that the offer was conditioned upon the Belden-Crouse agreement being rejected by the shareholders or terminated by the parties. *Belden* at 549. The lower court granted the preliminary injunction sought by Belden to enjoin InterNorth from proceeding with its tender offer. The appellate court, however, vacated the trial court's grant of the injunction, holding that Belden failed to satisfy the elements of tortious interference with contractual relations because it failed to allege that Crouse's management had breached any contractual duty or that a breach was imminent absent entry of an injunction. The court reasoned that the contract did not impose any duty upon the Crouse shareholders to ratify the merger agreement. In a significant *obiter*, however, the court suggested that the contract could have entitled Belden to have the merger presented and recommended to Crouse's shareholders. The court made a distinction between Belden's "enforceable expectation with regard to the performance of Crouse's management" and its "mere expectancy with respect to the consummation of the merger." *Id.* at 553.

In *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.*, 741 F.2d 1555 (9th Cir. 1984), a case on appeal from the United States District Court of the Northern District of California, the court of appeals drew upon the *obiter* in *Belden* and upheld the enforceability of a deal protection provision in the merger agreement and remanded the case to the lower courts for further proceedings on the claim for tortious interference with the merger agreement. In *Jewel*, the plaintiff, Jewel Companies, Inc. ("Jewel") sued Pay Less Drug Stores Northwest Inc.'s ("Northwest") board of directors for tortious interference with a merger agreement between Jewel and Pay Less Drug Stores ("Pay Less").¹ The Jewel-Pay Less agreement required the board of directors of each entity to "use its best efforts to fulfill those conditions...over which it

¹ Northwest and Pay Less are not affiliated companies.

has control or influence and to consummate the Merger,” *Id.* at 1557, which included a prohibition from making commitments to sell Pay Less without Jewel’s consent during the term of the merger agreement. After the merger agreement was publicly announced, Northwest presented its higher competing bid to acquire the target entity and entered into an indemnity and record date agreement and a merger agreement with Pay Less. In the indemnity and record date agreement with Northwest, Pay Less, among other terms, agreed to abandon the Jewel-Pay Less agreement even in the unlikely scenario where Pay Less stockholders approved the Jewel-Pay Less merger. By the time the shareholder meeting on the Jewel-Pay Less agreement was held, Northwest had acquired a majority of the Pay Less stock. The Jewel-Pay Less agreement thus failed to obtain shareholder approval. While the district court found in favor of the defendant, the court of appeals reversed, holding that the Jewel-Pay Less agreement was binding because a board of directors had the authority to agree to refrain from negotiating or accepting competing offers until the shareholders had considered an initial offer. The court stated that the board of directors may bind itself to exert its best efforts to consummate the merger, if the commitment is temporary, in limited areas, and only pending shareholder approval. *Id.* at 1564. The court also held that even if the board of directors can bind itself to not enter into a competing merger agreement pending shareholder approval, it “may not, consistent with its fiduciary obligations to its shareholders, withhold information regarding a potentially more attractive competing offer” *Id.* at 1565. The court explicitly left open the question of whether upon the unsolicited receipt of a more favorable offer after signing the merger agreement the board of directors still must recommend to its shareholders that they approve the initial proposal.

In *ConAgra, Inc. v. Cargill, Inc.*, on an appeal of a judgment of the District Court of Douglas County, Nebraska, the state supreme court addressed the question left open by *Jewel*. The plaintiff, ConAgra, Inc. (“ConAgra”), filed suit against the defendant, Cargill, Incorporated (“Cargill”) alleging tortious interference with ConAgra’s merger agreement with the target company MBPXL Corporation (“MBPXL”). The merger agreement included a “best efforts” clause which provided that the board of each company would “take all such further action as may be necessary or appropriate in order to effectuate the transactions contemplated hereby including recommending to their respective shareholders that the merger be approved.” *ConAgra* at 582. The clause included a fiduciary out exception regarding the companies’ boards of directors’ continuing duties to their respective shareholders. *Id.* With knowledge of this agreement between ConAgra and MBPXL, Cargill proposed a tender offer for MBPXL. After acquiring most of MBPXL’s stock, Cargill merged into the company. The district court entered judgment against Cargill and MBPXL, awarding ConAgra nearly \$16 million in damages. The state supreme court reversed, concluding there was no breach of the ConAgra-MBPXL agreement. The court concluded as follows with regard to the board of directors’ obligations:

Once the directors of MBPXL learned of the competing Cargill offer, the “best efforts” clause in the ConAgra proposal could not relieve the MBPXL directors of their duties to act in the shareholders’ best interests. They had an obligation at that point to investigate the competing offer, and if, in the exercise of their independent good faith judgment, they found that the Cargill offer was a better offer for the MBPXL shareholders, they were bound to recommend the better offer. *Id.* at 588.

