

Excluding Third-Party Beneficiaries from Merger Agreements

by: James A. Smith

Synopsis

Often, in a merger-acquisition negotiated by two companies, the target company's shareholders receive a premium price for their shares. In the ordinary sense, the target's shareholders are "beneficiaries" of the merger agreement. If the agreement is clear on the point, however, the target company's shareholders are not third party beneficiaries and cannot sue the buyer for breach. Let's look at a case study.

The Merger Agreement

Acme and Beta executed a definitive merger agreement. All shares of Beta were to be redeemed for cash. The price was tied to the market price of Acme shares, and included a premium for Beta's shareholders - at least 25% over the last market quote for Beta shares before the deal was announced.

The Acme-Beta Merger Agreement contained "General Provisions." These "boilerplate" clauses were in the first draft of the agreement and were never revised during negotiations. They included such prosaic matters as addresses for notices, choice of governing law and counterpart execution. The General Provisions also included this clause:

"Entire Agreement; No Third Party Beneficiaries. This Agreement is the entire agreement between the Parties concerning its subject matter, supersedes all prior agreements and understandings, whether or not written, and is not intended to confer upon any person other than the Parties any rights or remedies hereunder."

Termination

On the eve of the merger, Acme terminated, claiming a substantial change in Beta's circumstances had occurred. The next day, Beta's share price fell back to premerger levels and no other buyer was interested in matching Acme's offer. Some angry Beta shareholders consulted a well-known class-action securities lawyer, Matthew Browning, hoping to sue Acme for the price premium they lost. They asked him to work on a contingency fee. Browning studied the merger agreement, especially the General Provisions, then shook his head.

"I tried to make a claim like this once," he told the shareholders, "but I won't try again. You won't get to trial, so you won't have much leverage for a settlement."

Browning explained: "The problem is, this merger agreement is between Acme and Beta, and you shareholders are not parties to the agreement. Normally, only a party to a contract can sue. Sometimes, you can sue as a third party beneficiary, but this agreement specifies that there are no third party beneficiaries. I know it sounds funny, but you can't sue for breach, even if there was a breach. I wouldn't take this case on a contingency and I wouldn't advise you to spend money suing Acme."

One of the disappointed shareholders was Harold Nelson, president of his own company. Nelson called his lawyer, Nancy Tatum, and asked her if Browning was right. Nancy asked for a copy of the Acme-Beta merger agreement and other papers and told Nelson she would review the cases and send him a memo.

"I can't afford any memos," Nelson protested. "Just call me when you know whether we can sue." Nancy

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Tatum set to work in the library, and here is what she found.

Excluding Third Parties

Nancy noted first that the merger agreement was governed by the law of Delaware, Acme's state of incorporation. Delaware's common law of contracts holds that no one can be a third party beneficiary of a contract unless it is apparent on the face of the contract that the parties to the contract intended to confer that status on others. *Insurance Company of North America v. Waterhouse*, 424 A.2d 675, 678 (Del. Sup. 1980). Michigan follows the same rule, by statute. MCL 600.1405, MSA 27A.1405.

"The courts use an objective standard to determine whether a plaintiff is a third-party beneficiary under the statute. The contract itself reveals the parties' intentions. The parties' motives and subjective intentions are irrelevant in determining whether a plaintiff is a third-party beneficiary. * * * "*Frick v. Patrick*, 165 Mich. App. 689, 694, *lv. den.*, 431 Mich 872 (1988).

See also, *Rieth-Riley Construction Co. v. Dept. of Transportation*, 136 Mich. App. 425 (1984), *lv. den.*, 422 Mich. 911 (1985).

So, Nancy knew what it takes to convince a court that someone is a third party beneficiary. It must be objectively clear from the terms of the contract itself. What about a contract which says that *nobody* is a third party beneficiary, even when the whole point of the agreement was to benefit an obvious group?

