



ARTICLE

The New Look of Deal Protection

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Abstract. Deal protection in mergers and acquisitions (M&A) deals evolves in response to Delaware case law and the business goals of acquirers and targets. We construct a new sample of M&A deals from 2003 to 2015 to identify four such areas of evolution in current transactional practice: (1) termination fee “creep,” which was pervasive in the 1980s and 1990s, seems to have gone away by the 2000s; (2) match rights, which were unheard of in the 1990s, became ubiquitous by the 2010s; (3) asset lockups, which disappeared from the landscape for thirty years, have reemerged, though in a “new economy” variation; and (4) practitioners have begun implementing side agreements to the deal that have a commercial purpose along with a deal protection effect. We offer three recommendations for how the Delaware courts should approach this “new look” to the deal protection landscape. First, courts should clarify that lockups must survive *Unocal/Unitrin* “preclusive” or “coercive” analysis in addition to *Revlon* “reasonableness” review. Second, Delaware courts should apply basic game theory to identify the deterrent effect of match rights and new economy asset lockups. And third, Delaware courts should take a functional approach to deal protection, meaning that collateral provisions that have a deal protection effect should be scrutinized under deal protection doctrine, even if these agreements have a colorable business purpose as well.

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Table of Contents

Introduction..... 1015

I. Background..... 1017

 A. Motivation for Deal Protection 1017

 B. Prior Literature 1019

II. Recent Trends in Deal Protection..... 1022

 A. End of Termination Fee Creep..... 1023

 1. Data analysis..... 1023

 2. Discussion 1024

 B. Proliferation of Match Rights 1031

 C. Emergence of “New Economy” Asset Lockups 1035

 D. Emergence of Financing Arrangements with a Deal Protection Effect..... 1041

III. A Proposed Approach to Deal Protections..... 1050

 A. Resolving the *Unocal/Revlon* Ambiguity 1051

 B. Applying Basic Game Theory 1057

 1. Match rights 1058

 2. Asset lockups..... 1063

 C. Adopting a Functional Approach 1069

Conclusion..... 1073

Introduction

It is well known in transactional practice that the magnitude of termination fees has gone up over the past thirty years. What used to be 1-2% of deal value in the 1980s¹ increased to 2-3% by the 1990s² and 3-4% by the 2000s.³ This trend cannot be readily explained by changes in mergers and acquisitions (M&A) fundamentals: as a percent of deal value, it is not obvious why compensation for search costs, out-of-pocket costs, reputational costs, and opportunity costs should be higher today than it was in the 1980s. The more plausible explanation lies in the nature of transactional practice. Nearly two decades ago, Richard Beattie, then the managing partner at Simpson Thacher & Bartlett LLP in New York City, explained this trajectory:

The percentage that is okay has slowly risen. A year ago, two years ago, people were talking about two percent, two-and-a-half percent. Now, you hear them talking about three, three-and-a-half percent. Some are even saying four percent. You sit there and ask, 'On what basis are you doing that? Where did you get that number?' There hasn't been a specific challenge, so everybody pushes the envelope.⁴

There are important policy reasons for the Delaware courts to set limits on deal protection. Sellers can gain leverage from judicial rules that require their management to search for bidders or to canvass the market as a matter of fiduciary duty. The purpose of these limits is to provide sell-side shareholders with full value and a meaningful shareholder vote. Legally shielding boards from preclusive deal protections prevents bidders from demanding such deal protections in the first place, which increases the likelihood that the target company will be acquired by the highest-value bidder. The result is greater allocational efficiency in the M&A marketplace (that is, resources will be more likely to flow to their most valuable uses), which improves overall social welfare.

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1. See John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 335 fig.2 (2000) (presenting empirical evidence on the magnitude of termination fees in the late 1980s and 1990s); see also BRUCE WASSERSTEIN, *BIG DEAL: THE BATTLE FOR CONTROL OF AMERICA'S LEADING CORPORATIONS* 589 (1998) ("For a large transaction, the typical fee is in the range of 1 to 2 percent . . . [F]ees in smaller deals (\$50 to \$500 million) tend toward the higher end of the range."). Using the Thomson Financial database, we estimate that the mean termination fee for deals over \$50 million (the threshold we use throughout the empirical analysis of this Article) was 1.93% of deal value and the median was 1.75%.
 2. See Coates & Subramanian, *supra* note 1, at 335 fig.2.
 3. See Jin Q. Jeon & James A. Ligon, *How Much Is Reasonable?: The Size of Termination Fees in Mergers and Acquisitions*, 17 J. CORP. FIN. 959, 963 tbl.1 (2011).
 4. Coates & Subramanian, *supra* note 1, at 334 n.90 (quoting Interview with Richard I. Beattie, Chairman, Simpson Thacher & Bartlett, in N.Y.C. 3 (July 23, 1999)).

In a 2000 article, one of us (along with coauthor John Coates) recommended that the Delaware courts provide guidance to practitioners on the permissible boundaries of deal protection.⁵ Around the same time—while not actually invalidating any deal protections—the courts began to signal that 4-5% was at the very high end of what would be tolerated.⁶ We present empirical evidence in this Article indicating that this guidance has had the desired effect: termination fees for Delaware targets (including any additive expense reimbursement) have capped out at just below this level, thus ending “termination fee creep.”⁷ We present further evidence that average termination fees are higher in non-Delaware jurisdictions, presumably due to the lack of judicial guidance in these jurisdictions as to the permissible limits on deal protection.

But consistent with thirty years of deal protection experience⁸ and reflecting the fact that deal protections are for the most part fungible, deal protections have migrated from continued increases in termination fees to other areas where Delaware courts have signaled tolerance or have not yet provided guidance. We document three such areas in current transactional practice. First, match rights, which were unheard of in the 1990s, became ubiquitous by the 2010s. While practitioners claim that match rights should have no effect on M&A deals and while the Delaware courts have (perhaps based on these claims) signaled tolerance of match rights, we use basic game theory to document why match rights have a significant deterrent effect on prospective third-party bidders. Second, asset lockups, which disappeared from the landscape after the Delaware Supreme Court’s seminal *Revlon* decision in 1986,⁹ have reemerged. Unlike the hard-asset lockups of the 1980s, the new generation of asset lockups tends to involve intangible assets, such as licensing or service agreements. Third, and perhaps most interestingly, practitioners have begun implementing side agreements to the deal that have both a commercial purpose and a deal protection effect.

We offer three recommendations for how the Delaware courts should approach this new deal protection landscape. First, Delaware courts should clarify that deal protection must survive *Unocal*¹⁰/*Unitrin*¹¹ “preclusive” or

5. See Coates & Subramanian, *supra* note 1, at 386.

6. See *infra* notes 58-70 and accompanying text.

7. Cf. Steven M. Davidoff & Christina M. Sautter, *Lock-Up Creep*, 38 J. CORP. L. 681, 681 (2013) (coining the term “lock-up creep”).

8. See Coates & Subramanian, *supra* note 1, at 319-37 (presenting empirical evidence on substitution across different kinds of deal protections in response to Delaware case law).

9. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

10. *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946 (Del. 1985).

11. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

“coercive” analysis in addition to *Revlon* “reasonableness” review. Second, Delaware courts should apply basic game theory to identify the deterrent effect of match rights and “new economy” asset lockups. And third, Delaware courts should take a functional approach to deal protection, meaning that collateral provisions which have a deal protection effect should be scrutinized under deal protection doctrine even if these agreements have some colorable business purpose as well.

The remainder of this Article proceeds as follows: Part I provides general background on deal protection, including the business motivations for such devices and the prior literature on this topic. Part II identifies the “new look” of deal protection, relying in part on a new database of M&A transactions from 2003 to 2015. Part III provides our recommendations on how Delaware courts should refine existing deal protection doctrine to accommodate the new landscape of deal protection.

I. Background

A. Motivation for Deal Protection

In any public company acquisition, the need for shareholder and regulatory approval creates a window between the date of the deal announcement and the date the acquirer can close the deal. This window—which, based on the database used in this Article,¹² is three months on average—introduces the possibility that a higher-value bid will emerge. Because the target board’s fiduciary duty typically requires consideration of any such higher offer, the acquirer cannot eliminate this risk through contracting with the target.

Instead, the typical solution in public company M&A is “deal protection” (equivalently, a “lockup agreement”), which provides value to the first bidder in the event that the target board accepts a higher-value bid. As defined by Coates and Subramanian, a deal protection is “a term in an agreement related to an M&A transaction involving a public company target that provides value to the bidder in the event that the transaction is not consummated due to specified conditions.”¹³

12. *See infra* Part II.A.

13. Coates & Subramanian, *supra* note 1, at 310 n.2. Based on this definition, we exclude from our analysis certain developments in transactional practice that might be considered to have a deal protection effect. For example, “don’t ask, don’t waive” standstill provisions prevent a buyer from making a competing bid or requesting a waiver of the standstill provision itself. When a standstill clause is included in a merger contract, the possibility that the buyer will make a topping bid could be precluded if the target subsequently signs a merger agreement with another bidder that prohibits the waiver of the previous standstill agreement with the first bidder. The proliferation of “don’t ask, don’t waive” standstills is excluded from our analysis because such

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In the 1980s, three main types of deal protection emerged: termination fees (or equivalently, “breakup fees” or “break fees”), which gave the acquirer the right to receive a cash amount from the target in the event that the target accepted a superior offer; asset lockups, which gave the acquirer the right to buy certain assets at a specified price in the event of an overbid (typically, at a price lower than fair market value); and stock option lockups, which gave the acquirer the right to buy a specified number of the shares of the target company (typically, due to stock exchange constraints, 19.9% of the outstanding shares¹⁴) at a specified price (typically the deal price).¹⁵

Deal protection has two main effects in the M&A marketplace. First, it encourages a first bidder to bid by compensating that bidder for, among other things, opportunity costs, reputational costs, and out-of-pocket expenses.¹⁶ Second, it discourages second bidders from bidding because it siphons value out of the target company for the first bidder’s benefit in the event of an overbid.¹⁷ These two effects have directionally opposite implications for overall social welfare. The ex ante inducement effect for first bidders promotes value-enhancing deals, but the ex post deterrent effect for second bidders discourages potential bids that could increase target shareholder returns. Allocational efficiency therefore requires a balance between giving first bidders *some* deal protection to incentivize them to bid and, at the same time, not giving them *excessive* protections, which hinders competing bids. As reflected in the

provisions do not provide value to the bidder—they simply preclude a topping bid. For a discussion of these provisions, see, for example, Christina M. Sautter, *Auction Theory and Standstills: Dealing with Friends and Foes in a Sale of Corporate Control*, 64 CASE W. RES. L. REV. 521, 547-74 (2013); and Christina M. Sautter, *Promises Made to Be Broken?: Standstill Agreements in Change of Control Transactions*, 37 DEL. J. CORP. L. 929, 987-92 (2013). For a discussion of the ability of the target’s board to promise a bidder that the target will not waive a standstill provision, see, for example, Transcript of Court’s Ruling on Plaintiffs’ Motion for Preliminary Injunction at 22-29, *In re Ancestry.com Inc. S’holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012), 2012 WL 6971058, which criticizes the implementation of the “don’t ask, don’t waive” provision in this particular case but emphasizes that those provisions are not per se unenforceable; and Transcript of Telephonic Oral Argument & the Court’s Ruling at 14-22, *In re Complete Genomics, Inc. S’holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012), which invalidates a confidentiality agreement because it included a “don’t ask, don’t waive” standstill provision.

14. Using the Thomson Financial database, we estimate that approximately 60% of the deals that included a stock lockup during the 1990-2015 period involved a 19.9% threshold. Most of these lockups were granted during the 1990-2001 period.

15. See, e.g., Coates & Subramanian, *supra* note 1, at 315, 316 & fig.1.

16. See *id.* at 337.

17. See *id.*

Delaware Court of Chancery's reluctance to adopt bright-line rules¹⁸ and as other commentators have noted,¹⁹ however, it would be difficult to answer the question how much protection is too much with a specific threshold.

B. Prior Literature

There is a large body of theoretical and empirical literature on deal protection. In the realm of theory, Schwartz proposes a ban on termination fees and other deal protections to encourage ex post competition.²⁰ In contrast, Ayres, as well as Fraidin and Hanson, present theoretical models showing that under certain assumptions, deal protection should not reduce allocational efficiency in the M&A marketplace.²¹ As a result, they propose a more tolerant view of deal protections.²²

According to Ayres's model, lockups in particular reduce the reservation price (that is, the maximum bid that a bidder is willing to make) for all potential bidders.²³ This is so for the first bidder because lockups create an opportunity cost associated with increasing the bid, namely the cost of forgoing the possibility of profiting from the lockup (because that profit only materializes if the bidder loses the bidding contest).²⁴ For subsequent bidders, the lockup reduces their reservation value because it dilutes the value of the target.²⁵ Despite these effects, Ayres argues, lockups can also persuade a bidder to hold his offer open for a longer period and thus give the target board more time to create an auction.²⁶ Ayres then concludes that although a lockup itself reduces the participants' reservation price, an auction with reduced reservation prices can result in a higher bid for the target company than no auction at all.²⁷

18. See *infra* notes 58-70 and accompanying text (discussing cases signaling that deal protections around 4% are at the upper end of what is permissible in Delaware but refusing to adopt a particular threshold).

19. See *infra* Part I.B.

20. Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229, 238 (1986); see also Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 376-78 (1987) (proposing a requirement that shareholders approve lockups above reasonable negotiation expenses or involving more than 15% of the target's stock or assets).

21. See Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 696 (1990); Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1784-804 (1994).

22. See Ayres, *supra* note 21, at 696-710; Fraidin & Hanson, *supra* note 21, at 1784-804.

23. Ayres, *supra* note 21, at 688.

24. *Id.*

25. See *id.* at 694.

26. See *id.* at 696.

27. See *id.*

In Ayres's model, lockups will not necessarily benefit the target shareholders, who can be hurt if the lockup is "extreme" (that is, if it "overcompensate[s]" or provides "overinsurance" to the rightholder).²⁸ To distinguish between lockups that overcompensate and those that simply compensate the rightholder, Ayres proposes that courts determine whether the rightholder would profit more from the lockup in the event of an overbid than from the transaction at the initial offer price.²⁹ If the profit from the lockup is greater than the profit from the original transaction, the lockup would then be a form of overcompensation to the rightholder, and courts should invalidate it.³⁰ Ayres recognizes, however, that applying this criterion is difficult in practice because courts would have to calculate the profit that the rightholder would have earned from the original transaction (which is not a straightforward task because that profit is a function of the bidder's valuation of the target).³¹ Emphasizing, among other things, this practical difficulty, Fraidin and Hanson go even further and propose that virtually all lockups should be enforced.³²

Bainbridge similarly takes an accommodating view, proposing a bright-line rule that deal protection should be limited to 10% of the overall deal value.³³ To support this rule, Bainbridge argues that whether a lockup precludes competing bids is something that cannot be known *ex ante* and that a bright-line rule is therefore desirable because it creates greater certainty.³⁴ He admits, however, that this rule can be underinclusive (by allowing some preclusive lockups to be enforced) or overinclusive (by also prohibiting some nonpreclusive lockups).³⁵ Despite these limitations, he argues, the gains from greater certainty should overcome the costs.³⁶ In addition, Bainbridge argues that although any specific threshold will be arbitrary, the 10% threshold is a reasonable compromise due to legal reasons.³⁷ For example, courts have found lockups of 8% of the deal value not to be preclusive and lockups of 17% of the deal value to be preclusive.³⁸

28. *See id.* at 699, 704.

29. *See id.* at 704.

30. *See id.*

31. *Id.*

32. Fraidin & Hanson, *supra* note 21, at 1744-45, 1775-76.

33. Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 323-24 (1990).

34. *Id.* at 323.

35. *Id.*

36. *Id.* at 323-24.

37. *Id.* at 324.

38. *Id.*

In response to Bainbridge's proposal, Fraidin and Hanson point out that, in addition to being underinclusive or overinclusive, the benefits from greater certainty of the 10% rule are questionable.³⁹ Specifically, they argue that when the rule is overinclusive, it will create unnecessary costs by forcing the target board to implement additional procedural safeguards or by eliminating the lockup.⁴⁰ When the rule is underinclusive, it protects disloyal directors at the expense of the target shareholders.⁴¹ Based on these arguments, the authors conclude that the certainty of the benefits Bainbridge puts forward "is hardly a *plus*."⁴²

Kahan and Klausner take a middle-ground view. While accepting the general claim that deal protections should not influence allocational efficiency among existing bidders, they distinguish deal protections granted to first bidders from those granted to second bidders.⁴³ They argue that first-bidder deal protections can reasonably compensate for search costs and informational externalities, while second-bidder deal protections should be viewed more skeptically because they do not induce a sale process.⁴⁴

In the realm of empirical evidence, Coates and Subramanian present a model that incorporates several real-world factors, such as agency costs, tax effects, and switching costs.⁴⁵ In addition, they present evidence from U.S. deals between January 1988 and August 1999 that indicates that lockups do affect deal outcomes (they affect the likelihood that an initial bid will be consummated and thus are likely to affect allocational efficiency)⁴⁶ and use the real-world factors previously identified to explain this result.⁴⁷ Subsequent empirical

39. Fraidin & Hanson, *supra* note 21, at 1768.

40. *See id.*

41. *See id.*

42. *Id.* at 1769 (emphasis added).

43. *See* Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1551-64 (1996).

44. *See id.* at 1563-64.

45. Coates & Subramanian, *supra* note 1, at 353-64.

46. *Id.* at 313, 347-53.

47. *Id.* at 353-64.

work by Burch,⁴⁸ Bates and Lemmon,⁴⁹ and Officer⁵⁰ confirms and further elaborates on these findings with respect to U.S. M&A deals.⁵¹

II. Recent Trends in Deal Protection

This Part describes developments with respect to each of the three basic forms of deal protection. Part II.A documents developments with regard to the magnitude of termination fees, and Part II.B describes the proliferation of matching rights, which amplify the deal protection effect of termination fees. Part II.C describes the emergence of “new economy” asset lockups. Part II.D describes the emergence of financing arrangements that are the functional equivalent of old-style stock option lockups.

48. See Timothy R. Burch, *Locking out Rival Bidders: The Use of Lockup Options in Corporate Mergers*, 60 J. FIN. ECON. 103, 114-39 (2001).

49. Thomas W. Bates & Michael L. Lemmon, *Breaking Up Is Hard to Do?: An Analysis of Termination Fee Provisions and Merger Outcomes*, 69 J. FIN. ECON. 469, 478-501 (2003).

50. Micah S. Officer, *Termination Fees in Mergers and Acquisitions*, 69 J. FIN. ECON. 431, 440-61 (2003).

51. There are also empirical studies comparing deal volumes between the United States and United Kingdom, which have significantly different regulatory regimes for deal protection. In the United States, Delaware courts have signaled tolerance of termination fees in the 4-5% range. See *infra* notes 58-70 and accompanying text. In contrast, until 2011, the U.K. Takeover Panel limited termination fees to a bright-line 1% of deal value. See, e.g., CODE COMM., U.K. TAKEOVER PANEL, NO. 2010/22, REVIEW OF CERTAIN ASPECTS OF THE REGULATION OF TAKEOVER BIDS § 5.12 (2010), <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/2010-22.pdf>. Two studies find that deal volumes were significantly lower in the United Kingdom compared to the United States during this period. See John C. Coates IV, *M&A Break Fees: U.S. Litigation Versus UK Regulation*, in REGULATION VERSUS LITIGATION: PERSPECTIVES FROM ECONOMICS AND LAW 239, 261-62 (Daniel P. Kessler ed., 2011); Stefano Rossi & Paolo F. Volpin, *Cross-Country Determinants of Mergers and Acquisitions*, 74 J. FIN. ECON. 277, 280, 281 tbl.1 (2004). Coates concludes:

While many other factors may contribute to this difference, a lower bid incidence rate in the United Kingdom is consistent with the finding[] . . . that [termination fee] law inhibits some bids that might otherwise occur if the target were free to provide an initial bidder with insurance against the risk of competition.