The court held that because the merger agreement was not breached and the MBPXL board of directors had the duty to investigate the offer from Cargill, a cause of action for tortious interference with contract had not been established.

B. Exclusivity Agreements and Letters of Intent

A binding exclusivity provision does not immunize negotiations from the impact of a competing third party bid. Even where its board of directors does not benefit from a fiduciary out (such as in the case of a closely held corporation where the shareholders have consented to the agreement), the target company's actions and bargaining power in negotiations with the original bidder can be affected by a higher third-party bid. The following analysis is useful not only because it finds that the target companies can ask for significantly higher price from the original bidder as a result of the higher third-party bid, but also because it announces to potential third party bidders that it may gain an advantage by making a higher offer to the target and legitimately usurping the original bidder, or ultimately making the deal more expensive for the initial bidder—a possible competitor—by increasing the target's bargaining power.

Pursuant to our review of the case-law, the obligation to negotiate in good faith in an exclusivity agreement or in a letter of intent limits the target company's ability to abandon negotiations and wait for the end of the exclusivity period in order to undertake negotiations with a third-party bidder.² However, it does not limit the target's ability to make new (even significant) demands that may be deemed reasonable in the context of a higher third party bid, including the demand to match the third party offer price. As discussed below, the terms of the letter of intent or exclusivity agreement, the behavior of the target company and its intent in negotiations with the original bidder are fundamental to the court's determination whether there was a breach.

Both parties to a letter of intent may demand to modify non-binding (or "open") terms and conditions in the letter of intent if such terms or conditions are within the scope of good faith negotiations. To the extent that a third party higher offer increases the market value of the target, the target may demand a higher price from the initial bidder, even if it's a price that would have been outside the scope of good faith negotiations but for the higher third party offer. *Venture Associates Corporation v. Zenith Data Systems Corporation*, 96 F.3d 275 (7th Cir. 1996) and *Teachers Insurance And Annuity Association of America v. Tribune Company*, 670 F. Supp. 491 (S.D.N.Y. 1987)³.

The court's analysis in *Venture*, as well as in *JamSports & Entm't, LLC v. Paradama Prods.*, 336 F. Supp. 2d 824 ("*JamSports I*") provides insight into the type of conduct that could amount to a breach of the duty to negotiate in good faith in the context of a letter of intent with a binding exclusivity provision.

In *JamSports I*, the plaintiff, JamSports & Entm't, LLC ("JamSports"), a sporting events promoter, sued Paradama Productions – which does business as "AMA Pro Racing" ("AMA

² This memorandum does not address whether there is an implied obligation to negotiate in good faith where the agreement is silent on the point.

³ The existence of an implied duty to bargain in good faith in an open-term agreement is also supported by E. Allan Farnsworth in "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations" (1987) 87 Colum. L. Rev. 217. - an authority in the domain, cited repeatedly by the court in *Venture* when discussing the effects of preliminary agreements. *Venture* at 279.

Pro”) - for breach of contract and also Clear Channel for tortious interference with contract – after JamSports’ deal with AMA Pro for the right to produce and promote the AMA Supercross Series 2003-2009 fell apart. The contract between JamSports and AMA Pro took the form of a letter of intent which required AMA Pro to negotiate exclusively and in good faith with JamSports during a 90-day period in order to reach the promotion agreement. After the agreement was publicly announced, Clear Channel, who was competing for the same contract, sent letters to all AMA Pro board members, stating its willingness to continue negotiations for the contract and presented a letter of proposal to one of the board members. In the final day of the extended exclusivity period, the AMA Pro board of directors demanded that JamSports renounce its requirement to make refundable the \$3 million up-front payment to AMA Pro. By midnight of the last day, JamSports agreed to remove the condition, but the AMA Pro board required a written submission on this issue, signed and approved by the board of trustees of the parent company of JamSports. Under these conditions, at midnight the last day of negotiations, an agreement between JamSports and AMA Pro had not been signed. The next day AMA Pro contacted Clear Channel to reopen negotiations and subsequently signed the promotion contract with it.

