ISSN 1936-5349 (print)
ISSN 1936-5357 (online)

# HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

# THE NEW LOOK OF DEAL PROTECTION

Fernan Restrepo
Guhan Subramanian

Forthcoming in *Stanford Law Review*, Vol. 69 (2017)

Discussion Paper No. 875

09/2016

Harvard Law School
Cambridge, MA 02138



This paper is also Discussion Paper 2016-8 of the
Harvard Law School Program on Corporate Governance

# THE NEW LOOK OF DEAL PROTECTION

Fernán Restrepo[*]
Guhan Subramanian[**]

*Draft – July 2016*
*Please do not cite or circulate without permission*

**Abstract**

*Deal protection in 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, have become ubiquitous by the 2010s; (3) asset lockups, which disappeared from the landscape for thirty years, have re-emerged, 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.*

---

[*] John. M. Olin Fellow and Gregory Terrill Cox Fellow in Law and Economics, Stanford Law School.

[**] Joseph Flom Professor of Law & Business, Harvard Law School; Douglas Weaver Professor of Business Law, Harvard Business School. Subramanian served as an expert witness for plaintiffs in some of the cases discussed in this Article. We thank participants in the Harvard Program on Negotiation Research Lab for helpful comments.

## Table of Contents



## Tables & Figures

## I. 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 1980s[1] increased to 2-3% by the 1990s[2] and 3-4% by the 2000s.[3] This trend cannot be readily explained by changes in 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 they were in the 1980s. The more plausible explanation lies in the nature of transactional practice. Nearly two decades ago, Dick Beattie, then Managing Partner at Simpson Thacher & Bartlett in New York City, explained this trajectory to one of us as follows: "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 some degree of market canvass 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. Giving boards legal protection against preclusive deal protections prevents bidders from demanding such deal protections in the first place. The result is greater allocational efficiency in the M&A marketplace, which improves overall social welfare.

In a 2000 article, one of us (along with co-author John Coates) recommended that the Delaware courts should provide guidance to practitioners on the permissible boundaries of deal protection.[5] Beginning 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

---

1 John Coates & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 336 (Figure 2) (2000) (presenting empirical evidence on the magnitude of termination fees in the late 1980s). *See also* BRUCE WASSERSTEIN, BIG DEAL at 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 that range.").

2 Coates & Subramanian, *supra* note 1, at 3336 (Figure 2).

3 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 (2011).

4 Interview with Richard I. Beattie, Chairman, Simpson Thacher & Bartlett, in New York, NY (July 23, 1999), *quoted in* Coates & Subramanian, *supra* note 1, at 335 n. 90.

5 Coates & Subramanian, *supra* note 1, at 387.

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 experience,[8] and reflecting the fact that deal protections are for the most part fungible, deal protections have migrated away from continued increases in termination fees to other areas where the 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, have become ubiquitous by the 2010s. While practitioners claim that match rights should have no effect on M&A deals and (perhaps based on these claims) the Delaware courts have 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, have re-emerged. Unlike the hard-asset lockups of the 1980s, the new generation of asset lockups tends to involve intangible assets such as licensing agreements or service agreements. Third, and perhaps most interestingly, 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, Delaware courts should clarify that deal protection 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 ("if it walks like a duck, it is a duck"), meaning that collateral provisions that 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 II provides general background on deal protection, including the business motivations for such devices and the prior literature. Part III identifies the "new look" of deal protection, relying in part on a new database of M&A transactions from 2003-2015. Part IV provides our

---

6 *See infra* notes 24-27 and accompanying text.

7 *Cf.* Steven M. Davidoff & Christina M. Sautter, *Lockup Creep*, 38 J. CORP. L. 681 (2011) (coining the term "lockup 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).

recommendations on how Delaware courts should refine existing deal protection doctrine to accommodate the new deal protection landscape. Part V concludes.

## II. Background

### A. Motivation for Deal Protection

In any public-company acquisition, the need for shareholder and regulatory approvals creates a window between the date of the deal signing/announcement and the date that the acquirer can close the deal. This window, which can be three months or longer, 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 in Coates & Subramanian (2000), 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."[9]

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 the shares of the target company

[9] 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 provisions do not provide value to the bidder – they simply preclude a topping bid. For a discussion of these provisions, *see*, *e.g.*, Christina M. Sautter, *Promises Made to Be Broken? Standstill Agreements in Change of Control Transactions*, 37 DEL. J. CORP. L. 929, 987–92 (2013); 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 (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, e.g.*, *In re* Complete Genomics, Inc. S'holder Litig., C.A. No. 7888-VCL (Del. Ch. Dec. 4, 2012); *In re* Ancestry.com Inc. S'holder Litig., C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012).

(typically, due to stock exchange constraints, 19.9%) at a specified price (typically the deal price).

Deal protection has two main effects in the M&A marketplace. First, it encourages a first bidder to bid, by compensating that bidder for (e.g.) opportunity costs, reputational costs, and out-of-pocket expenses. 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. 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 overbids that would increase target shareholder returns, conditional on a bid being brought.

### B. Prior Literature

There is a large theoretical and empirical literature on deal protection. In the realm of theory, Schwartz proposes a ban on termination fees and other deal protections, in order to encourage *ex post* competition.[10] In contrast, Ayres, as well as Fraidin & Hanson, present theoretical models demonstrating that, under certain assumptions, deal protection should not reduce allocational efficiency in the M&A marketplace; as a result they propose a more tolerant view of deal protections.[11] Bainbridge similarly takes an accommodating view, proposing a bright-line rule that deal protection should be limited to 10% of the overall deal value.[12]

Kahan & Klausner take a middle ground view. While accepting the general claim that deal protections should not influence allocational efficiency among existing bidders, they distinguish between deal protections granted to first bidders versus second bidders.[13] They argue that first-bidder deal protections can reasonably compensate for search costs

---

[10] 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, 377-78 (1987) (proposing requirement that shareholders approve lockups above reasonable negotiation expenses or involving 15+% of target's stock or assets).

[11] Ian Ayres, *Analyzing Stock Lockups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682 (1990); Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739 (1994).