Coates, *supra*, at 263. In 2011, the United Kingdom instituted a bright-line prohibition on termination fees. Fernán Restrepo & Guhan Subramanian, *The Effect of Prohibiting Deal Protection in M&A: Evidence from the United Kingdom 1* (Aug. 1, 2016), <https://www-cdn.law.stanford.edu/wp-content/uploads/2016/09/SSRN-id2820434.pdf>. In a current working paper, which has recently been accepted for publication by the *Journal of Law and Economics*, we find that deal volumes decreased significantly in the United Kingdom after this reform. *Id.* at 11-16. This evidence supports the view that the ex ante benefits of deal protection are nontrivial.

A. End of Termination Fee Creep

This Subpart proceeds through two discussions. The first describes the data sources and presents summary statistics and the results on termination fees. The second discusses those results.

1. Data analysis

We collect systematic data on termination fees using the FactSet Merger-Metrics database.⁵² We begin with all acquisitions of U.S. public company targets larger than \$50 million announced between 2003 and 2015. We remove deals that involved a controlling shareholder and deals in which a merger agreement was not reached or was not available. This leaves 2318 deals in our sample (the Deal Protection Sample).

For each deal in this sample, we define the magnitude of the termination fee as the maximum amount the target must pay to the acquirer in the event of termination. This equals the termination fee plus any additional amount the target is required to reimburse the acquirer for out-of-pocket expenses. Table 1 below presents cross-sectional summary statistics, and Figure 1 below shows the evolution over time of the magnitude of termination fees as a percentage of deal equity value, dividing the sample into Delaware and non-Delaware targets.

As shown in Table 1, termination fees in Delaware are lower than termination fees outside Delaware. The magnitude of the difference is not large (0.23% of deal value), but it is statistically significant at the 1% level under a *t*-test of means difference. Figure 1 also shows that the gap between Delaware and non-Delaware targets has persisted over time and that there does not seem to be any secular trend in the magnitude of the fees, regardless of whether the target is incorporated in Delaware.

To examine whether the difference between Delaware and non-Delaware targets also holds after controlling for other factors, we estimate the magnitude of the difference in a multivariate framework. The results, which are presented in Table 2 below (Models 3 and 4), show that after controlling for other deal characteristics, the point estimate of the difference declines to 0.11% of deal value but is still statistically significant at the 5% level. After including industry dummies, the difference declines again (to 0.08% of deal value), but it continues to be significant (although the significance also declines to the 10% level). In any case, these results contrast with those from the 1990s, when termination fees were actually higher in Delaware than outside Delaware.⁵³

To explore whether the magnitude of termination fees has increased over time after controlling for other deal characteristics, we include time variables

52. FACTSET MERGERS, <https://www.mergermetrics.com> (last visited Apr. 4, 2017).

53. Coates & Subramanian, *supra* note 1, at 323 tbl.4, 325.

in our multivariate specification. Because increases over time might not be linear, we used biannual dummy variables for the last decade rather than a single time trend variable.⁵⁴ As shown in Models 2, 3, and 4 of Table 2, these variables are insignificant, consistent with the finding that termination fees have stabilized in magnitude since the 2000s.

Of course, exceptions still exist, with some deals pushing the limits of what is acceptable in M&A deals.⁵⁵ However, our results suggest that those are exceptional cases. The multivariate analysis in Table 2 confirms the finding from the univariate analysis that the general “creep” in termination fee magnitude in the 1980s and 1990s seems to have stopped by the 2000s.

In unreported logistic regression models, we also examine whether the incidence of termination fees has increased over time after controlling for other deal characteristics. The answer to this question is negative. In fact, termination fees have been virtually universal during the entire sample period, and therefore the time dummies are not statistically significant.

2. Discussion

Empirical research on the magnitude of termination fees in the 1980s and 1990s documented gradual “creep” during this timeframe.⁵⁶ Our finding that termination fees have leveled out at 3-4% of deal value suggests that this creep did not persist in the 2000s.

A series of Delaware Court of Chancery opinions over the past fifteen years provides a likely explanation for this change in trajectory. Until 1999, the Delaware courts had not provided guidance to practitioners on the permissible limits for termination fees. Practitioners therefore pushed the envelope in pursuit of their clients’ business objectives (on both sides of the table) to protect the deal from third-party competition.⁵⁷

54. The results are qualitatively the same if we use annual dummies for the last decade rather than biannual dummies.

55. *See, e.g., Baxter v. Syntroleum Corp.*, No. CJ-2013-5807, 2015 Okla. Dist. LEXIS 4, at *1-2, *17 (Okla. Dist. Ct. Oct. 6, 2015) (denying a motion to dismiss a challenge to a \$5 million termination fee in the sale of Syntroleum, a Delaware corporation, which amounted to 10.1% of deal value).

56. *See, e.g., Coates & Subramanian, supra* note 1, at 335 fig.2.

57. *See, e.g., id.* at 334 n.90 (“The percentage that is okay has slowly risen. A year ago, two years ago, people were talking about two percent, two-and-a-half percent. Now, you hear them talking about three, three-and-a-half percent. Some are even saying four percent. You sit there and ask, ‘On what basis are you doing that? Where did you get that number?’ There hasn’t been a specific challenge, so everybody pushes the envelope.” (quoting Interview with Richard I. Beattie, *supra* note 4, at 3)); *id.* (“I think it’s been creeping up. I used to think of it as 2%. Now I think of it as 2-3%. Until somebody comes down with a bright line, people tend to keep pushing, and pushing, and pushing.”

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In 1999, without actually invalidating any termination fees, the Delaware courts began signaling what the permissible limits would be. In *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, the court criticized a 6.3% termination fee as “seem[ing] to stretch the definition of range of reasonableness . . . beyond its breaking point.”⁵⁸ On this occasion, however, the court did not analyze in depth whether the 6.3% termination fee was preclusive because that issue was not necessary to determine whether to grant preliminary injunctive relief.⁵⁹

In *In re Topps Co. Shareholders Litigation*, the court upheld a 4.3% termination fee but called it “a bit high in percentage terms.”⁶⁰ In upholding the termination fee, the court noted that the fee included an expense reimbursement and that the deal was relatively small.⁶¹ Based on these factors, the court found the fee reasonable: “At 42 cents a share, the termination fee (including expenses) is not of the magnitude that I believe was likely to have deterred a bidder with an interest in materially outbidding [the first bidder].”⁶²

In *In re Answers Corp. Shareholders Litigation*, the court described a termination fee of 4.4% of deal equity value as “near the upper end of a ‘conventionally accepted’ range.”⁶³ The court noted that to measure the impact of deal protection devices, it is necessary to take into account their cumulative effect, and in this particular case, according to the court, the plaintiffs did not offer any reason to conclude that, on a cumulative basis, the protections were preclusive.⁶⁴ In addition, similar to the *Topps* court, the court stressed that the deal was relatively small and that the termination fee was not “atypical” for that particular kind of deal.⁶⁵

Finally, in *In re Comverge, Inc. Shareholders Litigation*, the court characterized a 5.6% termination fee as “test[ing] the limits of what this Court has found to be within a reasonable range for termination fees.”⁶⁶ In this case, the merger

Three’s okay, so three-and-a-half can’t be that bad.” (quoting Interview with Benjamin F. Stapleton, Partner, Sullivan & Cromwell, in N.Y.C. 1 (Aug. 10, 1999)).

58. Transcript of Afternoon Session, *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, No. Civ.A. 17398, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999).

59. *See id.*

60. 926 A.2d 58, 86 (Del. Ch. 2007).

61. *Id.*

62. *Id.*

63. *In re Answers Corp. S’holders Litig.*, C.A. No. 6170-VCN, 2011 WL 1366780, at *4 n.52 (Del. Ch. Apr. 11, 2011).

64. *Id.* at *4.

65. *Id.* at *4 n.52.

66. *In re Comverge, Inc. S’holders Litig.*, C.A. No. 7368-VCP, 2014 WL 6686570, at *14 (Del. Ch. Nov. 25, 2014); *see also* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 575 (4th ed. 2012) (“Lump-sum termination payments no larger than 3 to 4 percent of the deal price are easily rationalized as a means to assure

footnote continued on next page

agreement provided for a two-tier termination fee under which Comverge (the target company) would pay HIG (the bidder) \$1.206 million if Comverge entered into a superior transaction during the go-shop period and \$1.93 million if it did so after the expiration of the go-shop period.⁶⁷ In addition, Comverge would reimburse HIG for expenses up to \$1.5 million in either scenario.⁶⁸ The total payable to HIG would then be 5.6% of the deal equity value before the expiration of the go-shop period and 7% afterward.⁶⁹ The court noted that even the lower bound of this range was high and further added that this was true even for microcap acquisitions (where, as reflected in the opinions discussed above, there is somewhat more flexibility with respect to the size of termination fees).⁷⁰

Practitioners seem to have gotten the message. We document that termination fees have leveled out just below what the Delaware courts signaled would be permissible (approximately 4% of deal value, the lower bound of the termination fees criticized by the Court of Chancery). To the extent this interpretation is correct,⁷¹ our finding is consistent with prior work showing that the magnitude and structure of deal protection is highly responsive to the Delaware case law in general.⁷² Not surprisingly, practitioners read the Delaware case law and incorporated the signals that were sent from the bench into their deals.

For those who favor a relatively open market for corporate control, all of this might be viewed as good news: the end of termination fee creep means that barriers to potential third-party bidders have plateaued, which leads to a more open market for corporate control and greater allocational efficiency in the M&A marketplace. A less benign interpretation of the data is that deal protections have plateaued at a higher level than is required to motivate first

that a would-be acquirer will recover its transaction expenses (including opportunity costs) if the favored contract does not close.”); *id.* at 575 n.54 (“There have been indications, however, that courts will question the bona fides of amounts beyond a certain range (perhaps 4 to 5 percent of the deal price).”).

67. *In re Comverge*, 2014 WL 6686570, at *14.

68. *Id.*

69. *Id.*

70. *Id.*

71. Of course, there are other potential factors that might explain the lower fees in Delaware. For example, it might be possible that legal advisors of non-Delaware firms know less about the limits that Delaware will tolerate and therefore deals outside Delaware result in higher termination fees. However, the fact that termination fees in Delaware were actually higher than those outside Delaware in the 1990s (before the Court of Chancery started signaling that 4% was at the high end of what courts would tolerate) suggests that the Delaware case law did in fact have an effect on termination fees.

72. See Coates & Subramanian, *supra* note 1, at 316 fig.1.

bidders. In favor of this latter interpretation, it is not obvious why 1-2% of deal value was sufficient to motivate first bidders to come to the table in the 1980s, but 3-4% of deal value was required by the 1990s. In a parallel paper, we report evidence from the 2011 reforms to the U.K. Takeover Code suggesting that a termination fee of as little as 1% of deal value might be a sufficient incentive to attract first bidders.⁷³ In our opinion, termination fees have leveled out in a place where the ex post costs (reducing third-party competition) are likely to outweigh the ex ante benefits (inducing first bidders to bid). This becomes particularly true when one considers the interaction between the growth of termination fees and the proliferation of match rights, to which we now turn.

Table 1
Summary Statistics

Variable	Delaware Targets	Non-Delaware Targets	Difference (NDE - DE)
Termination fee magnitude (as % of deal value)	3.56 (1.01)	3.79 (1.12)	0.23***
Termination fee	0.98 (0.15)	0.98 (0.12)	0.01
Match right	0.89 (0.31)	0.84 (0.37)	-0.05***
Match period	3.86 (1.12)	4.17 (1.48)	0.32***
Expense reimbursement	0.77 (0.60)	0.80 (0.67)	0.03
Expense reimbursement in favor of bidder	0.43 (0.50)	0.43 (0.49)	-0.01
Transaction value	2540.45 (6252.84)	1826.92 (5430.34)	-713.53***
All-cash	0.67 (0.47)	0.51 (0.50)	-0.16***
Percentage of shares sought	98.77 (6.10)	99.38 (4.16)	0.61***
Friendly deal	0.95 (0.22)	0.97 (0.18)	0.02**
Same industry	0.08 (0.27)	0.04 (0.20)	-0.04***
Tender offer	0.24 (0.43)	0.11 (0.31)	-0.13***
MBO	0.01 (0.12)	0.02 (0.14)	0.00
Private equity	0.19 (0.39)	0.14 (0.34)	-0.05***
Auction	0.37 (0.48)	0.43 (0.50)	0.06***
Go-shop	0.09 (0.29)	0.07 (0.25)	-0.03**
Special committee	0.27 (0.44)	0.25 (0.43)	-0.02
<i>N</i>	1428	890	

Table 1 presents summary statistics. The dataset includes all mergers and acquisitions over \$50 million with available merger agreements between January 2003 and December 2015. “Termination fee magnitude” is the ratio of the maximum termination fee payable by the target to deal value. This value is winsorized at 1% to mitigate the influence of outliers. “Termination fee” is a dummy variable for the presence of a termination fee. “Match right” is a dummy

73. See Restrepo & Subramanian, *supra* note 51, at 17.

variable for the presence of a match right. “Match period” is the period in days that the first bidder has to match a competing bid. “Expense reimbursement” is the ratio of the maximum amount the target must reimburse the bidder for out-of-pocket expenses in the event the transaction is terminated to deal value. “Expense reimbursement” is a dummy variable for the presence of an expense reimbursement provision in favor of the bidder. “Transaction value” is the magnitude of the transaction value in millions of dollars. “All-cash,” “Friendly deal,” “Same industry,” “Tender offer,” “MBO,” “Private equity,” “Auction,” “Go-shop,” and “Special committee” are dummy variables for deals in which the consideration structure was exclusively cash, deals in which the attitude of the bidder was friendly (as opposed to “hostile” or “unsolicited”), deals in which the target and the acquirer had the same first-digit standard industry classification (SIC) code, deals in which the transaction was a tender offer, deals that were management buyouts, deals in which the acquirer was a private equity firm, deals that involved an auction, deals that included a go-shop provision, and deals in which the target formed a special committee of independent directors, respectively. The table reports mean values with standard deviation in parentheses. ** significant at 5%; *** significant at 1%.

Table 2
Regression Estimates on the Association Between the Magnitude of Breakup Fees and Target and Deal Characteristics

Variable	Model 1	Model 2	Model 3	Model 4
Delaware	-0.229*** (0.05)		-0.109** (0.05)	-0.084* (0.05)
2006-2007 dummy		-0.076 (0.06)	-0.047 (0.06)	-0.035 (0.06)
2008-2009 dummy		0.134 (0.09)	0.068 (0.09)	0.098 (0.09)
2010-2011 dummy		0.028 (0.08)	0.058 (0.08)	0.085 (0.08)
2012-2013 dummy		0.013 (0.08)	-0.004 (0.08)	0.015 (0.08)
2014-2015 dummy		-0.090 (0.07)	0.007 (0.07)	0.030 (0.07)
Log(value)			-0.196*** (0.01)	-0.188*** (0.02)
All-cash			-0.176*** (0.05)	-0.155*** (0.05)
Shares sought (%)			-0.008 (0.01)	-0.008 (0.01)

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69 STAN. L. REV. 1013 (2017)

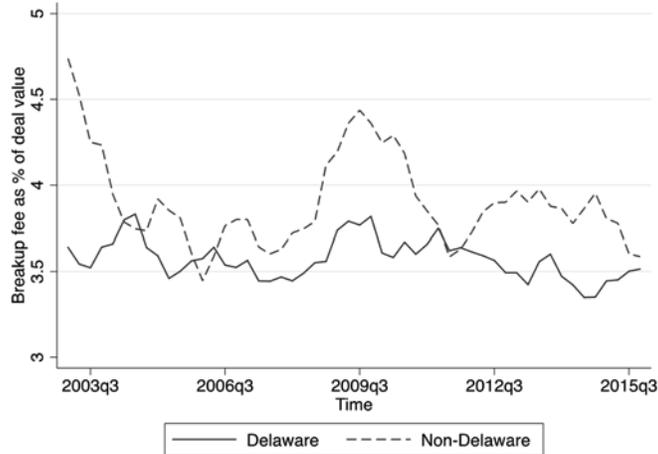
Friendly			0.140 (0.14)	0.127 (0.14)
Same industry			0.027 (0.10)	0.028 (0.10)
Tender offer			0.035 (0.06)	0.060 (0.06)
MBO			-0.056 (0.27)	-0.069 (0.27)
Private equity			0.093 (0.08)	0.046 (0.08)
Auction			0.118** (0.05)	0.109** (0.05)
Go-shop			-0.018 (0.10)	-0.020 (0.10)
Special committee			-0.119** (0.05)	-0.129** (0.05)
<i>R</i> -squared	0.011	0.004	0.107	0.116
<i>F</i> -statistic	24.262	1.755	15.715	12.578
Prob > <i>F</i>	0.000	0.119	0.000	0.000
Industry dummies	No	No	No	Yes
<i>N</i>	2273	2273	2273	2273

This table reports regression estimates on the association between termination fees as a percentage of deal value and the target's state of incorporation dummy, biyearly time dummies, and other characteristics of the transaction. The variables are defined as described in the legend of Table 1. The dependent variable is winsorized at 1% to avoid the influence of outliers, but the results are similar if the regressions are run as truncated regressions (that is, if observations with termination fees over 10% of deal value are eliminated). For the purposes of the time dummies, the excluded period is 2003-2005. In Model 4, the industry dummies are based on the target's macroindustry classification (the first digit of the target's SIC code). All the regressions are run using ordinary least squares with heteroskedasticity-consistent standard errors in parentheses. * significant at 10%; ** significant at 5%; *** significant at 1%.

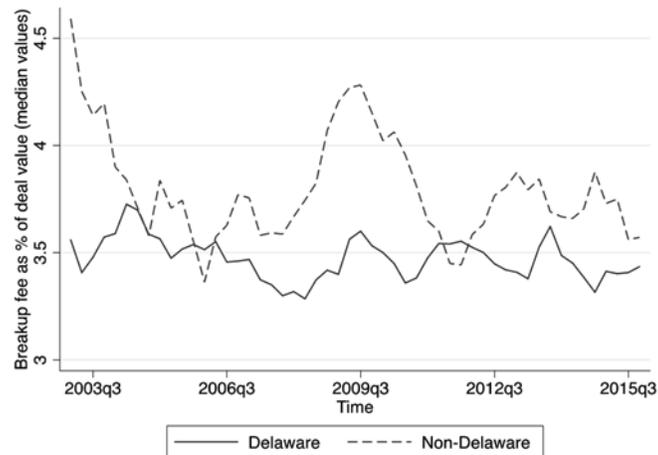
Figure 1

Termination Fees to Deal Value over Time

Panel A. Quarterly mean of termination fees to deal value (2003-2015)



Panel B. Quarterly median of termination fees to deal value (2003-2015)



The plot presents the evolution of the quarterly average and quarterly median of the ratio of termination fees to deal value for all mergers and acquisitions over \$50 million announced between 2003 and 2015. The data are smoothed by a moving average of four periods. Only deals with merger agreements available are considered. Fees are winsorized at 1%, but the pattern is similar without winsorization or if we truncate the data at termination fees over 10% of deal value. Panel A shows quarterly means, and Panel B shows quarterly medians.

B. Proliferation of Match Rights

Match rights (or “matching rights”) are contractual provisions that give a bidder the right to match a competing offer. Based on our database, a match right typically requires the target to notify the first bidder of any competing offer and negotiate in good faith for three to five days to see if the first bidder can match or beat the competing bid. We distinguish match rights from information rights, which merely require the target to share information about subsequent bids with the initial bidder but do not create any obligation to engage in negotiations with the first bidder.