JamSports claimed that AMA Pro breached its obligation to negotiate in good faith by insisting on the condition of the approval by the board of directors – a condition outside the letter of intent, allegedly serving as a “smokescreen” for its change of heart as to the deal with JamSports. The court found that the letter of intent between JamSports and AMA Pro was a binding agreement that created a contractual duty to negotiate in good faith. *JamSports 1* at 847. Citing *Teachers Insurance*, the court stated that the duty to negotiate in good faith in the letter of intent bars both parties from renouncing the deal, abandoning the negotiations, or “unreasonably insisting on a condition outside the scope of the parties’ preliminary agreement, especially where such insistence is a thinly disguised pretext for scotching the deal because of an unfavorable change in market conditions”. *Id.* However, the court held that in order to breach the obligation to negotiate in good faith, a party must have the requisite intent. Thus, insistence on a condition outside the letter of intent will not constitute a breach of the duty to bargain in good faith unless the bad intent (bad faith) of the contracting party is also proven. The court denied JamSports a motion for summary judgment, considering that the issue of AMA Pro’s alleged bad intent was genuinely disputed and remitted it to the jury. The jury found a breach of the duty to bargain in good faith. However, in this context there was sufficient evidence that AMA Pro’s actual intent in asking the condition was to prevent the conclusion of the final agreement with JamSports. The last day of the deadline for exclusive negotiations with JamSports, the AMA Pro board of directors was well aware of the fact that the JamSports-promoted AMA Supercross series were at risk of failure because of Clear Channel’s alliances and pressures on the market aimed at gaining leverage on AMA Pro and at putting JamSports out of the market. *JamSports 1* at 831.

Thus, whether the target company breached its agreement in consideration of the third-party bid depends on not only its actions, but also its intent. The target company cannot abandon negotiations with the original bidder because of the existence of the better offer. However, the party might not be required to completely ignore the change in circumstances created by a third party higher offer. As further discussed below, the target may impose new conditions and terms on the original bidder; whether such conditions will be considered a breach of good faith depends, at least in part, on the actual intent behind the new conditions (intent to kill the deal or simply to actually obtain a better deal from the original bidder).

In *Venture*, the plaintiff, Venture Associates Corporation (“Venture Associates”), sued Zenith Data Systems Corporation (“ZDS”) for breach of its duty to negotiate in good faith. ZDS had signed a letter of intent with Venture Associates agreeing to negotiate in good faith and on an exclusive basis for the sale of its ailing subsidiary - Heath Company. The negotiations broke off after 6 months because Venture Associates refused the price adjustments reflecting changes in Heath’s inventory. On appeal, Posner J., for the United States Court of Appeals for the Seventh Circuit decided that ZDS was free to demand a higher price in order to reflect the market value of the company at the time of the sale, even though it knew that the other party could not pay the price, assuming the intent was not to induce the other out of the deal:

“Not having locked itself into the \$11 million price, ZDS was free to demand as high a price as it thought the market would bear, provided that it was not trying to scuttle the deal, *Chase Consolidated Foods Corp.*, 744 F. 2d 566, 571 (7th Cir. 1984), or to take advantage of costs sunk by Venture in the negotiating process. The qualification is vital. If the market value of Heath rose, say, to \$25 million, ZDS would not be acting in bad faith to demand that amount from Venture even if it knew that Venture would not go so high. ZDS would be acting in bad faith only if its purpose in charging more than Venture would pay was to induce Venture to back out of the deal” (pp. 280-281).” *Id.* at 280-281

Venture suggests that where the target company whose market value has increased asks for a higher price just in order to get out of the deal, it breaches its duty to negotiate in good faith. But where it asks for a higher price in order to obtain a better deal from the other party and it gives this party a reasonable opportunity to close the deal with it under the new terms, it is not likely that a breach will be found.⁴ To the extent a higher third-party affects the market value of the target, the target is justified demanding an increase (even significant) in the price, possibly up to a price matching the competing bid.