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

[13] Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539 (1996).

and informational externalities, while second-bidder deal protections should be viewed more skeptically because they do not induce a sale process.[14]

In the realm of empirical evidence, Coates & Subramanian present a model that incorporates several real-world factors, such as agency costs, tax effects, and switching costs.[15] When these factors are considered, Coates & Subramanian demonstrate that allocational efficiency can be reduced through deal protection, even among existing bidders. The authors then present empirical evidence from U.S. deals between 1988 and 1998 that is consistent with their predictions. Subsequent empirical work by Burch,[16] Bates & Lemmon,[17] and Officer[18] confirms and further elaborates these findings, with respect to U.S. M&A deals.[19]

---

[14] *Id.* at 1563-64.

[15] Coates & Subramanian, *supra* note 1, at 355-361.

[16] *See* Timothy R. Burch, *Locking Out Rival Bidders: The Use of Lockup Options in Corporate Mergers*, 60 J. FIN. ECON. 103 (2001).

[17] 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 (2003).

[18] Micah S. Officer, *Termination Fees in Mergers and Acquisitions*, 69 J. FIN. ECON. 431 (2003).

[19] There are also empirical studies comparing deal volumes between the U.S. and U.K., which have significantly different regulatory regimes for deal protection. In the U.S., Delaware courts have signaled tolerance of termination fees in the 4-5% range. *See infra* Part III.A. In contrast, until 2011 the U.K. Takeover Panel limited termination fees to a bright-line 1% of deal value. Two studies find that deal volumes were significantly lower in the U.K. compared to the U.S. during this period. *See* S. Rossi, & P.F. Volpin, *Cross-Country Determinants of Mergers and Acquisitions*, 74 J. FIN. ECON. 277 (2004); John C. Coates, IV, *M&A Break Fees: U.S. Litigation Versus U.K. Regulation in* REGULATION VS. LITIGATION: PERSPECTIVES FROM ECONOMICS AND LAW (D. Kessler, ed.) (2010). Coates concludes that "[w]hile 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." *Id.* at 263. In 2011, the U.K. instituted a bright-line prohibition on termination fees. In a current working paper, we find that deal volumes decreased significantly in the U.K. after this reform. *See* Fernán Restrepo & Guhan Subramanian, *The Effect of Prohibiting Deal Protection on M&A Activity: Evidence from the United Kingdom* (Harvard Business School and Stanford Law School Working Paper, 2016). This evidence supports the view that the *ex ante* benefits of deal protection are non-trivial.

## III. Recent Trends in Deal Protection

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

### A. End of Termination Fee Creep

#### 1. Data Analysis

We collect systematic data on termination fees using the Factset MergerMetrics database. 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 2,318 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 that the target must pay to the acquirer in the event of termination. This equals the termination fee plus any additional amount that the target is required to reimburse the acquirer for out-of-pocket expenses. **Table 1** presents cross-sectional summary statistics and **Figure 1** 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 of Delaware. The magnitude of the difference is not large (0.23% of deal value), but it is statistically significant at 1% 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 are presented in **Table 2** (Models 1 and 3), which shows that, after controlling for other deal characteristics, the point estimate of the difference declines to 0.12% of deal value but is still statistically significant at 5% significance.

To explore whether the magnitude of termination fees has increased over time after controlling for other deal characteristics, we include time variables 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.[20] As shown in Models 2 and 3 of Table 2, these variables are insignificant, consistent with the finding that termination fees have stabilized in magnitude in the 2000s and onward.

Of course, exceptions still exist, with some deals pushing the limits of what is acceptable in M&A deals.[21] 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 results show that the incidence of fees has not changed over the last decade. In fact, termination fees have been virtually universal during the entire sample period.

2. Discussion

Empirical research on the magnitude of termination fees in the 1980s and 1990s documented gradual "creep" during this timeframe.[22] 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 Chancery Court 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.[23]

---

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

[21] *See, e.g.*, Baxter v. Syntroleum Corp. et al., Order on Defendant Syntroleum Board's Motion to Dismiss, C.A. No. CJ-2013-5807 (Oct. 6, 2015) (denying motion to dismiss against challenge to $5 million termination fee in sale of Syntroleum, a Delaware corporation, which amounted to 10.1% of deal value).

[22] *See, e.g.*, Coates & Subramanian, supra note 1, at 336 (Figure 2).

[23] *See, e.g.*, Interview with Richard I. Beattie, Chairman, Simpson Thacher & Bartlett, in New York, NY (July 23, 1999), *quoted in* Coates & Subramanian, *supra* note 1, at 335 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."); Interview with Benjamin F. Stapletown, Sullivan & Cromwell, in New York, NY (Aug. 10, 1999), *quoted in* Coates & Subramanian, *supra* note 1, at 335 n. 90 ("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. Three's okay, so three-and-a-half can't be that bad.").

Beginning in 1999, without actually invalidating any termination fees, the Delaware courts began signaling what the permissible limits would be. In *Phelps Dodge 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."[24] In *In re Topps Co. Shareholders' Litigation*, the Court upheld a 4.3% termination fee but called it "a bit high in percentage terms."[25] 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."[26] And in *In re Comverge Inc. Shareholder Litigation*, the Court characterized a 5.5% termination fee as "test[ing] the limits of what this court has found to be within a reasonable range for termination fees."[27]

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. To the extent that this interpretation is correct, 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.[28] Not surprisingly, practitioners read the Delaware case law and incorporated the signals that are sent from the bench (which include more than just the ultimate holdings) 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 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

---

[24] Phelps Dodge v. Cyprus Amax Minerals Co., No. Civ.A 17398, 1999 WL 1054255 at *2 ("Del. Ch. Sept. 27, 1999).

[25] *In re* Topps Co. S'holders Litig., 926 A.2d 58, 86 (Del. Ch. 2007).

[26] In re Answers Corp. S'holders Litig., No. CI. A. 6170-VCN, 2011 WL 1366780, at *4 & n.52 (Del. Ch. 2011).