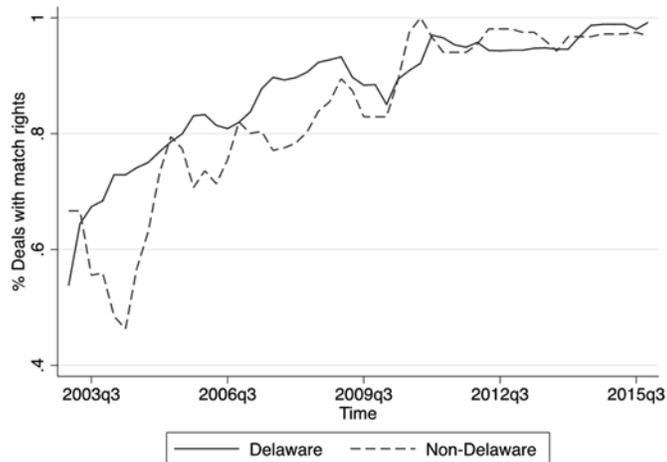
Using the Deal Protection Sample, we examine the incidence and duration of match rights. Figure 2 below reports the results, again divided between Delaware and non-Delaware targets. Panel A reports that match rights have gone from approximately 60% of deals in 2003 to virtually 100% of deals by 2015. What is interesting is not the fact that match rights are virtually ubiquitous today; that is well known among practitioners. Rather, what is noteworthy is the fact that match rights were *not* a nearly universal protection as recently as 2006—appearing in only about two-thirds of deals in that year.

Panel B shows that when match rights are granted, Delaware deals generally have shorter match rights than non-Delaware deals. The difference was widest at the beginning of the sample period and smaller by the end. Overall, the average match right duration is 3.86 days in Delaware and 4.17 days outside Delaware. In either a *t*-test of means difference or a nonparametric Kruskal-Wallis test, this difference is statistically significant at 1% confidence.

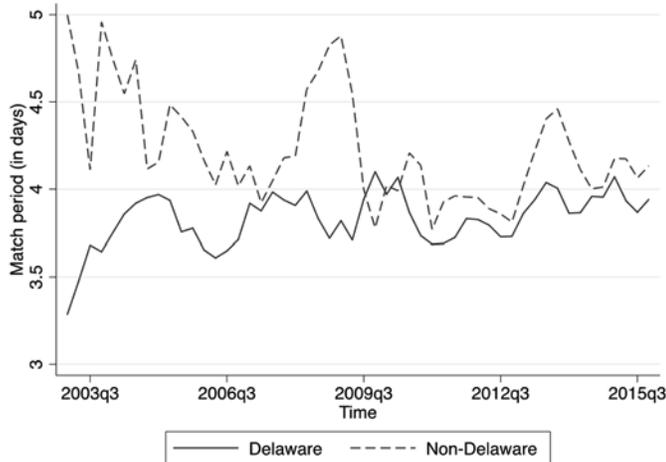
Figure 2

Match Rights over Time

Panel A. Quarterly incidence of match rights (2003-2015)



Panel B. Quarterly average of match period (2003-2015)



The plot presents the evolution of the quarterly incidence of match rights and the quarterly mean of the match period for all mergers and acquisitions over \$50 million with merger agreements available that were announced between 2003 and 2015. The data are smoothed by a moving average of four quarters.

Table 3 below shows that the patterns presented in Figure 2 hold after controlling for other factors. We run a logit regression model in which the

dependent variable is a dummy variable for the presence of a match right and the independent variables include time dummies. In Model 2, only those dummies are included in the right-hand side of the equation, and Model 3 includes other deal characteristics in addition to the time dummies. Similar to the models presented in Table 2, Table 3 does not include a unique time trend variable because the relationship between time and the incidence of match rights is not necessarily monotonic (which is confirmed by Figure 2).

As shown in Table 3, the time dummies are positive and significant at 1%, confirming that the increase of match rights over the 2000s holds after controlling for observable deal characteristics. As with termination fees, in unreported estimations we also run the regressions using annual dummies rather than biannual dummies. Consistent with the reported results, the dummies are positive, each is individually significant, and they are jointly significant at 1% (chi-square = 116.19). The results are similar when we include industry dummies in the regressions (Model 4).

The regression results also show that the difference between Delaware and other states in the incidence of match rights is not very robust. In particular, the simple regression in Model 1 suggests that the incidence of match rights is higher in Delaware than outside Delaware, but this difference becomes significant only at 10% in the full regression model (Model 3) and not significant in the full regression model that includes industry dummies (Model 4).

We also test the univariate finding that the duration of the matching period is shorter in Delaware deals than in non-Delaware deals. In the multivariate specification, we use the duration of the match right (number of days) as the dependent variable and the same independent variables as in Model 3 of Table 3. In unreported regressions, we find a statistically significant difference between Delaware and non-Delaware targets. In particular, in multivariate Poisson regression models, the *Delaware* variable is negative and significant at 1% in all the specifications. The finding is similar if we run the regression as an ordered logit or using ordinary least squares (OLS) with heteroskedasticity-consistent standard errors.⁷⁴ When we include industry dummies, the *Delaware* variable is significant at 5% in the Poisson and OLS models and at 10% in the ordered logit model. When we truncate the match period at five days and also include industry dummies, however, the *Delaware* variable is not significant in any of the models.

74. The result also holds if we truncate the maximum match period at five days, although in that case, the difference between Delaware and non-Delaware targets in the multivariate models is significant at 5%.

Table 3
Regression Estimates on the Association Between Match Rights and Target and Deal Characteristics

Variable	Model 1	Model 2	Model 3	Model 4
Delaware	1.528*** (0.19)		1.281* (0.18)	1.012 (0.16)
2006-2007 dummy		1.832*** (0.27)	1.602*** (0.25)	1.647*** (0.27)
2008-2009 dummy		3.014*** (0.67)	2.912*** (0.68)	2.821*** (0.67)
2010-2011 dummy		7.229*** (1.99)	6.273*** (1.78)	5.880*** (1.69)
2012-2013 dummy		7.033*** (2.00)	6.652*** (1.95)	7.110*** (2.12)
2014-2015 dummy		18.731*** (7.40)	19.654*** (7.88)	20.460*** (8.26)
Log(value)			1.196*** (0.05)	1.163*** (0.05)
All-cash			2.445*** (0.39)	2.077*** (0.36)
Shares sought (%)			0.998 (0.01)	0.997 (0.01)
Friendly			1.701 (0.59)	1.745 (0.61)
Same industry			1.195 (0.38)	0.987 (0.33)
Tender offer			1.173 (0.28)	1.062 (0.26)
MBO			0.871 (0.45)	0.824 (0.44)
Private equity			1.135 (0.28)	1.180 (0.31)
Auction			1.544*** (0.24)	1.708*** (0.27)
Go-shop			0.735 (0.23)	0.714 (0.23)
Special committee			0.755 (0.13)	0.731* (0.13)
Log-likelihood	-891.125	-806.809	-762.647	-735.432
Pseudo R-squared	0.006	0.100	0.150	0.180
LR chi-squared	11.547	180.178	268.503	322.932
Prob > chi-squared	0.001	0.000	0.000	0.000
Industry dummies	No	No	No	Yes
N	2318	2318	2318	2318

This table reports regression estimates on the association between the inclusion of match rights in a merger agreement and the target's state of incorporation, time variables, and other deal characteristics. The variables are defined as

described in the legend of Table 1. For the purposes of the time dummies, the excluded period is 2003-2005. In Model 4, the industry dummies are based on the first digit of the target's SIC code. All of the models are run as logistic regressions. The coefficients are odds ratios, and the standard errors are in parentheses. * significant at 10%; ** significant at 5%; *** significant at 1%.

C. Emergence of “New Economy” Asset Lockups

In addition to the proliferation of matching rights, another development in transactional practice is the reemergence of asset lockups. An “asset option” or “asset lockup” is an option given to the acquirer to buy certain assets of the target company at a specified price. If the assets are key assets of the target company or “crown jewels,” the asset lockup is referred to as a “crown jewel lockup.”⁷⁵ Asset lockups were apparently common in the 1980s until the Delaware courts struck down crown jewel asset lockups in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁷⁶ and *Mills Acquisition Co. v. Macmillan, Inc.*⁷⁷ Asset lockups were “rare” in the immediate aftermath of *Revlon* and *Macmillan* and “extinct” by the 1990s.⁷⁸

In the 1980s, asset lockups could help protect a deal by giving the buyer the right to buy certain key assets for less than market value, thereby siphoning value out of the company in the event a higher-value bidder appeared.⁷⁹ When the Delaware courts made clear in *Revlon* and other cases that asset lockups would be scrutinized carefully,⁸⁰ their deal protection effect diminished and

75. See, e.g., Davidoff & Sautter, *supra* note 7, at 682.

76. 506 A.2d 173, 176, 182-83 (Del. 1986). As discussed in Part I.D.2 above, the asset lockup involved in *Revlon* was less than fair market value. *Id.* at 178. The Delaware Supreme Court concluded that an asset lockup of that nature had a preclusive effect on the bidding process and therefore invalidated the protection device. *Id.* at 182. In the words of the Delaware Supreme Court: “A lock-up is not *per se* illegal However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders’ detriment.” *Id.* at 183.

77. 559 A.2d 1261, 1264, 1286 (Del. 1989); see also Coates & Subramanian, *supra* note 1, at 326-27 (discussing asset lockup incidence during the 1980s).

78. Coates & Subramanian, *supra* note 1, at 327.

79. For a discussion of the use of asset lockups in the 1980s, see *id.* at 328 n.54. “If you’re talking about [asset] lockups, early 80s, it was the wild west. We were doing preclusive crown jewel options and all sorts of stuff, and I just don’t think the law now lets you do that.” *Id.* (alteration in original) (quoting Interview with Robert E. Spatt, Partner, Simpson Thacher & Bartlett, in N.Y.C. 4 (Aug. 11, 1999)). For a discussion of the deal protection effect of asset lockups, see Part I.A above.

80. See Coates & Subramanian, *supra* note 1, at 328 n.54 (“I’m not saying that there are no situations where you can do an asset lockup, but the courts seem to frown on that
footnote continued on next page”)

practitioners migrated to other, cleaner (or less subject to judicial scrutiny) deal protection devices such as stock option lockups (until pooling accounting disappeared in 2001⁸¹) and termination fees.⁸²

This changed in 2008. Dating back at least to JPMorgan's acquisition of Bear Stearns and continuing through a series of deals into the 2010s, practitioners returned to the old religion of asset lockups. While systematic evidence does not exist for asset lockups as it does for termination fees, expense reimbursement, and match rights,⁸³ the following examples suggest that asset lockups are back after a thirty-year hiatus:

JPMorgan-Bear Stearns (2008). As the first signs of the financial crisis began to appear in March 2008, JPMorgan (JPM) agreed to buy Bear Stearns for \$2 of JPM stock for each share of Bear Stearns stock.⁸⁴ The deal included an asset lockup in the form of an option for JPM to buy Bear Stearns's Manhattan headquarters for \$1.1 billion in the event that Bear Stearns terminated the deal.⁸⁵ When JPM raised its offer to \$10 of JPM stock, the parties further agreed that JPM could exercise the asset option even if Bear Stearns shareholders voted down the merger agreement.⁸⁶ Attorneys for Bear Stearns shareholders filed suit to challenge the option, arguing that it should be considered deal protection because the \$1.1 billion strike price was lower than

generally, though they could be lawful under some circumstances." (quoting Interview with Stephen R. Volk, Managing Partner, Shearman & Sterling, in N.Y.C. 3 (Aug. 11, 1999)).

81. See *infra* Part II.D.

82. Coates & Subramanian, *supra* note 1, at 315-16, 316 fig.1, 324-26 (discussing the decreasing popularity of asset lockups in the late 1980s and the 1990s and the increasing use of termination fees during the 1990s).

83. The MergerMetrics and Thomson Financial databases both have a field called "Asset Lockup," but neither of these databases seems to capture asset lockups systematically. During our sample period, MergerMetrics only identifies the Bear Stearns asset lockup. Thomson Financial only identifies the AuthenTec asset lockup. Even the unsystematic list reported in this Part reveals that neither database is comprehensive.

84. Bear Stearns Cos., Agreement and Plan of Merger, Dated as of Mar. 16, 2008, by and Between the Bear Stearns Companies Inc. and JPMorgan Chase & Co. (Exhibit 2.1 to Form 8-K), § 1.4(c) (Mar. 20, 2008); JPMorgan Chase & Co., Press Release, Dated March 16, 2008 (Exhibit 99.1 to Form 8-K), at 1 (Mar. 17, 2008) (announcing the merger agreement).

85. Bear Stearns Cos., *supra* note 84, § 6.11.

86. See *In re Bear Stearns Cos. S'holder Litig.*, C.A. No. 3643-VCP, 2008 WL 959992, at *3 (Del. Ch. Apr. 9, 2008); see also Bear Stearns Cos., Amendment No. 1, Dated as of March 24, 2008, to the Agreement and Plan of Merger, Dated as of March 16, 2008, by and Between JPMorgan Chase & Co. and the Bear Stearns Companies Inc. (Exhibit 2.1 to Form 8-K), § 2.9 (Mar. 24, 2008) (amending the asset option of the merger agreement).

the fair value of the building.⁸⁷ The Delaware Court of Chancery declined to rule on this claim, staying the Delaware action in favor of a concurrent New York action (notwithstanding the parties' choice of Delaware law).⁸⁸ The New York court, applying Delaware law, rejected the challenge to the option on the ground that the evidence did not support the claim that the price was below fair value.⁸⁹

Apple-AuthenTec (2012). Apple agreed to acquire AuthenTec for \$358 million in cash, with an \$11 million termination fee (3.1% of deal value) if AuthenTec terminated the deal to accept a higher offer.⁹⁰ The parties also included a side agreement with a deal protection effect, which specified that Apple would pay \$20 million for the option to acquire a nonexclusive license to certain fingerprint recognition technologies (the New Technologies), regardless of whether the merger was consummated.⁹¹ Apple could exercise this option within 270 days after the deal announcement by paying an additional \$115 million.⁹² In total, Apple could pay \$135 million (38% of the total acquisition price) to acquire a nonexclusive license to the New Technologies regardless of whether the acquisition went through.⁹³ According to AuthenTec's proxy statement, AuthenTec "ensure[d] that the terms of the IP agreement and the development agreement were commercially acceptable to the Company independently from the proposed transaction."⁹⁴

87. *In re Bear Stearns Cos.*, 2008 WL 959992, at *2 n.8; Consolidated Amended Class Action Complaint ¶¶ 4, 7, 55, 57, 86, *In re Bear Stearns Litig.*, 870 N.Y.S.2d 709 (Sup. Ct. 2008) (No. 600780/80).

88. *In re Bear Stearns Cos.*, 2008 WL 959992, at *1, *6 ("What is paramount is that this Court not contribute to a situation that might cause harm to a number of affected constituencies, including U.S. taxpayers and citizens, by creating the risk of greater uncertainty.").

89. *In re Bear Stearns*, 870 N.Y.S.2d at 734-35.

90. AuthenTec, Inc., Agreement and Plan of Merger, Dated July 26, 2012, Among AuthenTec, Inc. and Bryce Acquisition Corporation (Exhibit 2.1 to Form 8-K), § 8.3 (July 27, 2012). There were 44,744,222 outstanding common shares at announcement and the price per share was \$8. *See id.* §§ 3.1(c), 4.3(a). This implies that the deal value was about \$358 million (44,744,222 shares × \$8/share ≈ \$358 million).

91. AuthenTec, Inc., Current Report (Form 8-K), item 1.01, at 3 (July 27, 2012) [hereinafter AuthenTec Current Report]; AuthenTec, Inc., Intellectual Property and Technology Agreement, Dated July 26, 2012, Between AuthenTec, Inc. and Apple Inc. (Exhibit 10.1 to Form 8-K), §§ 1.1, 2.2, exh. A § 1.6 (July 27, 2012) [hereinafter Apple-AuthenTec IP & Technology Agreement].

92. AuthenTec Current Report, *supra* note 91, item 1.01, at 3; *see also* Apple-AuthenTec IP & Technology Agreement, *supra* note 91, § 8.1.

93. This figure is calculated as: (\$135 million / \$358 million) × 100 ≈ 37.7%.

94. AuthenTec, Inc., Definitive Proxy Statement (Schedule 14A), at 23 (Aug. 31, 2012) [hereinafter AuthenTec Proxy Statement]. On July 30, 2012, AuthenTec shareholders filed the first of several putative class action lawsuits against AuthenTec's directors, claiming that the defendants breached their fiduciary duties by agreeing to sell the company to Apple for \$8 per share and that Apple aided and abetted the alleged

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Intercontinental Exchange-NYSE Euronext (2012). Intercontinental Exchange (ICE) agreed to acquire NYSE Euronext for \$8.0 billion in cash and stock, with a \$450 million termination fee (amounting to 5.6% of deal value) if NYSE Euronext terminated the deal to accept a superior proposal.⁹⁵ In addition, the parties entered into a side agreement that performed the role of an asset lockup, whereby ICE would be the exclusive provider of certain clearing services for the London market of NYSE Liffe (an affiliate of NYSE Euronext), regardless of whether the acquisition was completed.⁹⁶ The parties emphasized that, despite the potential deterrent effect on competing bidders, the side deal had an independent business purpose. According to Finbarr Hutcheson, co-CEO of NYSE Liffe: “This agreement will enable [NYSE Liffe] to deliver top quality clearing services through a proven futures and OTC clearing house that can securely and efficiently serve our customers, while creating new clearing opportunities.”⁹⁷

Turtle Beach-Parametric Sound (2013). Turtle Beach agreed to acquire Parametric Sound for \$78 million, with a \$1 million termination fee (1.3% of deal value) if Parametric terminated the deal to accept a superior proposal.⁹⁸ In addition, the parties entered into a separate licensing agreement that provided

breaches. Stipulation & Agreement of Compromise and Settlement ¶¶ 1-2, *In re AuthenTec, Inc. S'holder Litig.*, No. 05-2012-CA-57589 (Fla. Cir. Ct. July 14, 2016). The class action settled on July 14, 2016. *Id.* at 1. As part of the settlement, AuthenTec's shareholders who owned shares in the company as of October 4, 2012 (when the transaction closed) were entitled to receive additional payment. *Id.* ¶¶ 5, 19(a), 22(a), 22(c). The Circuit Court for the Eighteenth Judicial Circuit in Brevard County, Florida preliminarily approved the settlement on August 2, 2016. Order Preliminarily Approving Settlement, Providing for Notice & Scheduling a Final Settlement Hearing ¶ 5, *In re AuthenTec*, No. 05-2012-CA-57589 (Fla. Cir. Ct. Aug. 2, 2016).

95. NYSE Euronext, Agreement and Plan of Merger, Dated as of December 20, 2012, by and Among NYSE Euronext, InterContinentalExchange, Inc. and Baseball Merger Sub, LLC (Exhibit 2.1 to Form 8-K), §§ 3.1(b), 6.5(b)(iii) (Dec. 20, 2012) [hereinafter Intercontinental-NYSE Merger Agreement] (showing that there were 242,607,620 outstanding shares of NYSE on December 18, 2012 and mentioning the \$450 million termination fee); NYSE Euronext, Current Report (Form 8-K), item 1.01, at 1 (Dec. 20, 2012) (mentioning that the merger consideration was \$33.12 per share). The deal value was thus approximately \$8 billion ($\$33.12/\text{share} \times 242,607,620 \text{ shares} \approx \8 billion).