In conclusion, whether an action, demand or condition set by a negotiating party is within the scope of good faith negotiations will depend, in part, on the intent behind the action, demand or condition. The intent will be interpreted in the context of the negotiations. If the circumstances or market conditions surrounding the negotiations have changed favorably for the target, a court could find that the third party’s asking for a higher price might be warranted. For example, in the context of an open-term agreement with binding exclusivity period and non-binding indication of price, if a third party made a significantly higher offer to the target corporation, and the latter increased its asking price to that of the third party offer, courts would be more likely to find that the increased asking price is within the realm of good faith negotiations because the higher third party offer would reflect changes in market value of the target.

⁴ Other cases further support the idea that altering the initial conditions of the deal does not amount to a breach of the duty to negotiate in good faith : see also *Phoenix Mutual Life Insurance Company v. Shady Grove Plaza Limited Partnership*, 734 F. Supp. 1181. Two principles seem to stand at the basis of this position: 1) self-interest is not bad faith and, consequently, bargaining to get the best deal is not necessarily a breach, and 2) courts should not impose on parties obligations that they did not bind themselves to and should avoid enforcing terms that parties purposefully left open for future negotiations.

(ii) *Knowledge*

The third-party bidder cannot be held liable for interference with contractual relations unless he is aware of the merger agreement, exclusivity agreement or letter of intent. However, the courts impose a fairly low standard on the knowledge element of the tort.

Texaco, Inc. v. Pennzoil, Co. provides insight into the knowledge element of the tort. In *Texaco*, a case on appeal from the 151st District court of Harris County, Texas, the plaintiff, Pennzoil, Co. (“Pennzoil”), sued the defendant, Texaco, Inc. (“Texaco”), for tortious interference with a contract (the “Getty Agreement”) between Pennzoil and the Getty Oil Company (“Getty Oil”), the Sarah C. Getty Trust, and the J. Paul Getty Museum (collectively, “Getty”) which had provided for the purchase of Getty Oil stock. Whereas some of the cases discussed above concerned targets which were widely-held public corporations, the target in *Texaco* was a closely-held corporation. Gordon Getty, as trustee of the Sarah C. Getty Trust, and the J. Paul Getty Museum were owners of 40.2% and 11.8% of the Getty Oil Stock, respectively. Gordon Getty and the President of the J. Paul Getty Museum were also directors of Getty Oil. In this case, because of the shareholders’ position on the board of directors, management’s fiduciary obligation to its shareholders was not relevant to the analysis of the claim for tortious interference. Rather, Texaco invoked, among other defenses to the tort, the plaintiff’s failure to establish Texaco’s actual knowledge of the contract.⁵

The court’s analysis of Texaco’s alleged knowledge of the Getty Agreement and inducement of its breach (discussed in the next section below) provides a particularly valuable indication of what type of conduct could trigger a competing bidder’s liability for tortious interference. With regard to the requirement that the interfering party have actual knowledge of the contract, the court stated that “the defendant need not have full knowledge of all the detailed terms of the contract.” *Texaco* at 796. The court further allowed that “[t]here is even some indication that a defendant need not have an accurate understanding of the exact legal significance of the facts giving rise to a contractual duty, but rather may be liable if he knows those facts, but is mistaken about whether they constitute a contract.” *Id.* at 797. Texaco claimed that, while it had knowledge of a memorandum of agreement between Pennzoil and Getty, the memorandum and other documentation relating to the dealings between those parties expressly denied that a final agreement had been reached. Texaco therefore denied that its awareness of the Getty Agreement constituted knowledge of a binding contract between the parties. It is noteworthy that, in dismissing this argument, the court considered Texaco’s reaction to the public announcement of the Getty Agreement in principal and the manner in which it subsequently sought to acquire Getty. For example, the court found it to be relevant that Texaco was prompted to move quickly after the public announcement of the agreement in principal. Internal notes indicated that Texaco realized it had “24 hours” to “stop the train” of Pennzoil’s merger with Getty. *Id.* at 802. The court also considered that Texaco undertook detailed studies of the Pennzoil plan and that part of its acquisition strategy was to take advantage of the fact that some members of the Getty board were not happy with Pennzoil’s price. *Id.* at 804. Rather than

⁵ An important issue in *Texaco*, which is outside the scope of this memorandum, is whether there was sufficient evidence to support that the Getty Contract existed and was binding on the parties as it was in a form of a memorandum of understanding with certain essential terms agreed to orally between the parties. The Court of Appeal of Texas affirmed the lower court jury decision that the terms of the Getty Agreement were “supported by the evidence and the promises of the parties are clear enough for a court to recognize a breach and to determine damages resulting from that breach”. *Texaco* at 797.

advancing a tender offer for Getty's shares, Texaco entered into stock purchase contracts with major Getty shareholders and sought the support of Getty's board through those shareholders and representatives. These factors contributed to the court of appeals' confirmation of the jury's inference that Texaco had knowledge of Pennzoil's binding agreement with Getty.