[27] *In re* Comverge Inc., S'holder Litig., No. CV 7368-VCP, 2014 WL 6686570, at *14 (Del. Ch. Nov. 25, 2014). *See also* WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES & CASES ON THE LAW OF BUSINESS ORGANIZATION (4th ed. 2012) 575 & n. 54 ("Lump-sum termination payments no larger than 3 to 4 percent of the deal price are easily rationalized as a means to assure that a would-be acquirer will recover its transaction expenses (including opportunity costs) if the favored contract does not close. 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).").

[28] *See* Coates & Subramanian, *supra* note 1, at 316 (Figure 1).

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 sufficient incentive to attract first bidders.[29] 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, which we now turn to.

[29] Restrepo & Subramanian, *supra* note 19.

## TABLE 1: SUMMARY STATISTICS

Table 1 presents summary statistics for Delaware and non-Delaware targets. 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 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 as a percentage of deal value* 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 million dollars. *All-cash*, *Friendly deal*, *Same industry*, and *Tender offer* 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, and deals in which the transaction was a tender offer, respectively. The table reports mean values and standard deviation in parentheses. * significant at 90% confidence; ** significant at 95% confidence; *** significant at 99% confidence.

| Variable | Delaware targets | Non-Delaware targets | Difference (ND – DE) |
|---|---|---|---|
| Termination fee magnitude (as a percentage of deal value) | 3.56<br>(1.01) | 3.79<br>(1.12) | 0.23*** |
| Termination fee | 0.98<br>(0.15) | 0.98<br>(0.12) | 0.01 |
| Match right | 0.89<br>(0.31) | 0.84<br>(0.37) | -0.05*** |
| Match period | 3.86<br>(1.12) | 4.17<br>(1.48) | 0.32*** |
| Expense reimbursement in favor of bidder (as a percentage of deal value) | 0.77<br>(0.60) | 0.80<br>(0.67) | 0.03 |
| Expense reimbursement in favor of bidder | 0.43<br>(0.50) | 0.43<br>(0.49) | -0.01 |
| Transaction value | 2540.45<br>(6252.84) | 1826.92<br>(5430.34) | -713.53*** |
| All-cash | 0.67<br>(0.47) | 0.51<br>(0.50) | -0.16*** |
| Percentage of shares sought | 98.77<br>(6.10) | 99.38<br>(4.16) | 0.61*** |
| Friendly deal | 0.95<br>(0.22) | 0.97<br>(0.18) | 0.02** |
| Same industry | 0.08<br>(0.27) | 0.04<br>(0.20) | -0.04*** |
| Tender offer | 0.24<br>(0.43) | 0.11<br>(0.31) | -0.13*** |
| N | 1428 | 890 | |

## TABLE 2: REGRESSION ESTIMATES ON THE ASSOCIATION BETWEEN THE MAGNITUDE OF BREAKUP FEES AND TARGET AND DEAL CHARACTERISTICS

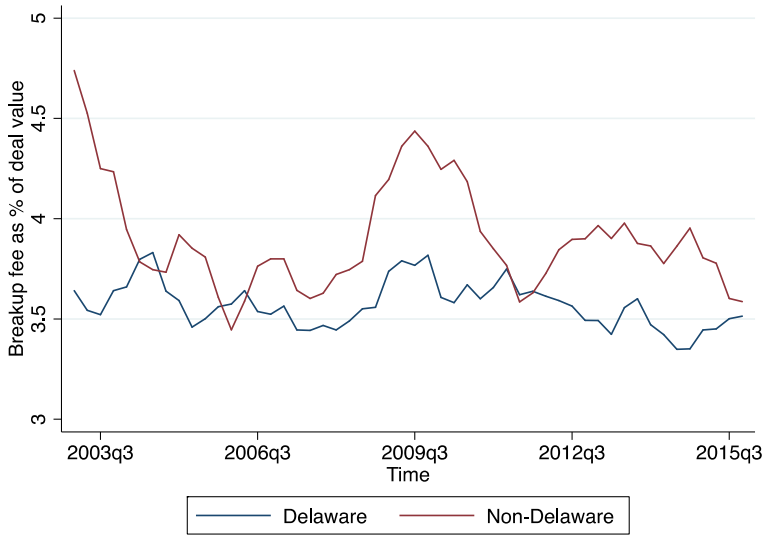
The table reports regression estimates on the association between termination fees as a percentage of deal value and the target's state of incorporation dummy, biyearly time dummies, and other characteristics of the transaction. The variables are defined as described in the legend of Table 1. The dependent 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. All the regressions are run using ordinary least squares with heteroskedasticity-consistent standard errors (in parentheses). * significant at 90% confidence; ** significant at 95% confidence; *** significant at 99% confidence.

| Variable | Model 1 | Model 2 | Model 3 |
|---|---|---|---|
| Delaware | -0.229*** | | -0.118** |
| | (0.05) | | (0.05) |
| 2006-2007 dummy | | -0.076 | -0.051 |
| | | (0.06) | (0.06) |
| 2008-2009 dummy | | 0.134 | 0.057 |
| | | (0.09) | (0.09) |
| 2010-2011 dummy | | 0.028 | 0.041 |
| | | (0.08) | (0.08) |
| 2012-2013 dummy | | 0.013 | -0.016 |
| | | (0.08) | (0.07) |
| 2014-2015 dummy | | -0.090 | -0.023 |
| | | (0.07) | (0.07) |
| Log(value) | | | -0.203*** |
| | | | (0.01) |
| All-cash | | | -0.162*** |
| | | | (0.05) |
| Shares sought (%) | | | -0.004 |
| | | | (0.01) |
| Friendly | | | 0.155 |
| | | | (0.14) |
| Same industry | | | 0.045 |
| | | | (0.09) |
| Tender offer | | | 0.028 |
| | | | (0.06) |
| Match right | | | 0.137** |
| R-squared | 0.011 | 0.004 | 0.103 |
| F-statistic | 24.262 | 1.755 | 19.357 |
| Prob > F | 0.000 | 0.119 | 0.000 |
| N | 2273 | 2273 | 2273 |