96. Intercontinental Exchange, Inc., Joint Press Release of IntercontinentalExchange, Inc. and NYSE Euronext Regarding Entry into a Clearing Services Agreement, Dated Dec. 20, 2012 (Exhibit 99.3 to Form 8-K), at 1 (Dec. 20, 2012).

97. *Id.*

98. Parametric Sound Corp., Agreement and Plan of Merger Dated August 5, 2013, Among Parametric, Merger Sub and Turtle Beach (Exhibit 2.1 to Form 8-K), § 8.3 (Aug. 5, 2013) [hereinafter Turtle Beach-Parametric Merger Agreement]. The merger agreement also included certain voting agreements with significant shareholders, who collectively held 19.2% of the Parametric shares, requiring these shareholders to vote in favor of the merger. Parametric Sound Corp., Definitive Proxy Statement (Schedule 14A), at 15 (Dec. 3, 2013) [hereinafter Parametric Sound Proxy Statement].

Turtle Beach with exclusive and nonexclusive licenses to Parametric's technologies even if the deal was not consummated.⁹⁹ This side agreement was termed the "Break-Up Fee License Agreement" in the Proxy Statement.¹⁰⁰ It provided that if Parametric terminated the deal to accept a superior proposal, Parametric would have to provide Turtle Beach with (1) an *exclusive* (even as to Parametric) worldwide license to Parametric's HyperSound technology in the "console audio products field" and (2) a *nonexclusive* worldwide license to Parametric's HyperSound technology in the "computer audio products field."¹⁰¹ The price of this asset lockup would be royalty payments: Parametric would receive a 6% royalty on net sales of such products and 30% from any sublicenses that Turtle Beach negotiated.¹⁰² The minimum term of the Break-Up Fee License Agreement was ten years, with a minimum royalty payment of \$2 million during the first five years and \$1 million each year after that (for a total minimum royalty payment of \$7 million).¹⁰³ If Turtle Beach failed to pay the minimum royalty payments, Parametric had the right to convert the gaming license to nonexclusive.¹⁰⁴

Table 4 below summarizes the asset lockups in the deals described above. In each instance, the acquirer obtained assets in the event of nonconsummation: either licenses (AuthenTec and Parametric), services arrangements (NYSE Euronext), or hard assets (Bear Stearns). This list is based on our own unsystematic survey and is not meant to be comprehensive. Because asset lockups can appear in side agreements to the deal, they are difficult to detect systematically, and it is very likely that the full list is longer. We do not claim

99. Turtle Beach-Parametric Merger Agreement, *supra* note 98, exh. E, § 2.1.

100. Parametric Sound Proxy Statement, *supra* note 98, at 99.

101. *Id.* at 99. The "console audio products field" was defined as:

gaming headsets and peripheral audio speakers that are (i) marketed specifically to be used in connection or combination with an entertainment console (including desktop consoles and mobile consoles), one of whose principal features is digital gaming, and (ii) which are designed to be connected directly to such entertainment consoles (including via audio cable, wireless or other future technology) or which are incorporated into such entertainment consoles.

Id. at 99-100. The "computer audio products field" was defined as:

headsets and peripheral audio speakers that are (i) marketed specifically to be used in connection or combination with personal computers . . . including desktop computers, laptop computers and mobile personal computing devices such as tablets, smartphones and other portable computing devices or future technologies similar to the foregoing and (ii) are designed to be connected directly to such devices (including via audio cable, wireless or other future technology).

Id. at 100.

102. *Id.* at 100.

103. *See id.*

104. *Id.* ("Parametric's right to convert such exclusive license to a non-exclusive license would be Parametric's sole remedy if [Turtle Beach] has not paid the minimum royalty.").

that asset lockups are present in a significant fraction of overall M&A deal volume. Nevertheless, even our partial list suggests that asset lockups have reemerged as part of the deal protection toolkit in a way not seen since the 1980s.

Table 4
Asset Lockups

Acquirer-Target	Date Announced	Deal Value (\$M)	Termination Fee (Percent of Deal Value)	Asset Lockup Description
JPMorgan-Bear Stearns	March 2008	\$1456	None	Option for JPM to buy Bear's Manhattan headquarters for \$1.1 billion
Apple-AuthenTec	July 2012	\$358	3.1	Option to buy nonexclusive license to certain fingerprint recognition software for \$115 million
Intercontinental Exchange-NYSE Euronext	December 2012	\$8035	5.6	ICE would be exclusive provider of certain clearing services for NYSE's European derivatives segment
Turtle Beach-Parametric Sound	August 2013	\$78	1.3	Option to obtain exclusive and nonexclusive licenses to certain technologies

One explanation for the reemergence of asset lockups might be the constraint on termination fees: with fees effectively capped at 3-4% of deal value, practitioners might have felt pressure to reintroduce other devices that would give their clients more of a leg up. Asset lockups can potentially put more “furniture against the door” than traditional termination fees because of the difficulty in valuing them. Siphoning just 6% out of the deal through an asset lockup (which would be well within the margin of error for a “fair value” determination) would deliver more value to a first bidder than any termination fee could.

The new generation of asset lockups has the additional appeal of having a colorable business purpose, which permits an argument that they should not be treated as deal protection at all. This business purpose is often related to a prior business relationship between the acquirer and target. In the Apple-AuthenTec deal, for example, the two companies began negotiating the terms of a commercial agreement to develop the New Technologies as early as February

2012.¹⁰⁵ But on May 1, 2012, after the parties seemed to be at an impasse on the terms of the commercial agreement, Apple proposed an outright acquisition of AuthenTec instead.¹⁰⁶ Apple made it clear that the commercial agreement would have to accompany the acquisition agreement so that “the development of the technology would not be interrupted regardless of whether the proposed transaction was completed.”¹⁰⁷

During the negotiation process, Apple representatives further informed AuthenTec that “Apple would not participate in an auction process and would rescind its proposal if the board decided to solicit alternative acquisition proposals.”¹⁰⁸ The AuthenTec board decided not to solicit other offers due to the fear of losing Apple, the belief that no other bidders could pay as much as Apple, and the concern that “shopping” the company could increase the chance of a leak, which would be disruptive for the company.¹⁰⁹

As a compromise on the shopping question, AuthenTec management proposed a “go-shop” provision, which would allow AuthenTec to shop for a higher bid after the announcement of the transaction with Apple.¹¹⁰ However, Apple rejected the possibility of a go-shop period.¹¹¹ As a result, AuthenTec and its representatives did not talk to any other potential buyers for the company, either before or after the announcement of the deal with Apple.

The absence of shopping either pre- or post-signing in the Apple-AuthenTec deal, combined with a new economy asset lockup that could easily put significant “furniture against the door” for a prospective third-party bidder, yields obvious deal protection concerns. Part III of this Article discusses how the Delaware courts should respond to the reemergence of asset lockups in transactional practice.

D. Emergence of Financing Arrangements with a Deal Protection Effect

Thus far in this Part we have examined the “new look” of termination fees and asset lockups. We now turn to stock option lockups, the third basic form of deal protection. In the 1990s, stock option lockups were a common form of deal protection.¹¹² Stock option lockups give the acquirer the right to buy a specified number of shares (typically amounting to 19.9% of the outstanding

105. AuthenTec Proxy Statement, *supra* note 94, at 18.

106. *Id.* at 18-19.

107. *Id.* at 23.

108. *Id.* at 19.

109. *Id.* at 19-20.

110. *Id.* at 20.

111. *Id.*

112. *See* Coates & Subramanian, *supra* note 1, at 316 fig.1.

shares¹¹³) at a specified price (typically the deal price to which the target company and the bidder agree¹¹⁴). Stock option lockups have a deal protection effect because a first bidder can exercise the option at the deal price and sell into the (higher) overbid price, thereby extracting value as a “consolation prize” for not getting the deal. Unlike termination fees, for which the value siphoned out of the target company is fixed, stock option lockups extract more value from the target company as the deal price in an overbid increases. This also differs from the way asset lockups siphon value out of the target because, in that case (and particularly in the case of the new generation of asset lockups), the first bidder extracts value by securing access to business opportunities or excluding competing bidders from them.

Stock option lockups were commonplace until the elimination of pooling accounting in 2001.¹¹⁵ This is because exercise of a stock option could “queer” pooling for a third-party bidder, thus discouraging third-party bids.¹¹⁶ Once

113. See *id.* at 344 fig.4. The reason for 19.9% is that the major exchanges require a shareholder vote for stock option grants of 20% or greater. See N.Y.S.E., LISTED COMPANY MANUAL § 312.03(c) (2015).

114. See Coates & Subramanian, *supra* note 1, at 343-44, 344 fig.3.

115. See, e.g., Davidoff & Sautter, *supra* note 7, at 685 n.18.

116. Broadly speaking, pooling accounting allowed the balance sheets of the acquirer and the target to be combined during a merger (that is, the target’s assets and liabilities were carried over to the acquirer’s books at the values that appeared on the target’s books). See ACCOUNTING PRINCIPLES BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, APB OPINION NO. 16, BUSINESS COMBINATIONS ¶ 8 (1970) [hereinafter APB OPINION NO. 16]. Pooling accounting disappeared in June 2001, when the Financial Accounting Standards Board (FASB) prohibited this method for mergers and acquisitions and required the use of the “purchase method” (in which the acquirer is considered as having purchased the assets of the target and therefore the target’s assets are accounted for at fair market value—if the price paid exceeds the fair market value of the target’s assets, the excess is recorded as goodwill on the acquirer’s balance sheet). FIN. ACCOUNTING STANDARDS BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 141, BUSINESS COMBINATIONS ¶¶ 13, 37, 43, 59 (2001); see also LOU R. KLING & EILEEN T. NUGENT, 1 NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 3.07, at 3-40 to -43 (2005). Prior to the June 2000 FASB ruling, the pooling method was required whenever certain criteria were met. For these criteria, see APB OPINION NO. 16; and ACCOUNTING PRINCIPLES BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, APB OPINION NO. 17, INTANGIBLE ASSETS (1970), which required that at least 90% of the voting common stock of the target be acquired for voting common stock of the acquirer. Shares with respect to which appraisal rights were perfected or which were converted into fractional shares of the buyer and were subsequently cashed out counted against the 10% nonstock limit. See APB OPINION NO. 16 ¶ 47(b); KLING & NUGENT, *supra*, § 3.07, at 3-45. The combined company was not allowed to dispose of a significant part of the combined assets within two years after the merger (except in the case of disposals in the ordinary course of business and eliminations of duplicate facilities or excess capacity). See APB OPINION NO. 16 ¶ 48(c); see also KLING & NUGENT, *supra*, § 3.07, at 3-45. These conditions implied that if the target granted a stock option lockup to the buyer (especially an option to acquire over 10% of the target’s stock), then that lockup could preclude a subsequent competing bidder from acquiring the target

footnote continued on next page

pooling accounting was eliminated, however, the need to queer pooling for a third-party bidder disappeared and stock option lockups went away.¹¹⁷

We find no examples of stock option lockups in the Deal Protection Sample. In their place, side financing arrangements with a deal protection effect have emerged. Consider the following examples:

Merit Medical-BioSphere (2010). Merit Medical agreed to acquire BioSphere for \$82 million in cash, with a \$3.8 million termination fee (amounting to 4.6% of deal value) if BioSphere terminated the deal to accept a superior proposal.¹¹⁸ Concurrent with the deal, BioSphere redeemed its Series A preferred stock.¹¹⁹ Merit loaned BioSphere \$10 million to fund this redemption.¹²⁰ If BioSphere terminated the merger, Merit would have the right to convert the outstanding balance of its loan into BioSphere common stock at the deal price (\$4.38 per share).¹²¹ If Merit exercised the conversion right over the entire principal of the loan, it would receive 2.3 million BioSphere shares,¹²² amounting to 11.0% of the new total common shares outstanding.¹²³ In the event of a \$5.00 per share offer, for example, Merit would convert its loan into 2.3 million BioSphere shares at \$4.38 per share and sell at \$5.00 per share for a \$1.4 million profit.¹²⁴ In this scenario, the total cost imposed on a third-party bidder would

and accounting for the transaction as pooling. This was so because the initial bidder could seek appraisal rights with respect to the stock involved in the lockup (which could result in the 10% nonstock limit being exceeded) or, alternatively, because the issuance of stock pursuant to the exercise of the lockup could have been considered a disposal of a significant part of the assets of the target, which would violate the second condition described above. See KLING & NUGENT, *supra*, § 3.07, at 3-46.

117. See KLING & NUGENT, *supra* note 116, § 3.07, at 3-46 (documenting the effect of stock lockups when pooling accounting was available); Davidoff & Sautter, *supra* note 7, at 685 n.18 (documenting the disappearance of stock lockups after the elimination of pooling accounting).

118. See BioSphere Medical, Inc., Current Report (Form 8-K), item 1.01, at 2 (May 13, 2010) [hereinafter BioSphere Medical Current Report]; BioSphere Medical, Inc., Agreement and Plan of Merger, Dated May 13, 2010, by and Among Merit Medical Systems, Inc., Merit BioAcquisition Corp. and BioSphere Medical, Inc. (Exhibit 2.1 to Form 8-K), § 3.2(a) (May 13, 2010) [hereinafter Merit Medical-BioSphere Merger Agreement]. There were 18,736,345 common shares and 9636 Series A preferred shares outstanding at announcement, at a price of \$4.38 per share. BioSphere Medical Current Report, *supra*, item 1.01, at 2; Merit Medical-BioSphere Merger Agreement, *supra*, § 3.2(a). For the purpose of this analysis, we illustrate the magnitude of the deal protection using common shares, implying a deal value of \$82 million.

119. See BioSphere Medical Current Report, *supra* note 118, item 1.01, at 2.

120. Merit Medical-Biosphere Merger Agreement, *supra* note 118, § 6.13.

121. *Id.*

122. This figure is calculated as: \$10 million / \$4.38.

123. This figure is calculated as: 2.3 million shares / (18.7 million shares outstanding + 2.3 million new shares).

124. This figure is calculated as: 2.3 million × (\$5.00 - \$4.38).

be \$1.4 million from the loan conversion plus \$3.8 million from the termination fee or \$5.2 million total (amounting to 5.6% of the new deal value¹²⁵). In the event of a \$6.00 per share offer, the total cost imposed on a third-party bidder would be \$7.5 million, or 6.7% of the new deal value.¹²⁶ At very high deal prices, the deal protection would approach 12.3% of deal value.¹²⁷

BGI Shenzhen-Complete Genomics (2012). BGI Shenzhen agreed to acquire Complete Genomics for \$108 million, with a \$5.2 million termination fee (amounting to 4.8% of deal value) if Complete Genomics terminated the deal to accept a superior proposal.¹²⁸ In a side agreement, BGI provided \$30 million of bridge financing, which was convertible into Genomics's outstanding stock at the deal price (\$3.15 per share).¹²⁹ If the loan was fully drawn, the conversion would amount to approximately 9.5 million shares,¹³⁰ or 21.7% of the new shares outstanding.¹³¹ In the event of a 5% overbid (as assumed in the Delaware Court of Chancery in this particular case¹³²), BGI could convert the bridge loan into shares and sell those shares at the price of the overbid for a \$1.5 million profit.¹³³ In this scenario, the total cost imposed on a third-party bidder would be \$1.5 million from the loan conversion plus \$5.2 million from the

125. This figure is calculated as: $(\$1.4 \text{ million} + \$3.8 \text{ million}) / (18.7 \text{ million shares} \times \$5.00 \text{ per share})$.

126. This figure is calculated as: $[2.3 \text{ million shares} \times (\$6.00 - \$4.38) + \$3.8 \text{ million}] / (18.7 \text{ million shares} \times \$6.00/\text{share})$.

127. This figure is calculated as: $\lim_{x \rightarrow \infty} \left(\frac{2.3(x - \$4.38) + 3.8}{(x)(18.7)} \right)$.

128. Transcript of Telephonic Ruling of the Court at 11, *In re Complete Genomics, Inc. S'holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 9, 2012) [hereinafter Transcript of Telephonic Ruling, *In re Complete Genomics*] (stating that the \$5.2 million termination fee was 4.8% of deal value, implying a total deal value of \$108 million).

129. Complete Genomics, Inc., Agreement and Plan of Merger, Dated as of September 15, 2012, by and Among BGI-Shenzhen, Beta Acquisition Corporation and Complete Genomics, Inc. (Exhibit 2.1 to Form 8-K), at 1 (Sept. 17, 2012) [hereinafter BGI Shenzhen-Complete Genomics Merger Agreement]; Complete Genomics, Inc., Convertible Subordinated Promissory Note, Dated September 15, 2012, by and Among BGI-Shenzhen, BGI-HONGKONG Co., Limited and Complete Genomics, Inc. (Exhibit 10.2 to Form 8-K), § 4(a) (Sept. 17, 2012).

130. This figure is calculated as: $\$30 \text{ million} / \3.15 .

131. According to the merger agreement, the total number of Complete Genomics' common shares at announcement was 34,385,800. BGI Shenzhen-Complete Genomics Merger Agreement, *supra* note 129, § 3.2(a). Therefore, the ratio of shares that could be converted to the total common shares outstanding would be: $9.5 \text{ million} / (34.386 \text{ million} + 9.5 \text{ million})$.

132. Transcript of Telephonic Ruling, *In re Complete Genomics*, *supra* note 128, at 11-12. For a discussion of the court's ruling, see Part III.C below.

133. A 5% overbid would be \$3.31 per share, calculated as: $\$3.15 \times (1 + 0.05)$. Therefore, the profit from selling into the overbid would be: $(\$3.31 - \$3.15) \times 9.5 \text{ million shares} \approx \1.5 million .

termination fee, or \$6.7 million total (amounting to 5.9% of the new deal value¹³⁴). With a 10% overbid, which would be a more realistic assumption,¹³⁵ the total cost imposed on a third-party bidder would be \$8.2 million, or 6.9% of deal value.¹³⁶

Softbank-Sprint Nextel (2012). Softbank agreed to acquire Sprint Nextel for \$7.30 per share, or \$21.9 billion total, with a \$600 million termination fee (amounting to 2.7% of deal value) if Sprint terminated the deal to accept a superior proposal.¹³⁷ Concurrent with the merger agreement, the parties negotiated a convertible bond agreement. Under the terms of this side agreement, Sprint would give Softbank a \$3.1 billion loan, convertible into 590.5 million shares (amounting to 19.7% of Sprint's original common stock¹³⁸), for an effective price of \$5.25 per share.¹³⁹ In the event of a 10% overbid, Softbank could convert the loan into shares and sell into the overbid for a \$1.64 billion profit.¹⁴⁰ In this scenario, the total cost imposed on a third-party bidder would be \$1.64 billion from the loan conversion plus \$600 million from the termination fee, or \$2.24 billion in total (amounting to 9.3% of the new deal value¹⁴¹). At very high deal prices, the deal protection would asymptotically approach 19.7% of deal value.¹⁴²

HIG-Comverge (2013). HIG agreed to acquire Comverge for \$48 million, with a \$1.9 million termination fee and \$1.5 million of additive expense reimbursement (7.1% of deal value) if Comverge terminated the deal after the go-shop

134. This figure is calculated as: \$6.7 million / (34.386 million shares × \$3.31 per share).

135. See *infra* note 269 and accompanying text.

136. A 10% overbid would be: $\$3.15 \times 1.10 \approx \3.47 . Therefore, profits from selling into the overbid would be: $(\$3.47 - \$3.15) \times 9.5 \text{ million shares} \approx \3.0 million . The total cost imposed on a third-party bidder would be: \$3.0 million from loan conversion + \$5.2 million termination fee = \$8.2 million. As a percent of deal value, this amounts to $\$8.2 \text{ million} / (34.386 \text{ million shares} \times \$3.47 \text{ deal price}) \approx 6.9\%$.