(iii) *Inducement*

Pursuant to our review of the case-law, whether an outside bidder (and more broadly, a third party injecting itself into the deal by whatever means) can be held to have induced the breach will ultimately depend on the reasonableness and fairness of its conduct, particularly in light of business standards and ethics in the community. Merely sending a better offer to the target company will not, in most cases, be sufficient to constitute inducement. But where the third-party bidder takes active measures, such as creating market pressure in order to obtain the deal for itself (*JamSports & Entm't, LLC v. Paradama Prods.*, 382 F. Supp. 2d 1056 (“*JamSports 2*”)), or where the third-party bidder becomes “unduly persuasive” (*Middleton v Wallich*s 536 P.2d 1072 (Ariz. Ct. App. 1975)), its will be held liable for inducement of breach (if all the other elements of the tort are met).

A third-party bidder is liable if its conduct amounts to an intentional and improper interference with the letter of intent or exclusivity agreement. Restatement (Second) of Torts § 767 (1979). The intent requirement is easily met in a competing bid context because an interference “incidental to the actor's independent purpose and desire but known to him to be a necessary consequence of his action” is sufficient. *Id.* The more salient question is whether the third-party's action amounts to an “improper interference” with the letter of intent or the exclusivity agreement. The factors to be taken into account in determining whether the actor's intentional interference is improper, are: “a) the nature of the actor's conduct, b) the actor's motive, c) the interests of the other with which the actor's conduct interferes, d) the interests sought to be advanced by the actor, e) the social interests in protecting the freedom of action of the actor and the contractual interests of the other, f) the proximity or remoteness of the actor's conduct to the interference and g) the relations between the parties.” Restatement (Second) of Torts § 767.

Where the third-party bidder is at least in part motivated by self-interest (which is the case with third-party competing bids),⁶ the decision of the court on whether its action amounts to “improper interference” will ultimately depend on the balancing of competing interests at stake: the first bidder's interest in the protection of his contractual rights and the third party's interest in the freedom of action. The means of inducement, the conduct of the outside bidder will be integral to the outcome of the balancing exercise. The balance of interest will “potentially [weigh] heavily in favor of the third party where the conduct is not predatory in nature.” Restatement (Second) of Torts § 766.

However, the balancing of competing interests in competitive bids in the merger context may in most instances lead to stalemate, as the actors are competing in the same market, the freedom of action interest is sufficiently strong to outweigh the strong interest in the protection of contracts. As a result, the nature of the conduct of the outside bidder in pursuing its interest

⁶ If the third-party bidder's sole motive is the desire to interfere with the merger agreement, the interference is “almost certain to be improper”. Restatement (Second) of Torts § 767.

will be the decisive factor on the issue of liability. Indeed, in canvassing the case-law in this area, we have identified the means used (the conduct of the third party) as one of the most important factors in deciding the outcome of the interference branch of the test. Sometimes, this is the only element of the test that is expressly discussed (see *Texaco, JamSports*, etc.). Moreover, the business ethics and custom have a significant impact in evaluating the conduct of the defendant (*Adler v Epstein*, 393 A.2d 1175 at 434 (Pa. Super. (1977))). This conclusion is supported by the Restatement, according to which the real question on the inducement branch is “whether the actor’s conduct was fair and reasonable under the circumstances. Recognized standards of business ethics and business customs and practices are pertinent, and consideration is given to concepts of fair play and whether the defendant’s interference is not ‘sanctioned by the rules of the game’.” Restatement (Second) of Torts § 767.

The courts’ analysis of the inducement element of the tort in *Texaco* and *JamSports* provides a particularly valuable indication of what type of conduct could trigger a competing bidder’s liability for tortious interference.