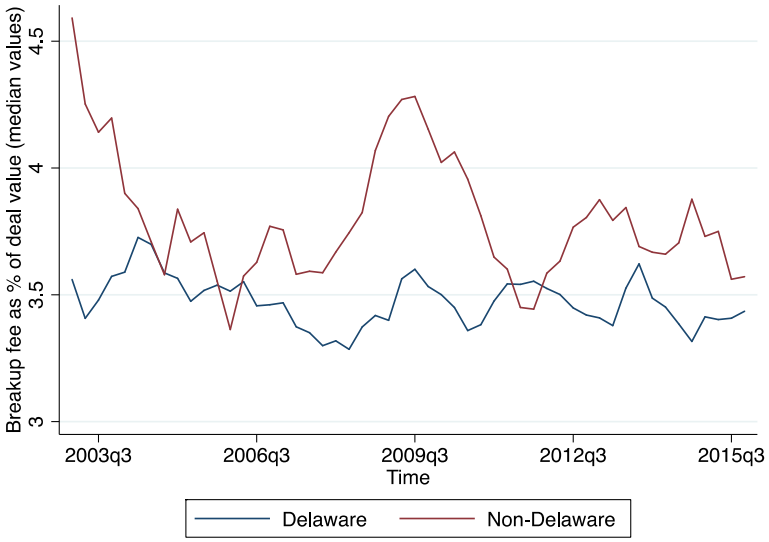
**FIGURE 1: TERMINATION FEES TO DEAL VALUE OVER TIME**

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.

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




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



### B. Proliferation of Match Rights

Match rights (equivalently, "matching rights") are contractual provisions that give a bidder the right to match a competing offer. Typically, a match right requires the target to notify the first bidder of any competing offer and negotiate "in good faith" for 3-5 days to see if the first bidder can match or beat the competing bid, such that the competing offer no longer constitutes a Superior Proposal that would permit the board to change its recommendation to shareholders. 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** 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; this is well-known among practitioners. Rather, it is the fact that match rights were *not* ubiquitous as recently as 2006 – appearing in only about two-thirds of deals in that year.

Conditional on granting a match right, Panel B shows that 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. Using either a *t*-test of means difference or a non-parametric Kruskal-Wallis test, this difference is statistically significant at 1% confidence.

## FIGURE 2: MATCH RIGHTS OVER TIME

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, which were announced between 2003 and 2015. The data are smoothed by a moving average of four quarters.

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


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

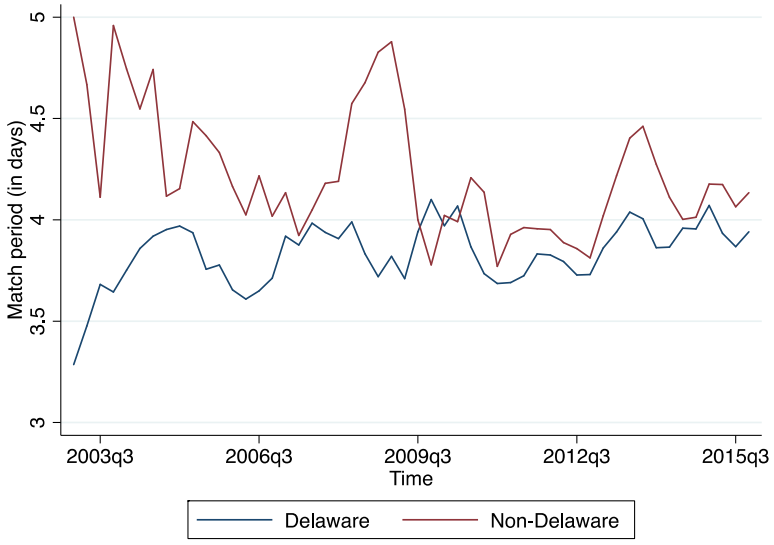


**Table 3** shows that the patterns presented in Figure 2 hold after controlling for other factors. We run a logit regression model in which the dependent variable is a dummy variable for the presence of a match right and the independent variables include only time dummies (Model 2) and time dummies with other deal characteristics (Model 3). Similar to the models presented in Table 2, we do 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 3).

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 bi-annual dummies. Consistent with the reported results, the dummies are positive, each is individually significant, and they are jointly significant at 1% (chi-sq = 129.49).

The regression results also show that there is no robust difference between Delaware and other states in the incidence of match rights. 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 insignificant in the full regression model (Model 3).

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 for the duration of the match right. In particular, in multivariate Poissson 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 with heteroskedasticity-consistent standard errors.[30]

[30] The result also holds if we truncate the maximum match period at 5 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

The 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. All the models are run as logistic regressions. The coefficients are odds ratios and the standard errors are in parentheses. * significant at 90% confidence; ** significant at 95% confidence; *** significant at 99% confidence.

| Variable | Model 1 | Model 2 | Model 3 |
|---|---|---|---|
| Delaware | 1.528*** | | 1.253 |
| | (0.19) | | (0.17) |
| 2006-2007 dummy | | 1.832*** | 1.623*** |
| | | (0.27) | (0.25) |
| 2008-2009 dummy | | 3.014*** | 3.000*** |
| | | (0.67) | (0.69) |
| 2010-2011 dummy | | 7.229*** | 6.305*** |
| | | (1.99) | (1.77) |
| 2012-2013 dummy | | 7.033*** | 6.742*** |
| | | (2.00) | (1.95) |
| 2014-2015 dummy | | 18.731*** | 19.710*** |
| | | (7.40) | (7.86) |
| Log(value) | | | 1.170*** |
| | | | (0.05) |
| All-cash | | | 2.500*** |
| | | | (0.36) |
| Shares sought (%) | | | 1.007 |
| | | | (0.01) |
| Friendly | | | 1.856* |
| | | | (0.63) |
| Same industry | | | 1.203 |
| | | | (0.38) |
| Tender offer | | | 1.172 |
| | | | (0.27) |
| Log-likelihood | -891.125 | -806.809 | -769.000 |
| Pseudo R-squared | 0.006 | 0.100 | 0.143 |
| LR chi2 | 11.547 | 180.178 | 255.795 |
| Prob > chi2 | 0.001 | 0.000 | 0.000 |
| N | 2318 | 2318 | 2318 |