137. Sprint Nextel Corp., Current Report (Form 8-K), item 1.01, at 1-2 (Oct. 15, 2012) [hereinafter Sprint Nextel Current Report]; Sprint Nextel Corp., Agreement and Plan of Merger, Dated as of October 15, 2012, by and Among Sprint Nextel Corporation, SOFTBANK CORP., Starburst I, Inc., Starburst II, Inc. and Starburst III, Inc. (Exhibit 2.1 to Form 8-K), §§ 3.5(a), 8.3(b) (Oct. 15, 2012) [hereinafter Softbank-Sprint Nextel Merger Agreement]. According to the merger agreement, there were approximately 3 billion Sprint-Nextel shares outstanding at the time of the merger agreement, implying a deal value of \$21.9 billion at \$7.30 per share. Softbank-Sprint Nextel Merger Agreement, *supra*, § 3.5.

138. See Sprint Nextel Current Report, *supra* note 137, at 3.

139. This figure is calculated as: \$3.1 billion / 590.5 million shares.

140. This figure is calculated as: $(\$7.30 \times 1.10) - \$5.25 \times 590.5 \text{ million shares}$.

141. This figure is calculated as: $\$2.24 \text{ billion} / [3 \text{ billion shares} \times (\$7.30 \times 1.10)]$.

142. This figure is calculated as: $\lim_{x \rightarrow \infty} \left(\frac{590.5(x - \$5.25) + 600}{(x)(3000)} \right)$.

period to accept a superior proposal.¹⁴³ Two concurrent side agreements also had a deal protection effect. First, HIG gave Comverge a \$12 million bridge loan, with a 15% annual interest rate (the Convertible Notes).¹⁴⁴ In the event of an overbid, HIG could convert the loan into 8.6 million shares of Comverge common stock at a conversion price of \$1.40 per share, representing a 20% discount from the \$1.75 per share deal price.¹⁴⁵ If HIG exercised the conversion feature in full, it would acquire 23.8% of the fully diluted shares of Comverge (that is, 23.8% of all the shares after the conversion of the notes).¹⁴⁶ Second, HIG and Comverge also entered into a Forbearance Agreement, which halted HIG from exercising its rights and remedies under an already-existing note (the PFG Note).¹⁴⁷ The Forbearance Agreement provided that if the merger was terminated by Comverge to accept a superior proposal, HIG could accelerate payment on the PFG Note and also receive a “Make Whole Amount,” which could be estimated at \$5.7 million.¹⁴⁸ At a \$2.00 per share deal price, the deal protection would be worth \$10.9 million, or 19.8% percent of deal value.¹⁴⁹ At a

143. *In re Comverge, Inc. S'holders Litig.*, C.A. No. 7368-VCP, 2014 WL 6686570, at *6, *14 (Del. Ch. Nov. 25, 2014).

144. Comverge, Inc., Note Purchase Agreement Dated as of March 26, 2012, by and Among the Company, Peak Holding Corp. and the Other Parties Named Therein (Exhibit 10.1 to Form 8-K), pmbL, § 2.3(a) (Mar. 26, 2012) [hereinafter Comverge Note Purchase Agreement].

145. *See id.* § 2.2(a)-(b). A \$12 million loan divided by the \$1.40 conversion price equals 8.6 million shares. The note conversion was in lieu of the termination fee, expense reimbursement, and a prepayment premium, which amounted to \$0.5 million. *See id.* § 2.3(d)(ii) (requiring prepayment of outstanding obligations and a prepayment premium upon the occurrence of a change of control); *id.* § 13.1 (defining the prepayment premium as 2-4% of the prepayment amount, depending on the date of payment).

146. This figure is calculated as: 8.6 million shares / (27.5 million shares outstanding + 8.6 million new shares). *See Comverge, Inc., Agreement and Plan of Merger Dated as of March 26, 2012, by and Among the Company, Peak Holding Corp. and Peak Merger Corp.* (Exhibit 2.1 to Form 8-K), § 5.4(a) (Mar. 26, 2012) (showing 27,511,443 shares outstanding).

147. Comverge, Inc., Forbearance Agreement Dated as of March 26, 2012, by and Among the Company, Grace Bay Holdings II, LLC and the Other Parties Named Therein (Exhibit 10.3 to Form 8-K), pmbL, at 2 (Mar. 26, 2012) [hereinafter Comverge Forbearance Agreement].

148. *Id.* §§ 1(g), 2(b). JPMorgan, Comverge's financial advisor, estimated the Make Whole Amount to be \$5.7 million. *See Plaintiffs' Brief in Opposition to Defendants' Motion in Limine* at 4-5, *In re Comverge, Inc. S'holders Litig.*, C.A. No. 7368-VCMR (Del. Ch. Oct. 21, 2016), 2016 WL 6299367.

149. This figure is calculated as: 8.6 million shares × (\$2.00 - \$1.40) + \$5.7 million Make Whole Amount ≈ \$10.9 million. Deal equity value would be: \$2.00 per share × 27.5 million shares = \$55.0 million. \$10.9 million / \$55.0 million ≈ 19.8%. We do not add the termination fee and expense reimbursement to the numerator because the Note Conversion was in lieu of those payments. Comverge Note Purchase Agreement, *supra* note 144, § 2.2.

\$3.00 per share deal price, the deal protection would be worth \$19.5 million (nearly double the value of the deal protection at \$2.00 per share), or 23.6% of deal value.¹⁵⁰ At a \$4.00 per share deal price, the deal protection would be worth \$28.1 million, or 25.5% of deal value.¹⁵¹ At very high deal prices, the deal protections in HIG-Comverge would asymptotically approach 31.3% of deal value.¹⁵²

In the HIG-Comverge deal, HIG might have been particularly concerned about the possibility of other bidders because of the unusual nature of the negotiation. HIG first submitted a nonbinding proposal to acquire Comverge for \$1.75 per share and eventually made a final offer of \$2.25 per share.¹⁵³ The Comverge board rejected these offers, indicating that it would be willing to accept no less than \$3.00 per share.¹⁵⁴ Approximately one month later, HIG notified Comverge that it had purchased 51% of the PFG Note with an option (exercised two weeks later) to buy the rest.¹⁵⁵ HIG then notified Comverge “that Comverge was in default under the PFG Note because it had failed to deliver certain compliance certifications.”¹⁵⁶ With Comverge pinned to the wall, HIG lowered its offer from \$2.25 per share to \$1.50 per share, before eventually raising it to \$1.75.¹⁵⁷ The Comverge board—which just one month earlier had turned down \$2.25 per share believing the company was worth \$3.00—accepted the \$1.75 per share offer.¹⁵⁸ Comverge shareholders challenged the deal protections, and the case is currently pending in the Delaware Court of Chancery.¹⁵⁹

Of course, HIG’s strategy only works if the deal protections prevent a meaningful auction for the company because, in the presence of greater bidding competition, Comverge’s default under the PFG Note would not have given the same level of bargaining power to HIG to obtain such a price reduction. In the HIG-Comverge deal, the deal protections of approximately

150. This figure is calculated as: 8.6 million shares × (\$3.00 - \$1.40) + \$5.7 million Make Whole Amount ≈ \$19.5 million. Deal equity value would be: \$3.00 per share × 27.5 million shares = \$82.5 million. \$19.5 million / \$82.5 million ≈ 23.6%.

151. This figure is calculated as: 8.6 million shares × (\$4.00 - \$1.40) + \$5.7 million Make Whole Amount ≈ \$28.1 million. Deal equity value would be: \$4.00 per share × 27.5 million shares = \$110.0 million. \$28.1 million / \$110.0 million ≈ 25.5%.

152. This figure is calculated as: $\lim_{x \rightarrow \infty} \left(\frac{8.6(x-1.4)+5.7}{(x)(27.5)} \right)$.

153. *In re Comverge, Inc. S’holders Litig.*, C.A. No. C.V. 7368-VCP, 2014 WL 6686570, at *3-4 (Del. Ch. Nov. 25, 2014).

154. *Id.* at *4.

155. *Id.*

156. *Id.*

157. *Id.* at *5.

158. *Id.*

159. *See id.* at *1.

19-31%, as computed above, were likely to have achieved the necessary deterrent effect.

Table 5 below summarizes the financing arrangements in the side deals described above. In each instance, the acquirer gave the target a loan that was convertible into common shares in the event of an overbid. Analytically, the deal protection effect is identical to the stock option lockups of the 1990s. In particular, the value extracted by the first bidder would increase as the deal price went up. As with the asset lockups described in Part II.C above, we do not claim that this list is comprehensive. Even if it were comprehensive, we do not claim that these kinds of deals represent a significant fraction of overall M&A deal volume. Nevertheless, they do suggest that stock options have reemerged as part of the deal protection toolkit in the form of financing arrangements for the target company.

Table 5
Financing Arrangements with Deal Protection Effect

Acquirer- Target	Date Announced	Deal Value (\$M)	Termination Fee (Percent of Deal Value)	Financing Arrangement Description	Deal Protection with 10% Overbid
BioSphere- Merit Medical	May 2010	\$82	4.6	\$10 million loan convertible into Merit Medical shares at the deal price	5.3%
BGI Shenzhen- Complete Genomics	September 2012	\$108	4.8	\$30 million bridge financing convertible into Complete Genomics shares at the deal price	6.9%
Softbank- Sprint	October 2012	\$21,900	2.7	\$600 million bond convertible into Sprint shares at 28% less than the deal price	9.3%
HIG- Comverge	March 2013	\$48	7.1	\$12 million bridge loan convertible into Comverge shares at 20% below deal price; restructuring of existing debt to include mandatory prepayment and \$5.7 million "Make Whole" provision in the event of an overbid	19.3%

Deal protection is reported as a percentage of deal value.

The final column of Table 5 provides the deal protection as a percentage of deal value when there is a superior bid of 10% over the original deal price. The

deal protection is calculated as the cost of the termination fee plus the cost of the financing arrangement. Because significantly higher overbids can happen,¹⁶⁰ the calculations provide a rather conservative illustration of how the deal protection effects of financing arrangements can dwarf those of termination fees on their own. This finding highlights the need to consider financing arrangements as a deal protection—a point we return to in Part III.C below.

A second point that emerges from Table 5 is that the maximum deal protection has generally increased over time in the four deals in the sample—from 5.3% of deal value in the 2010 Merit Medical deal to 19.3% of deal value in the 2013 Comverge deal.¹⁶¹ It is of course difficult to extrapolate from such a small sample, and it might well be possible that there would be no discernible trend if all the financing arrangements with deal protection effect were observed. With that important caveat, the increased potency of financing arrangements in the Table 5 sample tracks the termination fee creep from the 1980s-1990s. It is interesting to note that the first two financing arrangements (Merit Medical and Complete Genomics) converted the debt at the deal price, while the last two financing arrangements (Sprint and Comverge) converted the debt at significantly lower than the deal price. As a matter of reference, about 40% of stock option lockups in the 1990s were granted at the deal price.¹⁶² Converting the debt at lower than the deal price increases the potency of the deal protection. Our experience of more than twenty years of termination fee creep suggests that without guidance from the Delaware courts, practitioners will continue to test the limits on the permissible potency of financing arrangements.

Table 6 below summarizes the new look of deal protection as documented in this Part.

160. Examples include the Wilshire Enterprises, Inc./J&J Brothers Holdings, Inc. merger announced on December 18, 2015 and completed on February 18, 2016, in which a bidding contest caused the initial bidder to go from \$1.50 per share to \$3.38 per share, and the Terra Industries, Inc./CF Industries Holdings, Inc. deal announced on March 2, 2010 and completed on April 15, 2010, which involved a premium greater than 100% from an overbid. Information on these deals is available in the FactSet MergerMetrics database. See FACTSET MERGERS, *supra* note 52; see also *infra* notes 236-49 and accompanying text (describing bidding contests for 3PAR and Retek that yielded very high overbids).

161. Unlike the stock option lockups, which were typically capped at 19.9% of deal value, deal protection through financing arrangements can be greater than the 19.9% limit if the deal documents permit cashless exercise. See, e.g., Comverge Forbearance Agreement, *supra* note 147, § 1(b) (defining “Additional Prepayment Amount” as “the amount by which the Converted Share Value exceeds the value of the Obligations”).

162. See Coates & Subramanian, *supra* note 1, at 343, 344 fig.3.

Table 6
The New Look of Deal Protection

Old Look	New Look
Termination fees crept upward from 1-2% of deal value in the 1980s to 3-4% of deal value by the 2010s.	Termination fees stabilized at 3-4% of deal value, but their deterrent impact is amplified by the proliferation of matching rights.
Asset lockups disappeared after “hard” asset lockups in <i>Revlon</i> and <i>Macmillan</i> were invalidated in the 1980s.	New economy asset lockups have emerged in the form of licensing agreements or services agreements.
Stock option lockups disappeared after the elimination of pooling accounting in 2001.	Stock option lockups have reappeared in the form of financing arrangements.

The general question, of course, is how the Delaware courts should respond to this shift in the deal protection landscape. In the next Part, we propose an answer.

III. A Proposed Approach to Deal Protections

Part II identified four developments in the deal protection landscape: the end of termination fee creep, the proliferation of match rights, the reemergence of asset lockups (often intangible, new economy asset lockups), and financing arrangements that have the same effect as traditional stock option lockups. These developments may be related. Precisely because the Delaware courts have clamped down on termination fees,¹⁶³ match rights, asset lockups, and financing arrangements have appeared to fill the gap.

This Part proposes how Delaware doctrine should respond.¹⁶⁴ We propose three refinements to existing deal protection doctrine: First, Delaware courts

163. *See supra* notes 58-70 and accompanying text.

164. The fact that side financing agreements and intangible asset lockups often have (or appear to have) a business purpose might explain, as mentioned in Part II, why those devices have not yet been subject to significant judicial scrutiny. Another potential explanation is the fact that these protections, as also discussed in Part II, might not be ubiquitous—which causes courts to be less concerned about them. Similarly, another factor that might contribute to the current state of affairs is the difficulty of valuing the protection effect of the new generation of lockups. Regardless of which of these explanations is correct, we think the recommendations proposed in this section should apply to all the transactional developments documented in Part II, and even though we recognize that valuation may be difficult in some instances, we think courts should still try to obtain an estimation of the deal protection effect in those cases.

should clarify that in addition to *Revlon* “reasonableness” review, lockups must survive *Unocal*¹⁶⁵/*Unitrin*¹⁶⁶ “preclusive” or “coercive” analysis. Second, drawing on basic game theory, Delaware courts should identify the deterrent effect of match rights and new economy asset lockups. And third, Delaware courts should take a functional approach to deal protection, meaning that even if collateral provisions have some colorable business purpose, they should be scrutinized under deal protection doctrine if they have a deal protection effect.

A. Resolving the *Unocal/Revlon* Ambiguity

As every student of corporate law will know, *Unocal Corp. v. Mesa Petroleum Co.*, *Unitrin v. American General Corp.*, and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹⁶⁷ provide the basic framework for analyzing the target board’s fiduciary duties in M&A. *Unocal* articulates an intermediate standard of judicial review, which stands between deferential business judgment (which mandates judicial deference to actions taken by disinterested and independent directors, absent proof that the board acted on grossly inadequate information) and stringent entire fairness (which generally requires that an interested party prove fair process and fair price).¹⁶⁸

Unocal involved a cash tender offer initiated by Mesa Petroleum Co., a 13% shareholder in Unocal Corp., for approximately 37% of Unocal’s outstanding stock at \$54 per share.¹⁶⁹ If successful in the first stage, Mesa would then conduct a “back-end” freeze-out to eliminate the remaining public shares, which Mesa would execute as an exchange offer for highly subordinated securities purportedly worth \$54 per share.¹⁷⁰ The Unocal directors concluded that the value of the company was substantially above \$54 per share and that the subordinated securities to be exchanged in the back-end freeze-out were “junk bonds” worth far less than \$54.¹⁷¹ In response to this offer, the board adopted a self-tender offer as a defensive strategy, which would exclude Mesa.¹⁷²

The Delaware Supreme Court noted that when responding to a hostile takeover, there is an “omnipresent” risk that the “board may be acting primarily in its own interests, rather than those of the corporation and its

165. *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946 (Del. 1985).

166. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

167. 506 A.2d 173 (Del. 1986).

168. *See Unocal*, 493 A.2d at 955.

169. *Id.* at 949.

170. *Id.*

171. *Id.* at 956.

172. *Id.* at 950-51.

shareholders.”¹⁷³ Given this risk, the court formulated two conditions that must be satisfied before the business judgment rule applies to the board’s defensive actions: (1) the “directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and (2) the defensive measures must be “reasonable in relation to the threat posed.”¹⁷⁴ In this particular case, the court found that that the board reasonably believed Mesa’s offer was inadequate and inherently coercive¹⁷⁵ and that the two conditions to apply the business judgment rule were met when the board implemented the self-tender offer.¹⁷⁶

Approximately ten years later, in *Unitrin, Inc. v. American General Corp.*,¹⁷⁷ the Delaware Supreme Court clarified what it means for a defensive measure to be “reasonable in relation to the threat posed.” *Unitrin* involved a hostile tender offer by American General Corp. (AmGen) for Unitrin.¹⁷⁸ Unitrin’s board found that AmGen’s offer was inadequate and therefore defended against it by implementing a poison pill, an advance-notice bylaw, and a tender offer to repurchase nearly 20% of Unitrin’s outstanding shares.¹⁷⁹ The Delaware Supreme Court held that so long as “the board of directors’ defensive response is not *draconian* (*preclusive or coercive*) and is within a ‘range of reasonableness,’ a court must not substitute its judgment for the board’s.”¹⁸⁰ Applying this reasoning, the court found that the poison pill and the buyback were neither coercive nor necessarily preclusive because AmGen could run a proxy contest to replace the Unitrin board.¹⁸¹ Thus, *Unitrin* added an important gloss on the reasonableness requirement of *Unocal*.

Revlon also involved an incumbent board’s use of defensive measures to resist an undesired bidder.¹⁸² But in contrast to the situations in *Unocal* and

173. *Id.* at 954.

174. *Id.* at 955.

175. *Id.* at 956, 958.

176. *Id.* at 958-59.

177. 651 A.2d 1361 (Del. 1995).

178. *See id.* at 1368.

179. *See id.* at 1369-70.

180. *Id.* at 1388 (emphasis added) (quoting *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 (Del. 1994)).

181. *Id.* at 1388 & n.39. The court then remanded the case to the Delaware Court of Chancery to determine whether the buyback was in fact preclusive and, if not, whether the pill and buyback were within the range of reasonable defenses. *Id.* at 1388-90. In contrast, a defensive action could be preclusive if, for example, it deprives the shareholders of the right to receive all offers. A defensive action could be coercive if, for example, it forces the shareholders to take a particular option (imposing, for instance, the realization of different benefits).

182. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176-77 (Del. 1986).

Unitrin, the board in *Revlon* attempted to pursue an alternative transaction, thus giving rise to a “sale” scenario.¹⁸³ Specifically, the board of directors of Revlon, Inc. opposed Pantry Pride’s hostile tender offer by adopting a “flip-in” rights plan and by repurchasing Revlon’s stock with unsecured debt (a transaction that allowed the board to insert a covenant barring Revlon from selling its assets without the approval of its independent directors).¹⁸⁴ In addition to these defensive measures, the board entered into an agreement with Forstmann Little & Co. that would result in the acquisition of all of Revlon’s outstanding shares and the subsequent breakup of the company.¹⁸⁵ The agreement included a waiver of the covenants contained in the recently issued unsecured debt, a lockup option that gave Forstmann Little the right to purchase Revlon’s most valuable assets at a reduced price (allegedly 20% less than the fair market value of the assets) if another bidder were to acquire 40% of Revlon’s stock, and a no-shop provision prohibiting Revlon from negotiating with other bidders except under certain qualified circumstances.¹⁸⁶

The Delaware Supreme Court held that when a sale or breakup of a company becomes “inevitable,” the duty of the board of directors is to maximize short-term value for the target shareholders.¹⁸⁷ As part of this reasoning, the court emphasized that the defensive measures adopted by the board to defend against undesired bidders must be “reasonable.”¹⁸⁸ The court then struck down the asset lockup provision of the deal because “the result of the lock-up was not to foster bidding, but to destroy it.”¹⁸⁹

Delaware courts have not been clear about how *Unocal/Unitrin* and *Revlon* interact in evaluating deal protections. Courts have indicated that *Unocal/Unitrin* should apply to deal protections generally because protecting the incumbent deal from third-party competition can be analogized to takeover defenses that protect the company from a hostile takeover.¹⁹⁰ In this analysis, if

183. *Id.* at 182.