In *Texaco*, the court stated that “merely entering into a contract with a party with knowledge of that party’s contractual obligations to someone else is not the same as inducing a breach.” *Id.* at 803. It further provided that “it is necessary that there be some act of interference or of persuading a party to breach, for example by offering better terms or other incentives, for tort liability to arise.” *Id.* The manner in which *Texaco* undertook to acquire Getty Oil was once again integral to the court upholding the jury’s finding that *Texaco* actively induced the breach of contract between Pennzoil and Getty. It was found that the evidence surrounding *Texaco*’s “calculated formulation and implementation of its ideal strategy to acquire Getty,” including its exploitation of Gordon Getty’s known fear of being left in a powerless minority ownership position, was inconsistent with its claim that it had passively accepted a deal proposed by Getty. *Id.* at 804.

In *JamSports 2*—a continuation of the *Jamsports* case—the court stated that a balancing test is required in order to determine whether the interference is unjustified; the ultimate question being “whether the protection of the particular contract interest at issue merits prohibition of the particular conduct at issue.” Here as well, the third party’s (Clear Channel) conduct – the circumstances under which Clear Channel convinced the target to enter into a contract – is essential to the court’s upholding the jury’s finding that the inducement element existed in the case. The court found that there was evidence that Clear Channel engaged in alliances with third parties in order to put AMA Pro at risk of expulsion from the Federation Internationale de Motocyclisme in the event it concluded the deal with *JamSports*, which Clear Channel had – in the words of the court – “basically elbowed out of the market”. All this was sufficient to satisfy the inducement requirement “even if Clear Channel’s submission of a proposal to and its discussions with AMA Pro were insufficient by themselves to do so.” *JamSports 2* at 1065-1066. The court did not reject Clear Channel’s argument that merely sending an offer does not constitute inducement of a breach of the agreement to negotiate exclusively. In its decision affirming the jury decision, the court provides (similarly to the *Texaco* case) a long recitation of all the pressure techniques that Clear Channel employed on both parties to the agreement in order to preclude the final contract from being signed. This seems to imply that something more than merely sending an alternative offer will trigger the third party’s liability. In the words of the Arizona Court of Appeals, “affirmative, unduly persuasive, initiating conduct [...] will weigh in

favor of a finding of liability.” *Middleton v Wallichs* 536 P.2d 1072 (Ariz. Ct. App. 1975).⁷ There will be no inducement where the third party acts at the request of the contracting one or where the initiative comes from the contracting party itself. *Id.*

In conclusion, the third-party bidder, and more generally a third-party injecting itself into a transaction, will be liable for interference where the means chosen in order to pursue its legitimate competitive interest go beyond what is generally held as acceptable or reasonable under the circumstances in the business community and where he violates the rules of fair play. Violating the “rules of the game” will likely lead to a finding of liability.

A third-party bidder might benefit from a privilege to interfere with a letter of intent or exclusivity agreement “where [he] was acting to protect an interest which the law deems to be of equal or greater value than the plaintiff’s contractual right” (*HPI Health Care Services, Inc. v Mt. Vernon Hospital Inc.* 131 Ill. 2d 145). However, in the context of tortious interference with contract, competition does not provide a privilege to interfere in a contract. *JamSports* at 1063. Competition might nevertheless be taken into account as one of main factors in deciding whether the conduct of the third party is justified under a reasonable business standard. The protection offered by any privilege is limited: it stops where the third party engages in conduct which is “totally unrelated or even antagonistic to the interest which gave rise to defendant’s privilege.” *HPI Health Care* at 158.

The law is still unsettled on the burden of raising and proving the issue of whether the interference was improper or not. In Illinois, where the conduct of the third party is privileged, the burden is on the plaintiff to prove that the conduct of the party went beyond the acceptable limits of the privilege. *HPI Health Care Services* at 677, *Philipsborn & Co. v. Morris Suson* 59 Ill. 2d 465, *Philip I. Mappa Interests, Ltd. v. James R. Kendle et al.* 196 Ill. App. 3d 703. But where the conduct was not privileged, it is the third party’s burden to prove that its conduct was justified.

(b) Assessment of Damages

The remedies available for tortious interference with contract include compensatory and punitive damages, restitution and injunctive relief. The measure of damages applicable to the tort is not settled, although *Texaco* and *Mid-Continent Telephone Corporation v. Home Telephone Company*, 319 F. Supp. 1176 (N.D.Miss. 1970) provides some insight into how damages are calculated.