### C. Emergence of "New Economy" Asset Lockups

In addition to the proliferation of matching rights, another development in transactional practice is the re-emergence 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 the "crown jewels" of the company, the asset lockup is further called a "crown jewel lockup." Asset lockups were common in the 1980s until the Delaware courts struck down crown jewel asset lockups in *Revlon v. MacAndrews & Forbes*[31] and *Mills Acquisition Co. v. Macmillan*.[32] Asset lockups were "rare" in the immediate aftermath of *Revlon* and *Macmillan*, and "extinct" by the 1990s.[33]

In the 1980s, asset lockups could help protect a deal by giving the buyer the right to buy certain key assets for below market value, thereby siphoning value out of the company in the event a higher-value bidder appeared.[34] When the Delaware courts made clear in *Revlon* and other cases that asset lockups would be scrutinized carefully,[35] their deal protection effect diminished and practitioners migrated to other, cleaner, deal protection devices such as stock option lockups (until pooling accounting disappeared in 2001[36]) and termination fees.

This changed in 2008. Beginning with 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,[37] the following examples suggest that asset lockups are back after a thirty-year hiatus:

---

31 506 A.2d 173, 178 (Del. 1986).

32 559 A.2d 1261 (Del. 1989).

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

34 *See id.* at 328 n.54 (quoting Robert Spatt of Simpson Thacher: "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.").

35 *See id.* (quoting Stephen R. Volk of Shearman & Sterling: "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.").

36 *See infra* Part III.D.

37 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 both databases are not comprehensive.

- **JPMorgan-Bear Stearns (2008):** As the first signs of the financial crisis began to appear in March 2008, JPMorgan agreed to buy Bear Stearns for $2 of JPM stock for each share of Bear Stearns stock.[38] The deal included an option for JPM to buy Bear's Manhattan headquarters for $1.1 billion in the event that Bear terminated the deal.[39] When JPM raised its offer to $10 of JPM stock, the parties further agreed that JPMorgan could exercise the asset option even if Bear Stearns shareholders voted down the merger agreement.[40] Attorneys for Bear Stearns shareholders challenged the option, arguing that it should be considered deal protection because the $1.1 billion strike price was lower than the fair value of the building.[41] The Delaware Chancery Court 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).[42] The New York court, applying Delaware law, rejected the challenge to the option, on the grounds that the evidence did not support the claim that the price was below fair value.[43]

- **Apple-AuthenTec (2012):** Apple agreed to acquire AuthenTec for $356 million in cash, with a $11 million termination fee (=3.1% of deal value) if AuthenTec terminated the deal to accept a higher offer.[44] The parties also

---

38 AGREEMENT AND PLAN OF MERGER BY AND BETWEEN THE BEAR STEARNS COMPANIES INC. AND JPMORGAN CHASE & CO. (Form 8-K), at Exhibit 2.1 (March 20, 2008) (hereinafter "BEAR STEARNS -JPMORGAN MERGER AGREEMENT") at 2; PRESS RELEASE: JPMORGAN TO ACQUIRE BEAR STEARNS (Form 8-K), at Exhibit 99.1 (March 18, 2008).

39 BEAR STEARNS -JPMORGAN MERGER AGREEMENT at 32.

40 *In re* Bear Stearns Companies, Inc. S'holder Litig., No. CIV.A. 3643-VCP, 2008 WL 959992, at *3 (Del. Ch. Apr. 9, 2008). *See also* AMENDMENT NO. 1 TO THE AGREEMENT AND PLAN OF MERGER BY AND BETWEEN THE BEAR STEARNS COMPANIES INC., AND JPMORGAN CHASE & CO. (Form 8-K), at Exhibit 2.1 (March 24 2008) at § 2.9.

41 *In re* Bear Stearns Companies, Inc. S'holder Litig., No. CIV.A. 3643-VCP, 2008 WL 959992, at *2 (Del. Ch. Apr. 9, 2008); *In re* BEAR STEARNS LITIGATION, 2008 WL 5168977 (N.Y.Sup.).

42 *See In re* Bear Stearns Companies, Inc. S'holder Litig., No. CIV.A. 3643-VCP, 2008 WL 959992, at *6 (Del. Ch. Apr. 9, 2008) ("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.")

43 *In re* Bear Stearns Litig., 23 Misc. 3d 447, 471-72, 870 N.Y.S.2d 709, 734-35 (Sup. Ct. 2008).

44 AGREEMENT AND PLAN OF MERGER BY AND AMONG APPLE INC., BRYCE ACQUISITION CORPORATION, AND AUTHENTEC, INC. (Form 8-K), at Exhibit 2.1 (July 27, 2012) (hereinafter "APPLE-AUTHENTEC MERGER AGREEMENT"), at §6.4(e).

included a side agreement specifying that Apple would pay $20 million for the option to acquire a non-exclusive license to certain fingerprint recognition technologies (the "New Technologies"), regardless of whether the merger was consummated. Apple could exercise this option within 270 days after the deal announcement by paying an additional $115 million.[45] In total, Apple could pay $135 million (=38% of the total acquisition price) to acquire a non-exclusive license to the New Technologies regardless of whether the acquisition went through. 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…"[46]

- **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. In addition, the parties entered into a separate agreement according to which ICE would be the exclusive provider of certain clearing services for the London market of NYSE Liffe, regardless of whether or not the acquisition was completed.[47] The parties emphasized that, despite the potential deterrent effect on competing bidders, the side deal had an independent business purpose. According to Fihbarr Hutcheson, Co-CEO of NYSE Liffe, "This agreement will enable us 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."[48]

- **Turtle Beach-Parametric Sound (2013):** Turtle Beach agreed to acquire Parametric Sound for $78 million, with a $1 million termination fee (amounting to 1.3% of deal value) if Parametric terminated the deal to accept a Superior Proposal.[49] In addition, the parties entered into a separate licensing

---

45 AUTHENTEC, INC., CURRENT REPORT (Form 8-K) (July 27, 2012) at 3. *See also* INTELLECTUAL PROPERTY AND TECHNOLOGY AGREEMENT (Form 8-K), at Exhibit 10.1.