184. *Id.* at 177.

185. *Id.* at 178.

186. *Id.*

187. *Id.* at 182.

188. *Id.* at 180.

189. *Id.* at 183, 185.

190. See *McMillan v. Intercargo Corp.*, 768 A.2d 492, 506 n.62 (Del. Ch. 2000) (“Under a ‘duck’ approach to the law, ‘deal protection’ terms self-evidently designed to deter and make more expensive alternative transactions would be considered defensive and reviewed under the *Unocal Corp. v. Mesa Petroleum Co.* standard. . . . Provisions of this obviously defensive nature (e.g., no-shops, no-talks, termination fees triggered by the consummation of an alternative transaction, and stock options with the primary purpose of destroying pooling treatment for other bidders) primarily ‘protect’ the deal and the parties thereto from the possibility that a rival transaction will displace the deal.” (citation omitted)).

the deal protections are not “coercive” or “preclusive,” the inquiry shifts to whether they are within the “range of reasonable responses.”¹⁹¹ However, when *Revlon* duties are triggered, the court’s inquiry focuses on the reasonableness of the board’s actions in maximizing shareholder value. The question then becomes: In a deal protection context, does *Revlon*’s reasonableness analysis replace the coercive/preclusive test from *Unocal/Unitrin*? Or must deal protections satisfy the coercive/preclusive inquiry from *Unocal/Unitrin* to survive *Revlon*’s reasonableness review?

The difference matters. If *Revlon* analysis replaces *Unocal/Unitrin*, then a finding that defenses were preclusive/coercive could be trumped by a showing that the board’s actions were nevertheless reasonable. In other words, there could be a scenario in which the defenses fail *Unocal/Unitrin* (because the deal protections are preclusive or coercive) but survive *Revlon* (because the board acted reasonably in agreeing to such deal protections). This would be anomalous, however, because most commentators believe that *Revlon* is a more stringent standard of review than *Unocal/Unitrin*.¹⁹²

Delaware courts have not answered this question definitively. On the one hand, courts have suggested that deal protections must not be preclusive/coercive to survive *Revlon* reasonableness scrutiny.¹⁹³ On the other hand,

191. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1367 (Del. 1995).

192. See, e.g., Brian JM Quinn, *Re-evaluating the Emerging Standard of Review for Matching Rights in Control Transactions*, 36 DEL. J. CORP. L. 1011, 1031 (2011).

193. See, e.g., *In re Comverge, Inc. S’holders Litig.*, C.A. No. 7368-VCP, 2014 WL 6686570, at *17 (Del. Ch. Nov. 25, 2014) (“Based on all these factors, I conclude that the combined effect of the termination fees, the expense reimbursement provision, and the Convertible Notes conceivably could have had an *unreasonably preclusive effect* on potential bidders who might otherwise have topped HIG’s offer and provided greater value to the Comverge stockholders. . . . I cannot rule out the possibility that the termination fee structure associated with the Merger Agreement, including the Convertible Notes, was unreasonable.” (emphasis added)); *In re BioClinica, Inc. S’holder Litig.*, C.A. No. 8272VCG, 2013 WL 673736, at *2 (Del. Ch. Feb. 25, 2013) (“The Plaintiffs point out, correctly, that I must examine the effect of the deal-protection devices as they operate in concert to determine whether they *preclude* other offers or *coerce* the votes of the stockholders.” (emphasis added)); *In re Smurfit-Stone Container Corp. S’holder Litig.*, C.A. No. 6164-VCP, 2011 WL 2028076, at *16, *21 (Del. Ch. May 24, 2011) (“After carefully reviewing the record, I find that the process undertaken by the Board included sufficient indicia of reasonableness under the circumstances to satisfy *Revlon*. . . . In addition, I am not persuaded that, collectively, the Merger Agreement’s three primary deal protections unreasonably inhibit another bidder from making a Superior Proposal. The challenged provisions are relatively standard in form *and have not been shown to be preclusive or coercive*, whether they are considered separately or collectively. Accordingly, on the record presented, I am not convinced that Plaintiffs are likely to be able to prove that the Board acted unreasonably in agreeing to give Rock-Tenn these deal protections.” (emphasis added)); *In re Dollar Thrifty S’holder Litig.*, 14 A.3d 573, 615 (Del. Ch. 2010) (“On this record, I simply cannot conclude that the Board’s approach to maximizing sale value was unreasonable. Certainly, *I cannot call the deal protections preclusive*, in that they left any serious bidder with the chance to buy
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none of these courts have found the deal protections to be preclusive, leaving it uncertain what would have happened if they were. The question is this: Can preclusive deal protections nevertheless be reasonable?

To make the point tangible, consider a situation in which an acquirer makes a cash offer at a 100% premium to the target's unaffected market price but insists on no pre- or post-signing market check (that is, no pre- or post-signing search for alternative bidders or invitation to present alternative proposals) and deal protections equivalent to 30% of the deal equity value. The board accepts the offer on the view that it is truly "take it or leave it." For purposes of argument, assume that the deal would satisfy *Revlon* because the board's decision was reasonable but it would fail *Unocal* because the deal protections would be likely to preclude a higher bid (given the size of the protections).¹⁹⁴ Plaintiff shareholders challenge the deal protections under *Revlon* and *Unocal/Unitrin*. What would be the result?

The better approach is to subject deal protections to the "preclusive" and "coercive" test from *Unocal/Unitrin*, regardless of whether *Revlon's* "reasonableness" inquiry should also be applied. Or put differently, a *Revlon* reasonableness inquiry should not replace *Unocal/Unitrin's* prohibition on preclusive or coercive deal protections. This means that the deal protections in the scenario described above would be invalidated. This policy would ensure that a sale situation is always subject to a meaningful market check, which in turn promotes short-term value maximization.

One might argue that if the acquirer in the hypothetical above cannot demand 30% deal protections, the 100% premium offer might never appear in the first place. But we would respond with a question: If the 100% premium offer is truly a blockbuster bid, then why did the acquirer need to insist on 30% deal protection? The proposed approach takes preclusive and coercive deal protections off the table to preserve allocational efficiency in the M&A marketplace. It gives target boards legitimate doctrinal backbone to resist draconian deal protections; as such, a well-advised acquirer will not make such

the company while bearing the cost of modest compensation to Dollar Thrifty's jilted first partner. As important, *the deal protections are not in any way coercive.*" (emphasis added)); *McMillan*, 768 A.2d at 505-06 ("Although in purely percentage terms, the termination fee was at the high end of what our courts have approved, it was still within the range that is generally considered reasonable. . . . *From the preclusion perspective*, it is difficult to see how a 3.5% fee would have deterred a rival bidder who wished to pay materially more for Intercargo. No doubt the presence of the fee would rebuff a bidder who wished to top XL's bid by a relatively insignificant amount that would not have been substantially more beneficial to Intercargo's stockholders, *but to call such an insubstantial obstacle 'draconian'* is inconsistent with the very definition of the term." (emphasis added)).

194. In our opinion, the analysis does not change in this hypothetical if the company is fully shopped before the offer is accepted (because, as mentioned, the size of the deal protections is likely to preclude any subsequent superior offer).

offers in the first place. And if the 100% premium offer is truly a blockbuster bid, then the acquirer should be comfortable making such a bid with (say) 3% deal protection rather than 30% (since a truly blockbuster bid will be less subject to the risk of being outbid). This would protect the legitimate interest of the acquirer in recouping its bid costs (including intangible costs) while also letting the market check confirm the fact that the offer is the highest available price.

By way of analogy, consider another all-cash 100% premium offer but this time conditioned on the target board eliminating its shareholder vote. Delaware corporate law does not permit this.¹⁹⁵ One might reasonably ask: Why not? For the same reasons that in a hypothetical scenario, Delaware law might want to facilitate an offer conditioned on 30% deal protection, Delaware law might also want to facilitate an offer conditioned on elimination of the target shareholder vote. But Delaware corporate law emphasizes the importance of a shareholder vote as a backstop protection against a negligent or captured board.¹⁹⁶ Knowing this, acquirers accept that their offer must gain approval from a majority of the outstanding shares. Likewise, we believe that Delaware corporate law should squarely endorse the principle that a cash offer must always be subject to a meaningful market check. Doctrinally, this means that *Unocal/Unitrin's* requirement that deal protections not be preclusive or coercive stands separate from *Revlon's* requirement that the board take reasonable steps to maximize shareholder value.

This refinement to deal protection doctrine becomes particularly important when deal protections take the form of commercial agreements. While conventional deal protections such as termination fees, stock option lockups, and old-fashioned asset lockups (hard-asset lockups) are well within the expertise of the courts,¹⁹⁷ commercial agreements generally are not. Consider a

195. See DEL. CODE. ANN. tit. 8, § 251(c) (West 2016) (providing a nonwaivable shareholder vote requirement).

196. *Cf. Singh v. Attenborough*, 137 A.3d 151, 151-52 (Del. 2016) (holding that where a fully informed and uncoerced vote of the disinterested shareholders occurred and the business judgment rule is invoked, a plaintiff can only challenge the transaction on the basis that it constitutes waste); *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 308 (Del. 2015) (holding that the business judgment rule applied to the transaction because it was approved by the fully informed and uncoerced vote of the disinterested shareholders); *In re Volcano Corp. Stockholder Litig.*, C.A. No. 10485-VCMR, 2016 WL 3626521, at *15 (Del. Ch. June 30, 2016) (“[T]he acceptance of a first-step tender offer by fully informed, disinterested, uncoerced stockholders representing a majority of a corporation’s outstanding shares in a two-step merger under Section 251(h) has the same cleansing effect . . . as a vote in favor of a merger by a fully informed, disinterested, uncoerced stockholder majority.”).

197. See *supra* notes 58-70 and accompanying text (discussing the case law in which the Delaware Court of Chancery has examined the effect of termination fees); see also, e.g., *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 39 (Del. 1994) (analyzing
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commercial agreement that has a colorable business purpose but performs the same function as the standard deal protections. In the absence of our doctrinal clarification, a court might be inclined to declare the commercial agreement “reasonable” and therefore valid even though it has a preclusive or coercive effect on potential competing bids. Our proposed approach rejects this result.¹⁹⁸

B. Applying Basic Game Theory

Delaware courts should also apply basic game theory to deal protection. One of the core insights of the field is highly relevant for transactional practice: sophisticated actors will respond rationally to the rules of the game and the moves of other parties. Therefore, market participants should be expected to “look forward and reason back” to anticipate the moves of others and incorporate those expected moves into their own decisionmaking.¹⁹⁹

This core insight has two implications for the new look of deal protection identified in Part II above. First, rather than categorical endorsement of match rights, Delaware courts should acknowledge that match rights amplify other deal protection measures. As such, match rights should be given a hard look, particularly in situations where information asymmetries between inside and outside bidders may be significant. The general idea that match rights can deter competing bids needs no explanation, but our analysis provides greater precision regarding the magnitude of the deterrent effect and the circumstances in which it will appear. Second, in contrast to Delaware doctrine from the 1980s that focuses on whether an asset lockup was granted at fair market value,²⁰⁰ Delaware courts should examine the competitive dynamic created by

a stock lockup); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 183 (Del. 1986) (analyzing the effect of asset lockups).

198. As discussed above, most commentators believe that *Revlon* is more stringent than *Unocal/Unitrin*, so courts would be generally unlikely to conclude that a deal protection survived *Revlon* if it failed *Unocal/Unitrin*. See *supra* note 192 and accompanying text. In the case of side commercial agreements, as also mentioned in Part I.C above, this scenario is less unlikely because the existence of a business purpose and the implicit nature of the deal protection effect of the agreement might make courts more prone to defer to the judgment of the target board. However, even under the assumption that it would be rare to find a situation in which a merger survives *Revlon* but not *Unocal/Unitrin*, the policy proposed in this Article would still be relevant as a matter of doctrinal clarity.

199. See, e.g., CHARLES W.L. HILL & GARETH R. JONES, STRATEGIC MANAGEMENT: AN INTEGRATED APPROACH 215 (8th ed. 2008) (formatting altered).

200. See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264, 1284 (Del. 1989) (striking down an asset lockup and stating that under *Revlon*, an “auction-ending” lockup “must confer a substantial benefit upon the stockholders in order to withstand exacting scrutiny by the courts”); *Revlon*, 506 A.2d at 178, 183-84 (holding that asset
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new economy asset lockups to identify situations where even an asset lockup struck at fair market value can have a deal protection effect. We discuss each of these implications in turn.

1. Match rights

Some practitioners claim that match rights have no significant effect in M&A deals because an overbid will always be shopped back to the first bidder.²⁰¹ But this claim incorrectly assumes that the prospective third-party bidder behaves passively. Among sophisticated bidders, in the absence of a match right, a third-party can put a “short fuse” on its offer or otherwise condition its offer on not having it shopped back to the first bidder. In this way, a match right eliminates an important tool a third-party bidder would otherwise have.

With a match right, there is no obvious “pathway to success” in making an overbid—either the first bidder will match (in which case the other bidder has nothing to show for its efforts) or the first bidder will not match (in which case, absent bidder-specific synergies, the third party has likely overpaid). The match right therefore fuels the classic “winner’s curse” problem: in any scenario where a third party bids and wins, it would know that a better-informed party (namely, the first bidder) thought that the price was too

lockups are not invalid per se but invalidating the lockup in question, which was granted at below market value).

201. See, e.g., Rock-Tenn Co.’s & Sam Acquisition, LLC’s Answering Brief in Opposition to Plaintiffs’ Motion for Preliminary Injunction at 20, *In re Smurfit-Stone Container Corp. S’holder Litig.*, C.A. No. 6164-VCP (Del. Ch. May 16, 2011), 2011 WL 1980476 (arguing that the plaintiffs’ challenge to match rights was based on the “hyperbolic and counter-intuitive grounds that providing Rock-Tenn with an express right to make *additional bids* for Smurfit-Stone” would destroy the bidding process); Defendant Alberto-Culver’s Brief in Opposition to Plaintiffs’ Counsel’s Application for an Award of Attorneys’ Fees at 11, *In re Alberto-Culver Co. S’holder Litig.*, C.A. No. 5873-VCS (Del. Ch. Feb. 7, 2011), 2011 WL 487119 (arguing that the Delaware Court of Chancery “has recognized . . . that matching rights are not obstacles for bidders in the highly competitive M&A market” and that “[f]ar from making it ‘impossible for an alternative bidder to acquire the Company,’ matching rights are frequently ‘overcome in . . . real-world situations.’” (second alteration in original) (first quoting Plaintiffs’ Brief in Support of Motion for Final Approval of the Proposed Settlement, Certification of the Class & an Award of Attorneys’ Fees & Reimbursement of Expenses at 26, *In re Alberto-Culver Co. S’holder Litig.*, C.A. No. 5873-VCS (Del. Ch. Jan. 25, 2011), 2011 WL 227835; and then quoting *In re Topps Co. S’holders Litig.*, 926 A.2d 58, 86 (Del. Ch. 2007))); Lear Defendants’ Answering Brief in Opposition to Plaintiffs’ Motion for Preliminary Injunction at 50, *In re Lear Corp. S’holder Litig.*, 967 A.2d 640 (Del. Ch. 2008) (C.A. No. 2728-VCS), 2007 WL 4944556 (arguing that match rights “do[] not chill topping bids”).

high.²⁰² Looking forward and reasoning back, a third party is unlikely to bid.²⁰³

When the first bidder has a match right, the only way a third party will bid is if it believes it can win a bidding contest against the first bidder. That is, the third party must believe that it can pay more than the full willingness to pay of the first bidder, not just the first bidder's current bid on the table. The deterrent effect of a match right is amplified by risk aversion because the bid on the table is a known quantity and the first bidder's full willingness to pay is an unknown quantity.²⁰⁴ While (well-advised) first bidders no longer make claims like Sumner Redstone's famous statement that Viacom's deal to buy

202. For an explanation of this point, see GUHAN SUBRAMANIAN, *DEALMAKING: THE NEW STRATEGY OF NEGOTIAUCTIONS* 172-73 (2011), which analyzes the leveraged buyout of Toys "R" Us—a deal that included a 4% termination fee and a three-day match right—as follows:

What have you learned if you make a bid in this situation, three days pass, and you win? You've learned, three days too late, that some really smart people at KKR, Bain Capital, and Vornado didn't want to match your offer. The combination of the breakup fee and the so-called matching right meant that winner's curse concerns ran rampant for a third party considering whether to enter the deal. The potent combination of deal terms effectively shut down the negotiauction for Toys "R" Us.

203. This line of argument implies that the effect of match rights is likely to be different in "private value" and "common value" settings. In private value settings, each potential acquirer has a different (private) value for the target. This is usually the case of transactions involving strategic buyers, where each bidder knows only its valuation of the target because there are specific synergies that depend on the characteristics of each bidder. In a common value setting, the target has a single value for all bidders (although each bidder has a different estimate of the target's value due to informational differences). See Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27, 33-45 (1991); R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LITERATURE 699, 704-05 (1987). A common value setting is more likely to arise in transactions involving private equity buyers, where the target represents mostly a source of cash flows for the buyer, not a source of synergies. Quinn, *supra* note 192, at 1027. According to this strand of the literature, the deterrent effect of match rights in common value settings is potentially greater than in private value settings precisely because a strategic bidder in a private value setting has greater incentives to bid (even in the presence of match rights) due to the particular synergies that might result from the transaction. See Sushil Bikhchandani et al., *On the Right-of-First-Refusal*, *ADVANCES THEORETICAL ECON.* 3 (Apr. 26, 2005), <https://www.degruyter.com/downloadpdf/j/bejte.2005.5.1/bejte.2005.5.1.1194/bejte.2005.5.1.1194.pdf>; Brian JM Quinn, *Bulletproof: Mandatory Rules for Deal Protection*, 32 J. CORP. L. 865, 870-71 (2007); Quinn, *supra* note 192, at 1027, 1039. Of course, there are several additional factors that affect the intensity of the deterrent effect of a match right, including the costs associated with preparing a bid, the extent to which the "second bidder can be compensated for those costs, the amount and quality of publicly available information about the seller," and "the reputation of the rightholder" in the context of bidding processes. Quinn, *supra* note 192, at 1025; see also Marcel Kahan et al., *First-Purchase Rights: Rights of First Refusal and Rights of First Offer*, 14 AM. L. & ECON. REV. 331, 333 (2012) (emphasizing the importance of investigation costs in determining the ultimate effect of match rights).

204. See Quinn, *supra* note 192, at 1025.

Paramount could only be thwarted by a “nuclear attack,”²⁰⁵ even seemingly innocuous presentations of “synergies” and “fit” at the initial press conference can send signals to potential third-party bidders about a very high willingness to pay. When a first-bidder match right is coupled with second-bidder risk aversion, even the possibility that the first bidder’s willingness to pay might be large would be a significant deterrent.