Nancy found few cases, but they supported Browning's advice to the Beta shareholders. The Oklahoma Court of Appeals addressed this question in *Cities Service Company v. Gulf Oil Corp.*, 797 P.2d 1009 (Okla. App. 1990), *reh. den.*, 5/29/90; *cert. den.*, 9/18/90 (Okla. S. Ct.). Gulf Oil had agreed to acquire Cities Service, but canceled the deal when the Federal Trade Commission obtained a temporary restraining order enjoining the merger. Cities Service sued Gulf for breach, joined by two shareholders, who contended that they were third party beneficiaries of the contract.

The Cities Service - Gulf merger agreement, §10.8, provided:

"Section 10.8 Miscellaneous. This agreement . . . (i) constitutes the entire agreement and supersedes all other prior agreements and understandings, both written and oral, among the parties, or any of them, with respect to the subject matter here [*sic*]; (ii) is not intended to confer upon any other person any rights or remedies hereunder; . . ." 797 P.2d at 1011.

The trial court dismissed *both* Cities Service's claim for the premium its shareholders would have received and the shareholders' direct claims for the premium. The Oklahoma Appeals Court affirmed, ruling:

"* * * Because of Section 10.8 of the merger agreement, we hold that the parties to said agreement (Cities, Gulf and GOCA [a Gulf subsidiary]) did not intend to confer upon the shareholders a right to receive performance by the promisor, Gulf, and therefore the shareholders were not in the legal sense third-party beneficiaries of the merger agreement." 797 P. 2d at 1012.

The Cities Service shareholders argued that they were the ones who were to receive the premium price offered by Gulf, so the "no third parties" clause could not have been intended to apply to them. The Oklahoma court turned this intuition around: *because* the shareholders were the "only class of potential third-party beneficiaries evident on the face of the contract", *ibid.*, and the corporate parties took pains to exclude third party beneficiaries, this clause *must* have been intended to exclude the shareholders.

Similar results have been reached in other courts. Disappointed Cities Service shareholders also filed class actions in New York. *In re Gulf Oil/Cities Service Tender Offer Litigation*, 725 F. Supp. 712 (SDNY 1989). Applying Delaware law, the District Court ruled that "any other person" was clear and unambiguous language which excluded the shareholders from any right to sue. In an unreported decision dealing with another failed merger, the Ohio Court of Appeals refused to allow shareholders to sue when a merger agreement excluded third party beneficiaries. *Matheny v. Ohio Bancorp*, 1994 Ohio App Lexis 6007.

Corbin on Contracts, §776, at 7 (Supp., 1971) expresses a similar view:

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"[I]f two contracting parties expressly provide that some third party who will be benefitted by performance shall have no legally enforceable right, the courts should effectuate the express intent by denying the third party any remedy."

The *Restatement of Contracts 2d*, §302, observes that persons, who otherwise might meet the tests for third party beneficiary status, will be denied the right to sue when it is "otherwise agreed between promisor and promisee."

Her research done, Nancy Tatum called Mr. Nelson and told him that Matthew Browning gave him good advice. "Browning wouldn't take the case on a contingency because he knew he'd never get a fee," she said. "You would be wasting your money if you paid a lawyer to sue, and Browning was right to say so."

"Why didn't the Board insist that shareholders like me be included in the agreement?" Nelson asked. "Isn't that their job?"

Nancy explained: "It's the directors' job to get the best deal they can for the shareholders, but they can't do the impossible. I believe Acme never would have signed the agreement without that clause. I certainly wouldn't let you sign one."

"I bet the board had their own sweet deal to sell their shares," Nelson fumed.

"Yes, they did sign lockup agreements", Nancy replied, "but that won't give them the right to sue, either. Acme's lawyers did a good job on the lockups, too."

RELATED AGREEMENTS

"Lockup" agreements, made between the acquiring company and shareholders of the target, frequently accompany merger agreements. The target's key shareholders agree to vote for the merger and to tender their shares. Usually, there is no separate agreement to purchase them; the lockup is executed to induce the acquiror to enter into the merger agreement. Another form of "extrinsic" agreement is the tender offer made to other target shareholders, under which the acquiror offers to purchase shares, subject to the conditions of the merger agreement.