(i) General Damages

In *Texaco*, the court of appeals provided the following with regard to the assessment of damages for tortious interference with contract:

In a cause involving a tortious interference with an existing contract, New York courts allow a plaintiff to recover the full pecuniary loss of the benefits it would have been entitled to under the contract [...]. The plaintiff is not limited to the

⁷ In *Middleton*, Charles Middleton filed suit against Wallichs Music City for intentionally interfering with its lease agreement with the lessor by inducing the lessor to breach the restrictive competition covenant in the lease agreement. The court ruled that the mere fact that Wallichs contracted with the lessor with knowledge of the covenant and of the breach thereof resulting as a consequence did not amount to improper interference.

damages recoverable in a contract action, but instead is entitled to the damages allowable under the more liberal rules recognized in tort actions. *Id.* at 859.

In light of this framework, the court of appeals upheld the jury's assessment of general damages against Texaco. At trial, the jury chose the "replacement cost" model of damages from among three damages models presented through expert testimony, which included a discounted cash flow model and a cost acquisition model. It accepted expert testimony that, through Texaco's interference, Pennzoil was deprived of the right to acquire 1.008 billion barrels of oil at a cost of \$3.40/barrel. The cost of finding equivalent reserves without the benefit of the contract with Getty was assessed at \$10.87/barrel. The jury calculated the general damages to be \$7.53 billion, representing the additional cost to Pennzoil of finding these equivalent reserves.

The court of appeals rejected Texaco's contention that the damages should have been evaluated as the difference between the market value of Getty Oil stock and its contract price at the time of the breach. The court reasoned that this would mistakenly restrict the plaintiff to damages recoverable in a contract action. The court instead confirmed that the correct measure of Pennzoil's damages was the pecuniary loss of the benefits it would have been entitled to under the contract. It therefore allowed that the purpose for which the plaintiff entered into the transaction was relevant to the assessment of damages. The court found sufficient evidence to infer that Pennzoil sought to purchase Getty Oil in order to acquire its oil reserves and did not consider the acquisition to be a mere buy-sell stock transaction. *Id.* at 860. The "replacement cost" model reflected this intention and therefore effectively compensated Pennzoil for the loss of the benefits it would have been entitled to under the contract.

In *Mid-Continent*, Mid-Continent Telephone Corporation ("Mid-Continent"), sued both the target company, Home Telephone Company ("Home") for breach of contract and the subsequent bidder, Union Telephone Company ("Union") for tortious interference with contract. The court found Home, a closely-held corporation, liable for breach of an informal agreement to sell its assets and liabilities to Mid-Continent. It assessed the damages for this breach at \$218,000, representing the difference between what Mid-Continent agreed to pay for Home and the fair market value of Home at the time of the contract. With regard to the tortious interference claim, the court found that Union recklessly and deliberately induced Home to breach its contract for Union's own profit. *Mid-Continent* at 1200. The court noted that when the Darleys (the controlling family of Home) offered to show Clarke Williams (a representative of Union) a copy of the agreement with Mid-Continent, Williams declined to examine it, stating that the less he knew about it the better. *Id.* at 1186. The defendant was found to have had sufficient knowledge of the contract despite having no direct knowledge of its specific terms.

On the issue of damages, the court stated that "in an interference action, the plaintiff need only prove that injury resulted to him from the interference in order to recover substantial damages, but wholly speculative damages based on conjectural profits are not recoverable." *Id.* at 1200. The amount of damages payable by Union for tortious interference was assessed in light of the fact that Mid-Continent had already been awarded \$218,000 for Home's breach of contract. The court found that Mid-Continent had sustained other substantial damages as a direct result of Union's tortious conduct. It assessed the damages payable by Union at \$25,000, representing the sum of Mid-Continent's various acquisition costs in dealing with Home and outlays incurred in the litigation.

(ii) *Punitive Damages*

In *Texaco*, the court of appeal judged that punitive damages were available to Pennzoil on the basis that Texaco's actions were intentional, wilful and in wanton disregard of the rights of Pennzoil. The court of appeals allowed that the following factors could be incorporated into this assessment:

Texaco deliberately seized upon an opportunity to wrest an immensely valuable contract from a less affluent competitor, by using its vast wealth to induce [Getty] to breach an existing contract [...]; the wrongful conduct came not from servants or mid-level employees but from top level management [...]; [although there was no evidence that Texaco sought to injure Pennzoil] Texaco cared little if such injury resulted from its interference. 729 S.W.2d 768 at 866.

