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"NUMB HANDS" NON-TERMINATION CLAUSE IN FIRST UNION-WACHOVIA MERGER AGREEMENT HELD INVALID

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Defensive measures and deal protection provisions that limit the ability of a target's directors to perform their fiduciary duties have consistently been rejected by the Delaware Courts in recent years. On July 20, 2001, a North Carolina state court, applying North Carolina law but relying heavily on Delaware precedents, struck down a clause (the "Non-Termination Clause") in the merger agreement between Wachovia Corporation and First Union Corporation providing that the agreement could not be terminated until January 16, 2002, whether or not the Wachovia shareholders vote in favor of the merger.

On April 15, 2001 First Union and Wachovia executed a merger agreement and reciprocal stock option agreements. The stock option agreement in which Wachovia is the grantor (the "Option"), which is at issue here, provides that if certain triggering events occur, including a Wachovia merger with another partner, First Union will have the right to buy Wachovia stock at a set price. The profit to be realized through exercise of the option is capped at $780 million.

On May 14, 2001, SunTrust announced its unsolicited proposal to acquire Wachovia. SunTrust's hostile bid was subject to a number of conditions, including its satisfactory completion of due diligence, but SunTrust has conceded that, as part of its proposal, it is willing to pay the "in the money" value of the option, up to $780 million. SunTrust has begun a proxy contest, which is still ongoing, in opposition to the merger. The Wachovia shareholders are scheduled to vote on the merger at a shareholders meeting on August 3, 2001.

SunTrust's lawsuit alleged that (a) the Wachovia directors did not fulfill their duty of care in approving the Option and the Option is coercive and preclusive; and (b) the Wachovia directors breached their fiduciary duties when they approved the Non-Termination Clause.

As to the Option, the Court found that the Wachovia directors were sufficiently informed as to its value and its effect. They were advised that the $780 million number was a high number (slightly less than 6% of the deal value) but that it was not preclusive or coercive. The record showed that some of the directors had a limited understanding of the details of the option agreement. The Court, however, said that this did not matter because "the directors understood that they were imposing a potential $780 million breakup fee." "They knew the bottom line, if they did not know how it could be reached." The Court said that the directors' duty was to act as "an ordinary prudent person under like circumstances" and that accordingly they were not required to understand every word of a complex legal document such as the Option in order to fulfill their duty of care.

The Court also rejected the claims that the Option was coercive and preclusive pointing out among other things that (i) the price of Wachovia stock consistently traded at a level higher than the value of the First Union deal, which shows that the market did not believe other offers were precluded, and (ii) SunTrust has stated in the press and in its proxy statement that it was prepared to pay the full $780 million "breakup fee" and still offer Wachovia shareholders a superior transaction.

As to the Non-Termination Clause, the Court, dubbing it a "numb hands" clause, found this "cryonic" contractual provision "that extends the life of the merger agreement five months beyond a shareholder vote disapproving the merger" invalid as "an impermissible abrogation of the duties of the Wachovia directors and an actionably coercive condition impeding the free exercise of the Wachovia shareholders' right to vote on the merger."

The Court analogized the Non-Termination Clause to the situation in Quickturn v. Shapiro, 721 A.2d 1281 (Del. 1998), where a similar delay was held to be impermissible.

In Quickturn, Quickturn Design Systems, in response to a hostile tender offer by Mentor Graphics, amended its shareholders rights plan to include a deferred redemption or "no-hand" provision which meant that no newly-elected board could redeem the rights plan for six months after taking office, if the purpose or effect of the redemption was to facilitate a transaction with the person who caused the directors to be elected to the board.

In Quickturn, the court held that the deferred redemption provision would impermissibly deprive any newly elected board of directors of both (1) its statutory authority to manage the corporation under §141(a) of the Delaware General Corporation Law ("DGCL") and (2) its concomitant fiduciary duty pursuant to that statutory mandate.

§141(a) provides that "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided in [the DGCL] or in its certificate of incorporation". (Quickturn's certificate of incorporation contained no such provision). The Quickturn Court stated that in discharging the statutory mandate under §141(a), directors have a fiduciary duty to the corporation and its shareholders. The deferred redemption provision would prevent a newly elected board from fully discharging its fiduciary duties to protect the interests of Quickturn and its shareholders because it would limit their freedom to approve a sale of the company that might otherwise be in the best interest of Quickturn's stockholders.

Likewise in this case if the Wachovia shareholders voted against the merger, the Wachovia board has impermissibly tied its hands and would not be able to sell the company for five months, even if their fiduciary duties dictated that they did so, without breaching the merger agreement. The Court noted that the directors could talk to suitors but found this to be insufficient because the directors could not consummate a transaction and "it is extremely unlikely that any suitor would negotiate an agreement that could not even be signed for months."

The Court also found the Non-Termination Clause to be coercive as it creates uncertainty for Wachovia shareholders: if they vote against the merger, they run the risk that in the ensuing five months an offer will be made to which the directors will be unable to respond. Accordingly the Court held the non-termination clause to be invalid and unenforceable. First Union Corporation, et al. v. SunTrust Banks, Inc., CA No. 01-CVS-4486 (N.C. Superior Ct. July 20, 2001).

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This memorandum constitutes only a general description of First Union v. SunTrust and should not be construed as legal advice.

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