Our interactions with transactional lawyers over the past fifteen years strongly confirm this analysis: match rights are put in merger agreements not only to give the bidder a relatively leisurely look at any third-party bid (ex post effects) but also to deter third-party bidders from emerging in the first place (ex ante effects). This commonsense point also explains the rapid proliferation of match rights: if they have no deterrent effect, as some practitioners claim, then they should not have proliferated as quickly as they did.

All of this is basic game theory,²⁰⁶ yet the trajectory of the Delaware courts has moved from a case-by-case consideration of the potential deal protection effect of match rights toward categorical approval. In early cases, the Delaware courts approved match rights obtained by the first bidder but only after considering the full array of deal protections and the difficult choices that the board faced.²⁰⁷ In contrast, more recent cases seem to have abandoned reasonableness analysis in favor of blank-check approval of match rights.²⁰⁸

This trajectory ignores the way bidders “look forward and reason back.”²⁰⁹ When faced with a match right, any rational third-party bidder that bid and won would have to wonder: What did the first bidder know that I don’t know? Even with slight information asymmetries between the first bidder and prospective third-party bidders, winner’s curse concerns would run rampant. The information asymmetry concern becomes particularly salient when there

205. *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 39 (Del. 1994) (“In a number of public statements, the parties indicated that the pending transaction was a virtual certainty. Redstone described it as a ‘marriage’ that would ‘never be torn asunder’ and stated that only a ‘nuclear attack’ could break the deal.”).

206. Brian Quinn put it well: “Unlike discussions of macroeconomic policy, there are no two-handed economists when it comes to the incentives generated by matching rights. Matching rights work to deter subsequent bids when held by an initial bidder.” Brian JM Quinn, *Normalizing Match Rights*, 1 HARV. BUS. L. REV. ONLINE 7, 9 (2010) (footnote omitted).

207. See, e.g., *In re Dollar Thrifty S’holder Litig.*, 14 A.3d 573, 613-18 (Del. Ch. 2010); *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1014-21 (Del. Ch. 2005).

208. See, e.g., *In re Cogent, Inc. S’holder Litig.*, 7 A.3d 487, 509 (Del. Ch. 2010) (“[W]hile it is true that 3M [the first bidder] would be able to match such an offer, this would not preclude an offer from being made.”); *In re 3Com S’holders Litig.*, Civil Action No. 5067-CC, 2009 WL 5173804, at *7 (Del. Ch. Dec. 18, 2009) (holding that the no-solicitation provision, the match right, and the termination fee at issue “are standard merger terms, are not *per se* unreasonable, and do not alone constitute breaches of fiduciary duty”).

209. See *supra* note 199 and accompanying text.

is a “ticking clock” imposed by a go-shop window²¹⁰ and/or when the first bidder partners with an insider, such as in the context of management buyouts.²¹¹

In *In re Cogent, Inc. Shareholder Litigation*, which is representative of the current approach to match rights, the court summarized its reasoning for upholding the match right as follows:

After reviewing the arguments and relevant case law, I conclude Plaintiffs are not likely to succeed in showing that the no-shop and matching rights provisions are unreasonable either separately or in combination. Potential suitors often have a legitimate concern that they are being used merely to draw others into a bidding war. Therefore, in an effort to entice an acquirer to make a strong offer, it is reasonable for a seller to provide a buyer some level of assurance that he will be given adequate opportunity to buy the seller, even if a higher bid later emerges.²¹²

This reasoning is flawed. A match right does not “entice an acquirer to make a strong offer” in the same way a termination fee might. In fact, a match right does the opposite: it encourages the first bidder to underbid, knowing that it will have another look if a higher bid comes along.²¹³

The proliferation of match rights is the latest illustration of how deal protections respond to pronouncements from the Delaware courts. When the Delaware Supreme Court invalidated asset lockups struck below fair market

210. See Guhan Subramanian, *Deal Process Design in Management Buyouts*, 130 HARV. L. REV. 590, 629 (2016). More specifically, go-shop clauses allow the target company to solicit alternative bids during a certain number of days after signing a merger agreement with the first bidder. See, e.g., *id.* at 602. Because this period, or “go-shop window,” is limited, subsequent bidders will be more time-constrained in the process of preparing a competing offer, which in turn increases the potential magnitude of information asymmetries between the first bidder and the subsequent bidders. See *id.* at 629.

211. *Id.* at 592, 613-15.

212. 7 A.3d at 502 (footnote omitted).

213. See Leandro Arozamena & Federico Weinschelbaum, *A Note on the Suboptimality of Right-of-First-Refusal Clauses*, ECON. BULL. 1 (July 5, 2006), <http://www.accessecon.com/pubs/EB/2006/Volume4/EB-06D40010A.pdf> (arguing that, in the context of independent private values, “no mechanism that includes a[] [right-of-first-refusal] clause can maximize the joint expected surplus of the seller and the right-holder”); Bikhchandani et al., *supra* note 203, at 24 (arguing that the seller places itself in a disadvantageous position by awarding a right of first refusal—that is, a match right—because the rightholder might buy the company even when its valuation is not the highest among all potential buyers); Albert H. Choi, *A Rent Extraction Theory of Right of First Refusal*, 57 J. INDUS. ECON. 252, 263 (2009) (arguing that match rights may decrease social welfare because they allow the rightholder to win the auction even when his value of the good is lower than that of the competing bidder); Quinn, *supra* note 192, at 1025 (arguing that match rights can lead to an inefficient allocation of resources because the rightholder might make a “low-ball initial bid” and subsequent bidders with higher valuations of the target might decline to bid).

value in *Revlon*²¹⁴ and *Macmillan*,²¹⁵ asset lockups disappeared.²¹⁶ When the Delaware Supreme Court struck down a stock option lockup in *Paramount Communications Inc. v. QVC Network Inc.*,²¹⁷ practitioners substituted away from stock option lockups to termination fees.²¹⁸ When the Delaware courts signaled that 4-5% was at the high end of what would be tolerated for termination fees, average termination fees capped out just below that level.²¹⁹ And when the Delaware courts permitted match rights in *In re Toys "R" Us*²²⁰ and *In re Dollar Thrifty*,²²¹ and then further accepted them as boilerplate in cases such as *In re 3Com*²²² and *In re Cogent*,²²³ match rights proliferated.

The Delaware courts should return to the old religion of evaluating deal protections as a whole, and in this analysis, courts should acknowledge that a match right can amplify other deal protection devices.²²⁴ For example, a match right might not have a significant deterrent effect when coupled with a 2% fee. But a match right coupled with a 5% fee puts a prospective third-party bidder at a 5% disadvantage in any bidding contest. In this context, the interaction between the fee and the match right could have a significant deterrent effect on third-party bids.

214. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176, 182-83 (Del. 1986). As discussed in Part I.D.2 above, the asset lockup involved in *Revlon* was struck at less than fair market value. The Delaware Supreme Court concluded that an asset lockup of that nature had a preclusive effect and, as a result, invalidated it. In the words of the Delaware Supreme Court: "A lock-up is not *per se* illegal However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment." *Revlon*, 506 A.2d at 183.

215. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264, 1286 (Del. 1989).

216. *See Coates & Subramanian*, *supra* note 1, at 326-27.

217. 637 A.2d 34, 36-37, 39 (Del. 1993).

218. *See Coates & Subramanian*, *supra* note 1, at 328, 331.

219. *See supra* notes 58-72 and accompanying text.

220. *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1017, 1021 (Del. Ch. 2005).

221. *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 618 (Del. Ch. 2010).

222. *In re 3Com S'holders Litig.*, Civil Action No. 5067-CC, 2009 WL 5173804, at *7 (Del. Ch. Dec. 18, 2009).

223. *In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487, 509 (Del. Ch. 2010).

224. *Cf. Quinn*, *supra* note 192, at 1038-44 (arguing for a "contextualized analysis" of match rights, which includes an assessment of how they interact with other protection devices and the nature of the bidder). There is some indication from the appraisal context that the Delaware courts are moving in this direction. *See In re Appraisal of Dell Inc.*, C.A. No. 9322-VCL, 2016 WL 3186538, at *41 (Del. Ch. May 31, 2016) (observing that an unlimited match right, as distinct from a one-time match right, was a "powerful disincentive" to a prospective third-party bidder).

Delaware courts should also not endorse match rights simply because those rights are now “standard merger terms.”²²⁵ Not only has this argument been squarely rejected by the Delaware courts in other areas of corporate law,²²⁶ it is also circular: match rights have become ubiquitous only because the Delaware courts have endorsed them so categorically.

2. Asset lockups

Game theory also has implications for new economy asset lockups. In the era of *Revlon* and *Macmillan*, the deal protection inquiry focused on whether the asset lockup was granted at fair market value.²²⁷ Implicit in this analysis was the assumption that an asset lockup granted at fair market value cannot have a deal protection effect (because it does not siphon value out of the company in the event of a competing bid). Even if an asset lockup was truly granted at fair market value,²²⁸ this assumption may have been appropriate because the assets at issue in *Revlon* and *Macmillan* were hard assets (in both cases, certain divisions of the respective target companies).²²⁹ The lesson from those cases is not that all asset lockups are invalid but only that asset lockups struck at less

225. *In re 3Com*, 2009 WL 5173804, at *7 (observing that the Delaware Court of Chancery has repeatedly upheld no-shop provisions, match rights, and termination fees as “standard merger terms . . . [that] do not alone constitute breaches of fiduciary duty”).

226. *See, e.g.*, *San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 983 A.2d 304, 306, 319 n.45 (Del. Ch.) (observing that continuing director provisions are “common-place” but noting that “[t]he fact that a term is customary is not proof that it is, in fact, either permissible or justifiable under the specific circumstances”), *aff’d mem.*, 981 A.2d 1173 (Del. 2009); *cf.* Transcript of Oral Argument on Cross Motions for Summary Judgment & Rulings of the Court at 67, *In re Vaalco Energy, Inc. Stockholder Litig.*, C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (“Just as ‘all the other kids are doing it’ wasn’t a good argument for your mother . . . [.] the idea that 175 other companies might have wacky provisions isn’t a good argument for validating your provision.”).

227. *See Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1286-87 (Del. 1989); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183 (Del. 1986).

228. In some cases, there is evidence of how the parties thought about the asset lockup. In the Turtle Beach-Parametric Sound merger, for example, the parties characterized the asset lockup as a “Break-Up Fee License Agreement.” *See, e.g.*, Parametric Sound Proxy Statement, *supra* note 98, at 99. This characterization suggests that the lockup was struck at less than fair market value because a license agreement can only be a “fee” (siphoning value out of the company and therefore analogized to a breakup fee) if it is struck at less than fair market value.

229. In *Revlon*, after several rounds of bidding by Ronald Perelman and Forstmann Little, Forstmann conditioned its final offer on a lockup option to purchase two of Revlon’s divisions (Vision Care and National Health Laboratories) for \$525 million, which was estimated to be between \$100 and \$175 million below market value. *See* 506 A.2d at 176, 178-79. In *Macmillan*, the target company granted one of the bidders (KKR) an option to purchase seven Macmillan subsidiaries for \$865 million. 559 A.2d at 1286.

than fair market value are invalid.²³⁰ Asset lockups nevertheless disappeared because (in the era of hard-asset lockups) a lockup that was struck at fair market value would have no deal protection effect.

In the new economy, asset lockups can be intangible—the AuthenTec, NYSE, and Parametric Sound deals are all examples of these intangible asset lockups.²³¹ With intangible asset lockups, even lockups that are granted at fair market value can create an unequal playing field and potentially preclude higher-value bidders.

To see why, consider Apple’s right to acquire a nonexclusive license to the New Technologies as part of its deal with AuthenTec.²³² Assume (for purposes of argument) that the asset lockup was granted at fair market value. With that assumption, and in view of the fact that Apple’s license would be nonexclusive under the Commercial Agreement, it might be argued that the asset lockup should have no deterrent effect on a potential third-party bidder.

However, such analysis would be incorrect in light of game theory’s core insight of looking forward and reasoning back. The asset lockup has the effect of eliminating any value a third-party bidder might perceive in keeping the New Technologies out of Apple’s hands. In contrast, if Apple completes the acquisition, it would keep the New Technologies out of competitors’ hands.²³³ Therefore the asset lockup has the effect of putting a wedge between Apple’s willingness to pay and other bidders’ willingness to pay for AuthenTec just like more conventional deal protections.

To make the point concrete, consider the following scenario:

1. Apple values AuthenTec on a standalone basis at \$100 and derives another \$20 of value from keeping the New Technologies out of Samsung’s hands.

230. See Coates & Subramanian, *supra* note 1, at 328 n.54 (“If you’re talking about [asset] lockups, early 80s, it was the wild west. We were doing preclusive crown jewel options and all sorts of stuff, and I just don’t think the law now lets you do that.” (alteration in original) (quoting Interview with Robert E. Spatt, *supra* note 79, at 4)); *id.* (“I’m not saying that there are no situations where you can do an asset lockup, but the courts seem to frown on that generally, though they could be lawful under some circumstances.” (quoting Interview with Stephen R. Volk, *supra* note 80, at 3)).

231. See *supra* Part II.C.

232. *Supra* Part II.C.

233. See STANLEY FOSTER REED ET AL., THE ART OF M&A: A MERGER/ACQUISITION/BUYOUT GUIDE 799 (4th ed. 2007) (“In the asset lockup (or ‘crown jewel’ lockup), the company grants the bidder the option to acquire a particularly attractive asset at a price that may or may not be commensurate with its full market value. Such an option may discourage other bidders if they were also interested in the crown jewel or if the loss of the asset would considerably change the financial position or prospects of the company.” (emphasis added)).

2. Samsung values AuthenTec on a standalone basis at \$110 and would derive another \$20 of value from keeping the New Technologies out of Apple's hands.

In the absence of the asset lockup, Apple and Samsung would both bid and Samsung would win the auction at some price between \$120 and \$130. With the asset lockup, Samsung declines to bid because a source of value (keeping the New Technologies out of Apple's hands) has been eliminated. Because Apple can keep the New Technologies out of Samsung's hands but not vice versa, the parties are not on a level playing field. In fact, one CEO of a target company advertised the deal protection effect of an intangible asset lockup ostensibly struck at fair market value. The CEO pointed out that the asset lockup would keep certain assets out of the exclusive hands of a competitor, thereby reducing the incentive for the competitor to bid.²³⁴

The degree of bidder deterrence in any particular deal would depend on the size of the asset lockup relative to the overall value of the transaction. In the AuthenTec case, the locked-up assets were worth \$135 million (using the fair market value assumption), or more than one-third of total deal value.²³⁵ In the Turtle Beach-Parametric asset lockup, there were three sources of value: (1) the value accruing to Turtle Beach for its own applications of the HyperSound technology; (2) the value of keeping this technology out of Parametric's hands; and (3) the value of keeping this technology out of all other competitors' hands, unless, of course, these competitors offered Turtle Beach (not Parametric) sufficient value to justify a sublicense. In theory, these three sources of value could even exceed the market capitalization of Parametric on a standalone basis.

These examples illustrate why the traditional analysis of asset lockups may not translate to the new generation of asset lockups. In the new economy, an intangible asset lockup may be at fair market value and still create a significant wedge between the inside bidder and prospective third-party bidders. As this next generation of asset lockups continues to proliferate, courts should acknowledge that in certain circumstances, even an asset lockup struck at fair market value may have a deal protection effect and should be analyzed as such.

In addition to the size of the asset lockup relative to deal value, the amount of value in keeping the asset from competitors makes the lockup more or less potent as a deal protection device. When this value is significant, the situation could be characterized as an "all-pay" auction because all bidders pay. The winning bidder pays more than fair market value because of the additional value in keeping the asset out of a competitor's hands, and losing bidders "pay" for not getting the asset.

234. Confidentiality obligations prevent us from disclosing the name of the company.

235. See *supra* Part II.C.

As an example of an all-pay auction in the M&A marketplace, consider the contest between Dell and Hewlett-Packard (HP) to acquire 3PAR. On August 16, 2010, Dell announced that it had entered into a merger agreement to acquire 3PAR for \$18 per share.²³⁶ 3PAR was a company in the emerging arena of cloud computing, an area where both Dell and HP were perceived to have strategic gaps.²³⁷ In response, HP decided almost immediately to make an overbid, and the HP board authorized management to make new bids as needed to “thwart [its] rival’s every possible move.”²³⁸ HP bid \$24 per share, Dell counteroffered at \$24.30, HP answered with \$27, Dell matched at \$27, and HP answered again with \$30.²³⁹ On September 1, 2010, Dell increased its offer to \$32 per share, and HP responded with \$33.²⁴⁰ Dell declined to continue bidding and accepted a \$72 million breakup fee (amounting to approximately 3.1% of the final deal value) from 3PAR.²⁴¹

“HP had bid less [for 3PAR] before it learn[ed] that Dell was the other suitor”²⁴² HP’s entry was motivated by an interest in blocking Dell from “gain[ing] ground in data storage, where HP [was] weak.”²⁴³ For HP, acquiring 3PAR would have improved its high-end data storage, but the deal was not a must-have.²⁴⁴ For Dell, in contrast, the acquisition would have had a much larger impact because Dell then lacked a high-end data storage business.²⁴⁵ As a result, 3PAR was “seen as a critical prong” in Dell’s efforts to expand its business beyond PCs.²⁴⁶

236. Dell Inc., Joint Press Release Issued by Dell Inc. and 3PAR Inc., Dated August 16, 2010 (Exhibit 99.1 to Form 8-K), at 2 (Aug. 16, 2010).

237. See, e.g., Cade Metz, *Nobody Knew How Big a Deal the Cloud Would Be—They Do Now*, WIRED (Dec. 22, 2015, 11:00 AM), <https://www.wired.com/2015/12/2015-was-the-year-the-cloud-defeated-techs-walking-dead> (arguing that Dell and HP are among “the tech giants most threatened by the cloud revolution”).

238. See Anupreeta Das & Ben Worthen, *H-P Outguns Dell in Takeover Duel*, WALL ST. J. (Sept. 2, 2010, 12:01 AM ET), <http://on.wsj.com/12k6Jdi>.

239. See *id.*

240. See *id.*

241. See Aaron Ricalde, *HP to Buy 3Par for \$2.35 Billion as Dell Walks Away*, BLOOMBERG (Sept. 2, 2010, 4:23 PM PDT), <http://www.bloomberg.com/news/articles/2010-09-02/dell-walks-away-from-3par-bidding-after-hp-s-33-a-share-offer>.

242. Joseph Menn, *HP to Buy 3Par as Dell Pulls Out of Race*, FIN. TIMES (Sept. 3, 2010, 12:22 AM), <http://on.ft.com/2dnVCI9>.

243. *Id.*

244. Michael Corkery, *Who Needs 3PAR More: H-P or Dell?*, WALL ST. J.: DEAL J. (Aug. 26, 2010, 3:26 PM ET), <http://blogs.wsj.com/deals/2010/08/26/who-needs-3par-more-h-p-or-dell>.