46 AUTHENTEC PROXY STATEMENT (Form DEFM-14A) (August 31, 2012) at 23.

47 PRESS RELEASE: INTERCONTINENTALEXCHANGE AND NYSE EURONEXT ENTER CLEARING SERVICES AGREEMENT; ICE CLEAR EUROPE TO CLEAR NYSE LIFFE'S DERIVATIVES MARKETS (Form 8-K), at Exhibit 99.3 (December 20, 2012).

48 *Id.*

49 PARAMETRIC-TURTLE BEACH MERGER AGREEMENT at § 8.3. The merger agreement also included certain voting agreements with significant shareholders, who collectively held 19% of the Parametric shares, requiring these shareholders to vote in favor of the merger. PARAMETRIC PROXY STATEMENT (Form DEFM-14A) (December 3, 2013) at 15.

> agreement that provided Turtle Beach with exclusive and non-exclusive licenses to Parametric's technologies even if the deal was not consummated.[50] This side agreement was termed the"Break-Up Fee License Agreement" in the Proxy Statement.[51] 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 *non-exclusive* worldwide license to Parametric's HyperSound technology in the "computer audio products field."[52] Parametric would receive a 6% royalty on net sales of such products, and 30% from any sublicenses that Turtle Beach negotiated.[53] The term of the Break-Up Fee License Agreement was a minimum of ten years, with a minimum royalty payment of $2.0 million during the first five years and $1.0 million for each year after that (for a total minimum royalty payment of $7.0 million).[54] If these minimum royalty payments were not made, Parametric had the right to convert the gaming license to non-exclusive.[55]

**Table 4** summarizes the asset lockups in the deals described above. In each instance, the acquirer obtained assets in the event of non-consummation: either licenses (AuthenTec and Turtle Beach), services arrangements (NYSE Euronext), or hard assets

---

[50] AGREEMENT AND PLAN OF MERGER BY AND AMONG PARAMETRIC SOUND CORPORATION, PARIS ACQUISITION CORP. AND VTB HOLDINGS, INC. (Form 8-K), at Exhibit E (August 5, 2013).

[51] PARAMETRIC PROXY STATEMENT (Form DEFM-14A) (December 3, 2013), at 99.

[52] *Id.* at 99-100. 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.* The "computer audio products field" was defined as: "headsets and peripheral audio speakers that are (i) marketed specifically to be used in connection 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.

[53] *Id.* at 100.

[54] *Id.*

[55] *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." *Id.*

(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, potentially much longer. We do not claim 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 re-emerged 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 ($MM) | Termination Fee (% of Deal Value) | Asset Lockup Description |
|---|---|---|---|---|
| JPMorgan-Bear Stearns | March 2008 | $1,456 | None | Option for JPM to buy Bear's Manhattan headquarters for $1.1 billion |
| Apple-AuthenTec | July 2012 | $358 | 3.1% | Option to buy non-exclusive license to certain fingerprint recognition software for $115 million |
| Intercontinental Exchange-NYSE Euronext | Dec. 2012 | $8,048 | 5.6% | ICE would be exclusive provider of certain clearing services for NYSE's European derivatives segment |
| Parametric Sound-Turtle Beach | August 2013 | $78 | 1.3% | Option to obtain exclusive and non-exclusive licenses to certain technologies |

One explanation for the re-emergence 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 do.

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 Apple-AuthenTec, for example, the two companies had begun negotiating the terms of a commercial agreement to develop the New

Technologies as early as February 2012.[56] 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.[57] 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."[58]

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."[59] 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.[60]

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.[61] However, Apple rejected the possibility of a go-shop period.[62] 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 IV of this Article discusses how the Delaware courts should respond to this development 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.[63] Stock option

---

56 AUTHENTEC PROXY STATEMENT (Form DEFM-14A) (August 31, 2012) at 18.

57 *Id.* at 19.

58 *Id.* at 23.

59 *Id* at 20.

60 *Id*.

61 *Id.* at 20.

62 *Id*.

63 *See* Coates & Subramanian, *supra* note 1, at 316 (Figure 1).

lockups give the acquirer the right to buy a specified number of shares (typically amounting to 19.9% of the outstanding shares[64]) at a specified price (typically the deal price[65]). Stock option lockups have a deal protection effect because they go "into the money" with any overbid. Therefore, 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 goes up.

Stock option lockups were commonplace until the elimination of pooling accounting in 2001.[66] The reason is that exercise of a stock option would "queer" pooling for a third-party bidder, thus discouraging third-party bids. Once pooling accounting was eliminated, the need to queer pooling for a third-party bidder disappeared, and stock option lockups correspondingly went away.[67] We find no examples of stock option lockups in the Deal Protection Sample.

In their place, 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. Concurrent with the deal, BioSphere redeemed its Series A preferred stock.[68] Merit loaned BioSphere $10 million to fund this redemption. 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).[69] If Merit exercised the conversion right over the entire principal of the loan, it would receive 2.3 million BioSphere

---

64 *Id.* at 345 (Figure 4). The reason for 19.9% is that the major exchanges require a shareholder vote for stock option grants of 20% or greater. *See, e.g.*, NEW YORK STOCK EXCH., LISTED COMPANY MANUAL § 312.03(c) (2015).

65 *Id.* at 345 (Figure 3).

66 *See, e.g.*, Davidoff & Sautter, *supra* note 7, at 685.

67 *See* LOU R. KLING & EILEEN NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 3.07 (2005 & SUPP.).

68 BIOSPHERE MEDICAL, INC., CURRENT REPORT (Form 8-K) (May 14, 2010). There were 18.74 million common shares and 9.64 million Series A preferred shares outstanding at announcement. *See* BIOSPHERE MEDICAL, INC., AGREEMENT AND PLAN OF MERGER BY AND AMONG MERIT MEDICAL SYSTEMS, INC., AND BIOSPHERE MEDICAL, INC. (Form 8-K), at Exhibit 2.1, § 3.2 (May 14, 2010). For the purposes of this analysis, we illustrate the magnitude of the deal protection using the common shares.