Nonetheless, the court found that the jury's awarding of \$3 billion was excessive. It found instead that "punitive damages of \$1 billion are sufficient to satisfy any reason for their being awarded, whether it be punishment, deterrence or encouragement of the victim to bring legal action." *Id.* at 866.

In *Mid-Continent*, the court stated that "because of the aggravation in Union's conduct to induce Home to breach its contract, as evidenced by Union's utter indifference and capricious disregard for Mid-Continent's right, we find this is a proper case for the assessment of punitive damages, including an award for attorneys' fees incurred by plaintiff in vindicating its rights." *Mid-Continent* at 1200. The court assessed the punitive damages at \$70,000.

(iii) *Relevance of a "Termination Fee" to the Assessment of Damages*

In *Mid-Continent*, the court, confronted with claims for both breach of contract and tortious interference, refrained from awarding Mid-Continent the same damages twice. Rather, the amount of damages calculated against Union for tortious interference was mitigated by the fact that \$218,000 in damages that were assessed against Home for its breach of the contract with Mid-Continent. Although no case law directly addressing the question has been identified, it is possible that the payment of a "termination fee" pursuant to a merger agreement could have the similar effect of reducing the amount of damages awarded for tortious interference insofar as the fee represents "liquidated damages" for breach of contract. However, the facts surrounding *SCEcorp et al. v. Tucson Electric Power Company* 3 Cal. App. 4th 673 (1992) discussed below may suggest otherwise with regard to the effect, or at least the perceived effect, of payment of a termination fee in the context of a "tortious interference" claim.

In *SCEcorp*, the court of appeal affirmed the decision of the San Diego Superior Court (California) overruling a petitioner corporation's demurrer, finding that the existence of certain conditions precedent to the consummation of a merger agreement does not preclude tortious interference claims. It is noteworthy that, at the trial, the third party bidder, SCEcorp, settled with a payment to Tucson Electric Power Company for \$40 million, despite the fact that Tucson Electric Power Company had received a \$25 million termination fee under the merger agreement, which contained a fiduciary out provision (see Arthur Fleisher, Jr. and Alexander R. Sussman, *Takeover Defense* at § 15.05 [D] n. 263 (6th ed. 2000)).

4. Conclusion

Inherent in the acquisition process is the risk that the parties will not consummate the merger. Deal protection provisions and exclusivity arrangements are a response to this risk; although they cannot ensure the consummation of a deal.

Making an unsolicited offer to a target that has entered into an exclusivity agreement, would not, without further action, be deemed inducement of breach. To the extent that a high third party bid increases the market value of the target, the target may demand a greater price from the initial bidder with whom the target has entered into an agreement without risking violating its obligation to negotiate in good faith during an exclusivity period. Absent any action that would be deemed inducement of breach, even if the third party bidder is not the victorious acquirer, it would benefit from the original seller paying a higher purchase price for a target, possibly reducing funds for operations. A third-party bidder will be deemed to have induced a breach and will be liable for interference where the means chosen in order to pursue its legitimate competitive interest go beyond what is generally held as acceptable or reasonable under the circumstances in the business community and where it violates the rules of fair play. Violating the “rules of the game” will likely lead to a finding of liability.

In context of a publicly traded target, both *ConAgra* and *Jewel* maintained that, pursuant to their fiduciary duties, a board of directors must disclose a higher competing offer to its shareholders before a shareholder vote to approve a transaction. Shareholders have the ultimate authority to approve or reject an offer. A best efforts clause only entitles the bidder to have the merger presented to the target shareholders, who are under no obligation to approve the transaction. Although it was suggested in *Belden* that a board may bind itself to recommend an offer to its shareholders, this possibility was explicitly rejected by the court in *ConAgra*. Thus, even if there is an enforceable exclusivity provision in place, as in *Belden* and *Jewel*, an outside bidder may still present a better offer to the target’s shareholders without incurring liability for tortious interference.

Damages awarded for tortious interference in the context of a “topping” bid are potentially enormous. The plaintiffs in such actions benefit from the liberal rules relating to the assessment of damages under tort law, including the availability of punitive damages. Moreover, a competing bidder may remain exposed to liability for tortious interference even if the plaintiff has already recovered damages for breach of contract or has reviewed a termination fee from the target.