245. *Id.*

246. *Id.* It appears that Dell got more sophisticated and aggressive about deal protections in the aftermath of the 3PAR situation as both an inside and outside bidder. For example, when Dell acquired Compellent shortly after losing 3PAR, it tried to avoid making the

footnote continued on next page

The 3PAR board, recognizing the all-pay structure, resisted onerous deal protections that would have dampened the auction. For example, at one point in the bidding contest, Dell asked for a license agreement similar to the Break-Up Fee License Agreement in the Turtle Beach-Parametric Sound deal.²⁴⁷ The 3PAR board rejected the proposal because “Dell’s proposed [Original Equipment Manufacturer] purchase agreement would have a significant adverse impact on the value of 3PAR as a stand-alone company and as a strategic asset to HP.”²⁴⁸

The 3PAR/HP/Dell case illustrates how all-pay structures can cause bidders both to enter a bidding contest and bid more than they would otherwise pay, potentially even more than the asset’s standalone value.²⁴⁹ Intangible asset lockups, even when struck at fair market value, can shut down this potential dynamic.

same mistake twice by putting “aggressive” deal protection measures into the Compellent deal. *See In re Compellent Techs., Inc. S’holder Litig.*, C.A. No. 6084-VCL, 2011 WL 6382523, at *5 (Del. Ch. Dec. 9, 2011). These deal protection measures were subsequently modified in a settlement with plaintiffs’ counsel. *Id.* at *17. And in the Quest Software management buyout, the special committee gave Dell (the third-party bidder) a novel three-part inducement: (1) an option for Dell to acquire 19.9% of the Quest shares; (2) a breakup fee of 2.0% of the transaction value, which amounted to approximately \$40 million, if shareholders voted down the deal; and (3) a 3.5% breakup fee, amounting to \$70 million, if the Dell offer were subsequently trumped. *See* Quest Software, Inc., Press Release Issued by Quest Software, Inc. on June 14, 2012 (Exhibit 99.1 to Form 8-K), at 1 (June 14, 2012); *see also* *Timeline: Dell Wins Quest Software Bidding War*, REUTERS (July 2, 2012, 9:38 AM EDT), <http://reut.rs/MOZWG4> (describing the timeline of the acquisition).

247. For Dell’s proposed agreement, see 3PAR Inc., Solicitation/Recommendation Statement Under Section 14(d)(4) of the Securities Exchange Act of 1934 (Schedule 14D-9), at 30 (Sept. 7, 2010) [hereinafter 3PAR Solicitation Statement]. For a discussion of the Turtle Beach-Parametric Sound license agreement, see Part II.C above.

248. 3PAR Solicitation Statement, *supra* note 247, at 31.

249. The Oracle/SAP/Retek bidding contest also illustrates the point. SAP announced it would buy Retek for \$8.50 per share in February 2005. Laurie J. Flynn, *Oracle Raises Offer for Retek, Topping Bid by German Rival*, N.Y. TIMES (Mar. 19, 2005), <http://nyti.ms/2d7m7A9>. In early March, Oracle topped SAP’s bid with a \$9 per share offer. *See id.* SAP responded with an \$11 “best and final offer”; Oracle answered “just a few hours” later with \$11.25 per share. *Id.* Retek’s board accepted Oracle’s offer and paid SAP a \$25 million termination fee (amounting to approximately 4.0% of the deal value). *See id.* Retek software provides a merchandising system that fills an important gap in enterprise retail by streamlining finance, supply, human resources, data management, and the like. *See* Lisa DiCarlo, *Why Are Oracle and SAP Fighting Over Retek*, FORBES, (Mar. 18, 2005, 6:00 AM), http://www.forbes.com/2005/03/18/cx_ld_0318retrek.html. In pursuing Retek, Oracle wanted to protect its top data management position in North America, which was being threatened by SAP. *See id.* SAP would have had access to key names in retail, including Gap and BestBuy, thereby becoming a top retail database and applications provider. *See id.* Oracle thwarted this strategy but paid full value as the all-pay auction structure would predict.

The analysis thus far has used basic insights from game theory to demonstrate why even an asset lockup struck at fair market value can deter prospective third-party bidders. Of course, this deterrent effect can become even more significant when the asset lockup is not granted at fair market value. The Delaware Court of Chancery has indicated that a 6.3% valuation wedge between a first bidder and a potential second bidder is likely to be preclusive and therefore impermissible under Delaware corporate law.²⁵⁰ This means that it only takes a slight valuation gap for an asset lockup to be preclusive: in a \$100 million deal, for example, an asset lockup that was struck \$6 million under fair market value would, on its own, be preclusive. This kind of valuation gap becomes easier to achieve, of course, when the assets being locked up represent a significant share of the overall value of the company.

None of this is to say that companies cannot negotiate a license agreement (or other commercial agreement) outside the context of a specific merger negotiation. In that scenario, the parties would be negotiating at arm's length and both sides would have every incentive to achieve fair market value. But Coates and Subramanian define a lockup as "a term in an agreement *related to an M&A transaction* involving a public company target that provides value to the bidder in the event that the transaction is not consummated due to specified conditions."²⁵¹ Admittedly, there may be gray areas in applying this principle in particular cases. But all of the licensing agreements and financing arrangements described in Parts II.C and II.D above are "related to an M&A transaction"—in part because of the temporal proximity but also because the business motivations for the licensing agreements were intertwined with the business motivations for the M&A deal. In this scenario, the incentive to negotiate a deal at arm's length goes away: both Parametric and AuthenTec, for example, had an incentive to enter the license agreement at less than fair market value in order to deliver deal certainty for their preferred buyers.²⁵² Corporate law in this context can no longer rely on bargaining at arm's length to protect shareholders' interests, and the *Unocal/Unitrin* scrutiny described in Part III.A above is warranted.

250. See Transcript of Afternoon Session, *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, No. Civ. A. 17398 (Del. Ch. Sept. 27, 1999), 1999 WL 1054255, at *2 ("I do not take up plaintiffs' challenge to the termination fee as being unduly coercive, although I think 6.3 percent certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point.").

251. Coates & Subramanian, *supra* note 1, at 310 n.2 (emphasis added).

252. See *supra* Part II.C (describing the deals).

C. Adopting a Functional Approach

Finally, and perhaps most importantly, Delaware courts should make clear that deal protection will be assessed from a functional perspective—if it walks like a duck, it is a duck.²⁵³ With respect to the new look of deal protection documented in Part II above, this principle means that licensing agreements and financing arrangements that have a deal protection effect should not be given automatic deference because they might have some colorable business purpose.²⁵⁴ As a corollary, courts should look outside the four corners of the merger agreement to identify devices that impede a potential third-party bid.²⁵⁵

The only Delaware court opinion to assess the new generation of deal protections is the 2012 *In re Complete Genomics* decision, which examined the financing arrangement in the BGI Shenzhen-Complete Genomics deal described in Part II.D above.²⁵⁶ On the deal protection question raised in that case, the court had to assess the combination of a 4.8% termination fee with a bridge loan that was convertible at the deal price into 22% of the target's fully

253. See *McMillan v. Intercargo Corp.*, 768 A.2d 492, 506 n.62 (Del. Ch. 2000) (“Under a ‘duck’ approach to the law, ‘deal protection’ terms self-evidently designed to deter and make more expensive alternative transactions would be considered defensive and reviewed under the *Unocal Corp. v. Mesa Petroleum Co.* standard.” (citation omitted)).

254. Note that financing arrangements can easily be structured to avoid having a deal protection effect; in this scenario, there would be no need to apply deal protection doctrine. The Metalico-Total Merchant deal, in which the buyer provided financing to the seller in the form of prepayments (without significant benefits to the buyer if the deal did not close) illustrates this. See, e.g., Metalico, Inc., Definitive Proxy Statement (Schedule 14A), at 23, 25-26 (July 27, 2015) (“Total Merchant [the eventual buyer] offered to assist with our short term liquidity, and from early May to May 20, 2015, various methods of assistance were discussed. Ultimately, on May 20, 2015, [an affiliate of Total Merchant] agreed to make \$5.0 million in prepayments for aluminum zorba by May 29, 2015, which payments were subsequently made. In connection therewith, we have delivered approximately \$2.5 million of zorba to [the affiliate] and the remaining \$2.5 million is being held by us as a deposit for additional purchases of zorba.”). Total Merchant signed a merger agreement to buy Metalico in June 2015, and the deal closed in September. See Metalico, Inc., Press Release Dated June 16, 2015 (Exhibit 99.1 to Form 8-K), at 1 (June 15, 2015) (announcing the merger agreement); Metalico Inc., Press Release Issued September 11, 2015 (Exhibit 99.1 to Form 8-K), at 1 (Sept. 11, 2015) (announcing the closing).

255. Compare Coates & Subramanian, *supra* note 1, at 310 n.2 (“We follow industry practice in using ‘lockup’ to mean a term in an agreement related to an M&A transaction involving a public company target that provides value to the bidder in the event that the transaction is not consummated due to specified conditions . . .” (emphasis added)), with Davidoff & Sautter, *supra* note 7, at 681-82 (“Lock-ups are contractual devices that buyers and sellers negotiate in an acquisition agreement.” (emphasis added)).

256. See Transcript of Telephonic Ruling, *In re Complete Genomics*, *supra* note 128, at 11-12; see also *supra* Part II.D.

diluted shares.²⁵⁷ The court began its ruling by explicitly declining to establish any precedent through the analysis.²⁵⁸ With that caveat, the court then examined the potential preclusive effect of the termination fee and the bridge loan conversion right:

[I]n *Paramount Communications v. QVC Network*, the Delaware Supreme Court aggregated the amount of the termination fee with the profits that the initial bidder could reap by exercising a stock option lock-up and receiving topping bid consideration to determine the amount of the termination payments. If one went that route, calculated an incremental premium on the bridge loan shares from an assumed 5-percent overbid, then added that to the break-up fee [of \$5.2 million, or 4.8% of deal equity value,] the effective cost to terminate would increase to approximately 6.1 percent of the public equity value of the transaction.²⁵⁹

However, the court then distinguished the stock option lockup in *Paramount* because “[t]he bridge loan here provided substantial benefit to Genomics in the form of much needed cash.”²⁶⁰ The court further noted that adding the bridge loan to the value of the denominator would bring the deal protections below 5% of deal equity value, which was within the range for comparable small-cap transactions.²⁶¹ For these reasons, the court upheld the termination fee and convertible bridge loan, though noting that “the heavy tolls that the merger agreement and bridge loan impose do make this a closer case than it otherwise might be.”²⁶²

While the court explicitly disavowed adopting any broader principles in *In re Complete Genomics*, the decision seems to endorse a functional approach to deal protections. Specifically, even though the bridge loan in *In re Complete Genomics* had a colorable business purpose (namely, providing “much needed cash”²⁶³), the court paid attention to its deal protection effect because the bridge loan was the functional equivalent of a stock option lockup. Subsequent

257. Transcript of Telephonic Ruling, *In re Complete Genomics*, *supra* note 128, at 11. In the discussion of the protections in the Complete Genomics transaction in Part II.D above, we used information directly from the SEC filings, which yields slightly different results. However, for the purposes of the discussion here, we use the deal information as stated in the court’s opinion.

258. *Id.* at 4 (“It became clear to me that any ruling in this case would risk making a kind of equitable rule of law by proclamation rather than the type of case-specific, factually intensive application that is the true realm of equity and the province of this Court. That didn’t strike me as an appropriate exercise, so I have decided to go ahead and give you my rulings orally now. They will be narrow.”).

259. *Id.* at 11-12.

260. *Id.* at 16.

261. *See id.* at 16-17.

262. *Id.*

263. *Id.* at 16.

Delaware doctrine should endorse this functional approach to deal protections.²⁶⁴

Kirkland & Ellis's memo to its clients on the new-style deal protections illustrates the risks of the alternative approach:

[I]n appropriate circumstances there may be room in the dealmaking toolkit for modern and creative variations on traditional lock-up arrangements (more so where there is demonstrable business benefit to one or both parties beyond the resulting deal protection). It goes without saying that these lock-ups, even in their modern iterations, must be handled with care with ample discussion and documentation of the reasoning and justification for their implementation.²⁶⁵

If “ample discussion and documentation of the reasoning and justification” would stop deal protection doctrine from applying, then practitioners would readily provide such documentation in order to deliver (for example) an 8% wedge to a client's favored bidder.²⁶⁶ That is, without a functional approach to deal protections, practitioners will engage in a kabuki dance with their clients and the courts to figure out exactly what is required to deliver deal certainty. This would subvert well-established principles inherent in *Unocal/Unitrin* and *Revlon*.

While the court took this functional approach to deal protections in *In re Complete Genomics*, it did not correctly apply this approach for two reasons. First, the court calculated the deterrent effect of a bridge loan conversion using a 5% overbid assumption.²⁶⁷ In *In re Compellent Technologies*, just one year prior to *In re Complete Genomics*, the court used an 11.4% overbid assumption.²⁶⁸ This

264. By way of analogy, consider a machine gun that has a flashlight on top. The manufacturer might argue that it should only be regulated as a flashlight because it has the ability to shine light just like a flashlight. Of course, such an approach would be absurd: just because a machine gun can also function as a flashlight does not mean that it should no longer be regulated as a machine gun. If this were not the case, then certainly every machine gun manufacturer would put a flashlight on top of its machine gun and declare that it should be regulated like a flashlight and not a machine gun. The functional approach proposed in the remainder of this Part avoids both the absurd outcome and the perverse incentives that outcome creates.

265. Daniel E. Wolf et al., *Crown Jewels—Restoring the Luster to Creative Deal Lock-Ups?* 2 (2013), https://www.kirkland.com/siteFiles/Publications/MAUpdate_021413.pdf.

266. Imagine the following conversation between a target company and its potential buyer:

Acquirer: We'd like to get an 8% leg up against a potential third-party bidder, but the Delaware courts have signaled that 4-5% is the most we can get in the termination fee. Is there any other way you can give us deal certainty? That would seem to be a win-win since we both want this deal to close.

Target: How about a 3% termination fee but a bridge loan that has mandatory prepayment and a 20% prepayment penalty on the face value of the note in the event of an overbid?

Acquirer: Do you need financing between signing and the closing?

Target: Sure, we'll call a board meeting and document our need for financing.

267. See Transcript of Telephonic Ruling, *In re Complete Genomics*, *supra* note 128, at 11-12.

268. See *In re Compellent Techs., Inc. S'holder Litig.*, C.A. No. 6084-VCL, 2011 WL 6382523, at *24-25 (Del. Ch. Dec. 9, 2011).

11.4% assumption would be more consistent with the weight of the academic evidence, which documents average overbids in the range of 10-15%.²⁶⁹ Under an 11.4% overbid assumption, the cost imposed on a third-party bidder would be \$3.4 million from loan conversion as compared to the court's estimate of \$1.5 million.²⁷⁰

Second, the court added the value of the full bridge loan conversion to the denominator, which had the effect of reducing the deal protection from 6.1% to below 5%.²⁷¹ This approach, if adopted more generally, would have a perverse effect. To see why, consider a \$3 million termination fee in a \$50 million deal. The bidder and target now add a \$25 million bridge loan convertible into shares of the target company at the deal price. Under the *Complete Genomics* approach, the denominator for deal protection purposes would balloon from \$50 million in deal value to \$75 million even though the intrinsic value of the target company does not change. The numerator would increase by \$1.25 million, assuming a 5% overbid.²⁷² By adding the convertible bridge loan, then, the magnitude of the deal protection goes down, from 6% to 5.7% of the original deal value,²⁷³ even though the actual deal protection has increased.

With these two methodological adjustments applied to the facts of *In re Complete Genomics*, the deal protections amount to 7.1% of the new deal value.²⁷⁴ This level of deal protection would be very high among comparable transactions and higher than anything the Delaware courts have previously endorsed. The correct methodology shifts the case from "a closer case than it otherwise might be"²⁷⁵ to a case that is probably over the line on permissible deal protections. This analysis illustrates how seemingly small choices in methodology can change the ultimate conclusion in deal protection doctrine.

269. See, e.g., Coates & Subramanian, *supra* note 1, at 349 n.124 (using an average overbid of 14.9% to calculate the potency of stock option lockups); Robert Comment & G. William Schwert, *Poison or Placebo?: Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 31 tbl.4, 32 (1995) (finding an 11.4% average overbid); Randall A. Heron & Erik Lie, *On the Use of Poison Pills and Defensive Payouts by Takeover Targets*, 79 J. BUS. 1783, 1804 tbl.7, 1805 (2006) (finding a 15% average overbid); G. William Schwert, *Markup Pricing in Mergers and Acquisitions*, 41 J. FIN. ECON. 153, 164 tbl.2, 167 (1996) (calculating a 10.5% average post-bid markup).

270. An 11.4% overbid would be: \$3.15 per share \times 1.114 per share \approx \$3.51 per share. Therefore, profits from selling into the overbid would be: (\$3.51 per share - \$3.15 per share) \times 9.5 million shares \approx \$3.4 million.

271. Transcript of Telephonic Ruling, *In re Complete Genomics*, *supra* note 128, at 11-12, 16.

272. The numerator is calculated as: \$25 million \times 0.05 (overbid assumption) = \$1.25 million.

273. These figures are calculated as: (1) \$3 million termination fee / \$50 million deal value = 6% of deal value; and (2) (\$3 million termination fee + \$1.25 million from note conversion) / \$75 million deal value \approx 5.7% of deal value.

274. This figure is calculated as: (\$3.4 million + \$5.2 million) / (1.114 \times \$108 million) \approx 7.1%.

275. Transcript of Telephonic Ruling, *In re Complete Genomics*, *supra* note 128, at 16.

Before concluding this Subpart, it is worth emphasizing that courts should not adopt a particular bright line in assessing licensing and financing agreements that have a deal protection effect. In this sense, courts should not necessarily be bound to strike down any side agreement that has a deal protection effect or all side commercial agreements.²⁷⁶ Rather, courts should be aware of the fact that, even if side agreements have or appear to have a business purpose, they can also deter prospective bidders. And this effect should be factored in when estimating the total amount of the deal protections in M&A transactions. As mentioned above, some side financing arrangements are actually structured to avoid having a deal protection effect, and there would therefore be no reason to invalidate them.²⁷⁷ Of course, the level of scrutiny on commercial agreements should be significantly more demanding when those agreements are related to an M&A transaction (either explicitly or simply due to temporal proximity). For in those cases, as suggested above, the business motivations for the agreement are intertwined with the motivations for the M&A deal, and therefore the target company will have incentives to offer conditions below fair value in order to deliver deal certainty.²⁷⁸ This policy, however, should be a form of enhanced scrutiny when the context warrants it—not a per se prohibition.

Conclusion

Richard Beattie, then-Chairman of Simpson Thacher, put it well: “Generally the business people want to get the transaction done, to happen, and they want it to happen with the partner they’ve picked. But legally you can’t always do what they want. Which is why business people don’t like lawyers.”²⁷⁹ This Article presents evidence that when Delaware courts indicated that 4-5% was the limit on termination fees in M&A deals, practitioners took the hint, and termination fees/expense reimbursement provisions capped out just below the 4-5% level. But (as Beattie observes) lawyers want to be able to do what their clients want, which means providing an even larger advantage for a client trying to get a deal done. The proliferation of match rights, the reemergence of asset lockups, and the emergence of financing agreements that have a deal protection effect may be manifestations of this dynamic.

276. Similarly, we do not argue that the aggregate value of all deal protections (including termination fees and expense reimbursements) should be capped at a specific level. *But see* Bainbridge, *supra* note 33, at 323-24 (advocating a bright-line rule of 10%); *see also supra* notes 33-38 and accompanying text (discussing Bainbridge’s proposal).

277. *See supra* note 254.

278. *See supra* Part III.B.

279. Coates & Subramanian, *supra* note 1, at 310 (quoting Interview with Richard I. Beattie, *supra* note 4, at 1).

New Look of Deal Protection
69 STAN. L. REV. 1013 (2017)

Just as they did with termination fees, Delaware courts should address these latest developments in transactional practice. And just as with termination fees, it can be done through dicta by providing clear guidance on how the courts will approach the new look of deal protection devices in the future without actually striking down deal protections. This Article proposes three such guiding principles. First, Delaware courts should clarify that lockups must survive *Unocal/Unitrin* “preclusive” or “coercive” analysis in addition to *Revlon* “reasonableness” review. Second, Delaware courts should apply basic game theory to identify the deterrent effect of match rights and new economy asset lockups. And third, Delaware courts should take a functional approach to deal protections, meaning that collateral provisions that have a deal protection effect should be scrutinized under deal protection doctrine even if they also have some colorable business purpose. The result of implementing these principles would be greater allocational efficiency in the M&A marketplace, which improves overall social welfare.