69 BIOSPHERE MEDICAL, INC., FORM 10-Q (May 14, 2010), at 14, 22.

shares,[70] amounting to 11.0% of the new common shares outstanding.[71] In the event of a $5.00 per share offer, for example, Merit would convert its loan into 2.3 million BioSphere shares and sell into the overbid for a $1.4 million profit.[72] In this scenario the total cost imposed on a third-party bidder would be $1.4 million from the loan conversion plus $3.8 million from the termination fee, or $5.2 million in total (amounting to 5.0% of the new deal value[73]). At a $6.00 overbid, the total cost imposed on a third-party bidder would be $7.5 million or 6.0% of the new deal value.[74] At very high deal prices, the deal protection would asymptotically approach 11.0% of deal value.[75]

- **BGI Shenzhen-Complete Genomics (2012):** BGI Shenzhen agreed to acquire Complete Genomics for $108 million, with a $5.2 million termination fee (=4.8% of deal value) if Complete Genomics terminated the deal to accept a Superior Proposal. In a side agreement, BGI provided $30 million of bridge financing, which was convertible into Genomics' outstanding stock at the $3.15 per share deal price.[76] If the loan was fully drawn, the conversion would amount to approximately 9.5 million shares,[77] or 21.6% of the new shares outstanding.[78] In the event of a 5% overbid (as assumed in the Delaware

---

70 Calculated as: $10 million / $4.38

71 Calculated as: 2.3 million shares / (18.7 million shares outstanding + 2.3 million new shares)

72 Calculated as: 2.3 million × ($5.00 – $4.38)

73 Calculated as: ($1.4 million + $3.8 million) / (21.0 million shares × $5.00 per share)

74 Calculated as: [2.3 million shares × ($6.00 - $4.38) + $3.8 million] / (21.0 million shares × $6.00 per share)

75 Calculated as: $\lim_{x\to\infty}\left(\frac{2.3\ (x-\$4.38)+3.8}{(x)(21.0)}\right)$

76 COMPLETE GENOMICS, INC. CONVERTIBLE SUBORDINATED PROMISORY NOTE, (Form 8-K), at Exhibit 10.2 § 4(a) (September 15, 2012); AGREEMENT AND PLAN OF MERGER AMONG BGI-SHENZHEN, BETA ACQUISITION CORPORATION, AND COMPLETE GENOMICS, INC. (Form 8-K), at Exhibit 2.1 (September 15, 2012), at 1.

77 Computed as: $30 million / $3.15

78 According to the merger agreement, the total number of Complete Genomics' common shares at announcement was 34.385 million shares. *See* AGREEMENT AND PLAN OF MERGER AMONG BGI-SHENZHEN, BETA ACQUISITION CORPORATION, AND COMPLETE GENOMICS, INC. (Form 8-K), at Exhibit 2.1, § 3.2 (September 15, 2012). Therefore, the ratio of shares that could be converted to the total common shares outstanding would be: 9.5 million / (34.385 million + 9.5 million).

Chancery Court in this particular case[79]), BGI could convert the bridge loan into shares and sell into the overbid for a $1.5 million profit.[80] 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 termination fee, or $6.7 million in total (amounting to 4.6% of the new deal value.[81]) With a 10% overbid, which would be a more realistic assumption,[82] the total cost imposed on a third-party bidder would be $8.2 million, or 5.4% of deal value.[83]

- **Softbank-Sprint Nextel (2012):** Softbank agreed to acquire Sprint Nextel for $7.30 per share, or $21.9 billion in total, with a $600 million termination fee (amounting to 2.8% of deal value) if Sprint terminated the deal to accept to Superior Proposal.[84] Concurrent with the merger agreement, the parties negotiated a convertible bond agreement. Under the terms of this agreement, Sprint would give Softbank a $3.1 billion loan, convertible into 590.5 million shares (= 19.68% of Sprint's common stock[85]), for an effective price of $5.25 per share.[86] 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.[87] 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

---

79 *In re* Complete Genomics, Inc. S'holder Litig., C.A. No. 7888-VCL, at *11 (Del. Ch. Nov. 9, 2012) (transcript ruling). For a discussion of the Court's ruling, *see infra* Part IV.C.

80 A 5% overbid would be $3.31 per share, calculated as: $3.15 × (1 + 0.05). Therefore, the profit from selling into the overbid would be: ($3.31 - $3.15) × 9.5 million shares = $1.5 million.

81 Calculated as: $6.7 million / (43.9 million shares x $3.31 per share)

82 *See infra* note 174 and accompanying text.

83 A 10% overbid would be $3.15 × 1.10 = $3.47. Therefore, profits from selling into the overbid would be: ($3.47 - $3.15) × 9.5 million shares = $3.0 million. 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 million / (43.9 million shares x $3.47 deal price) = 5.4%.

84 SPRINT-SOFTBANK MERGER AGREEMENT (Form 8-K), at Exhibit 2.1, § 8.3 (October 15, 2012). According to the merger agreement, there were approximately 3 billion Sprint-Nextel shares outstanding at the time of the merger agreement.

85 SPRINT-NEXTEL CORPORATION BOND PURCHASE AGREEMENT (Form 8-K), at Exhibit 10.1, § 1.1(a), §10.1 (October 15, 2012). This value is slightly different from what is reported in the bond purchase agreement (19.65%) due to rounding.