If the merger agreement and all related agreements have their own integration and "no third party" clauses, the courts will not merge the agreements into a "super contract" under which the target shareholders could sue. Lockup agreements can define their parties to include only the acquiror and the signing shareholder, thus excluding the target company and its other shareholders as parties. They also can exclude third party beneficiaries. Both courts which decided the Gulf Oil/Cities Service disputes ruled that the existence of such other agreements did not make target shareholders parties to or third party beneficiaries of the merger agreement.

"Faced with § 10.8's preclusive effect on their third-party beneficiary argument, plaintiffs argue that § 10.8 does not apply to shareholders because it includes 'instruments . . . referred in the Agreement' and the Offer to Purchase was referred to in the Merger agreement. * * * Defendants correctly respond that the language 'instruments . . . referred in the Agreement' is limited to those agreements 'among the parties' and, since even the shareholders agree they were not 'parties' to the Merger Agreement, plaintiffs' imaginative reading of § 10.8 fails." *Gulf Oil/Cities Service, supra*, 725 F. Supp. at 733-734.

See also *Cities Service Co. v. Gulf Oil Co, supra*, 797 P. 2d at 1012 (shareholders not parties to merger agreement by virtue of tender agreement).

All agreements used in connection with the merger must be reviewed carefully to determine whether they could be read together to confer rights on ancillary parties. If drawn carefully, they will not. An example of problems created by lack of "boilerplate" is found in the litigation over the failed acquisition of ICO, Inc. *Bush et al. v. Brunswick Corp. et al.*, 783 S.W.2d 724 (Ct. App. Tex. 1989), *reh. den.* (2/13/90); *Brunswick Corp. et al. v. Bush et al.*, 829 S.W.2d 352 (Tex. App. 1992).

Brunswick agreed to acquire ICO, Inc., through merger with a new Brunswick subsidiary, "ICO Transitory".

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Brunswick also made lockup agreements with seven ICO shareholders, who held 51% of ICO's stock. The merger agreement provided that it was "not intended to confer upon any other person any rights or remedies". It also "superseded all other prior oral agreements and understandings between the parties", but did not provide that it was the "entire agreement" between the parties. The lockup agreements lacked "entire agreement" and "supersedes other agreements" clauses, and did not exclude third parties.

When trouble developed, ICO sued, alleging anticipatory breach by Brunswick. The seven shareholders who had made lockup agreements petitioned to intervene, claiming third party beneficiary status. The Texas Court of Appeals ruled that the seven insiders could intervene, because the merger agreement had no "entire agreement" clause. The Court read the lockup agreements together with the merger agreement, concluding that the shareholders were intended beneficiaries of the merger agreement and could sue for its breach. The court read "any other person" as meaning persons other than the necessary participants in the merger. The court observed that the parties could have used language such as "no person who is not a party to the Merger Agreement", if that was what they meant. 783 S.W.2d at 730.

In its second opinion, the Texas court held that the seven insiders could sue for themselves, but not for a class of all ICO shareholders, because the shareholders who had not signed lockups were not necessary parties to the merger. 829 S.W.2d 352. This anomalous result probably could have been avoided if both merger and lockup agreements had used all of the necessary "boilerplate".

Nancy Tatum explained to Nelson that Acme had been careful to include all the necessary clauses in both the merger and the lockup agreements. Nelson listened to this explanation quietly, then asked: "Do we have clauses like these in our contracts?"

"Yes, in the contracts I've prepared", Nancy replied. "The only time I don't use a standard "no third parties" clause is when you really mean to create a third party beneficiary. There were some third party beneficiaries in one deal, when you agreed to honor agreements with employees of the company you bought. But we made sure the employees were the only third party beneficiaries, and only as to those agreements."

"Thanks, Nancy. I guess I'm getting good advice."

Nelson was right. He was getting good advice, both on his own company's contracts and on the contract between Acme and Beta. Using a no third party beneficiary clause is easy, seldom controversial in negotiating a deal, and can be crucial to defending a claim of breach. Coupled with integration and supersession clauses, it will do the job intended by the parties.

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