86 Calculated as: $3.1 billion / 590.5 million shares

87 Calculated as: (($7.30 × 1.10) - $5.25) × 590.5 million shares

billion in total (amounting to 9.4% of the new deal value[88]). At very high deal prices, the deal protection would asymptotically approach 19.7% of deal value.[89]

- **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 to accept a Superior Proposal. Two concurrent 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"). In the event of an overbid, HIG could covert the loan into 8.6 million shares of Comverge commons stock at a conversion price of $1.40 per share, representing a 20% discount from the $1.75 per share deal price.[90] If HIG exercised the conversion feature in full, it would acquire 23.8% of the fully-diluted shares of Comverge.[91] 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").[92] 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 (for discussion purposes) could be estimated at $5.7 million.[93] At a $2.00 per share deal price, the deal protection would be worth $10.9 million, or 19.8% percent of deal value.[94] At a $3.00 per share deal price, the deal protection would be worth $19.5 million (nearly double

---

88 Calculated as: $2.24 billion / $21.6 billion x 1.1

89 Calculated as: $\lim_{x\to\infty}\left(\frac{590.5\ (x-\$5.25)+600}{(x)(3004+590.5)}\right)$

90 NOTE PURCHASE AND SECURITY AGREEMENT (Form 8-K), at Exhibit 10.1, § 2.2(a) (Mar. 26, 2012). The note conversion was lieu ofthe termination fee, expense reimbursement, and a pre-payment premium, which amounted to $0.5 million. *See id.* at § 2.3(b) (requiring prepayment of outstanding obligations and Prepayment Premium upon the occurrence of a change of control) & 64 (defining Prepayment Premium as 2-4% of the prepayment amount).

91 Calculated as: 8.6 million shares / (27.5 million shares outstanding + 8.6 million new shares).

92 GRACE BAY NOTE FORBEARANCE AGREEMENT (Form 8-K), at Exhibit 10.3 (Mar. 26, 2012).

93 *Id.* at § 2(b).

94 Calculated as: 8.6 million shares x ($2.00 - $1.40) + $5.7 million Make Whole Amount = $10.9 million. Deal equity value would be $2.00 per share x 27.5 million shares = $55.0 million. $10.9 million / $55.0 million = 19.8%.

> the value of the deal protection at $2.00 per share), or 23.6% of deal value.[95] At a $4.00 per share deal price, the deal protection would be worth $28.1 million, or 25.5% of deal value.[96] At very high deal prices, the deal protections in HIG-Comverge would asymptotically approach 31.3% of deal value.[97]

On the last of these examples, HIG might have been particularly concerned about the possibility of other bidders because of the unusual nature of the negotiation. HIG first submitted a non-binding proposal to acquire Comverge for $1.75 per share, and eventually made a "best and final" offer of $2.25 per share.[98] The Comverge board rejected these offers, indicating that it would be willing to accept no less than $3.00 per share.[99] 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.[100] HIG then notified Comverge that Comverge was in default under the PFG Note because it had failed to deliver certain compliance certifications.[101] With Comverge pinned to the wall, HIG lowered its offer from $2.25 per share to $1.50 per share, eventually raising to $1.75.[102] The Comverge board – which just one month earlier had turned down $2.25 per share because the company was worth $3.00 – accepted the $1.75 per share offer.[103] Plaintiff shareholders challenged the deal protections, and the case is currently pending in the Delaware Chancery Court.

Of course, HIG's strategy only works if the deal protections prevent a meaningful auction for the company. In Comverge, the deal protections of 25-30% were likely to have achieved the necessary deterrent effect.

---

95 Calculated as: 8.6 million shares x ($3.00 - $1.40) + $5.7 million Make Whole Amount = $19.5 million. Deal equity value would be $3.00 per share x 27.5 million shares = $82.5 million. $19.5 million / $82.5 million = 23.6%.

96 Calculated as: 8.6 million shares x ($4.00 - $1.40) + $5.7 million Make Whole Amount = $28.1 million. Deal equity value would be $4.00 per share x 27.5 million shares = $110.0 million. $28.1 million / $110.0 million = 25.5%.

97 Calculated as: $\lim_{x\to\infty} \frac{8.6(x-1.40)+5.7}{27.5x}$

98 *In re* Comverge, Inc., No. CV 7368-VCP, 2014 WL 6686570, at 7 (Del. Ch. Nov. 25, 2014) (Del. Ch. 2014).

99 *Id.* at 8-9.

100 *Id.* at 10.

101 *Id.* at 10-11.

102 *Id.* at 12.

103 *Id.*

**Table 5** summarizes the financing arrangements in the 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 the prior Part, we do not claim that this list is comprehensive, and even if 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 re-emerged as part of the deal protection toolkit, in the form of a financing arrangement for the target company.

**TABLE 5: FINANCING ARRANGEMENTS WITH DEAL PROTECTION EFFECT**

| Acquirer-Target | Date Announced | Deal Value ($MM) | Termination Fee (% of Deal Value) | Financing Arrangement Description | Maximum Deal Protection (%) |
|---|---|---|---|---|---|
| BioSphere-Merit Medical | May 2010 | $82 | 4.6% | $10 million loan convertible into Merit Medical shares at the deal price | 11.0% |
| BGI Shenzhen-Complete Genomics | September 2012 | $108 | 4.8% | $30 million bridge financing convertible into Complete Genomics shares at the deal price | 21.6% |
| Softbank-Sprint | Oct. 2012 | $21,900 | 2.8% | $600 million bond convertible into Sprint shares at 28% less than the deal price | 19.6% |
| HIG-Comverge | March 2013 | $48 | 7.1% | $12 million bridge loan convertible into Comverge shares at 20% below deal price; and restructuring of existing debt to include mandatory prepayment and $5.7 million "Make Whole" provision in the event of an overbid | 31.3% |

The final column of Table 5 provides the maximum deal protection, which is calculated as the cost of the termination fee plus the cost of the financing arrangement at very high deal prices. Although very high overbids do not happen often,[104] the

[104] For examples, *see, e.g*, Wilshire Enterprises, Inc. - J&J Brothers Holdings, Inc., announced on December 18, 2015 and completed on February 18, 2016 (bidding contest caused initial

calculations suggest that the deal protection effect of the financing arrangement has the potential to be much larger than the deal protection effect of the termination fee on its own. This finding highlights the need to consider the financing arrangement as a deal protection – a point we return to in Part IV.C.

A second point that emerges from Table 5 is that the maximum deal protection has generally increased over the four deals in the sample – from 11.0% of deal value in the Merit Medical deal to 31.3% of deal value in Comverge.[105] It is of course difficult to extrapolate from such a small sample. 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. In contrast, more than 80% of stock option lockups in the 1990s were granted at the deal price.[106] Converting the debt at lower than the deal price has the effect of increasing the potency of the deal protection. Our experience of 20+ 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** summarizes the new look of deal protection as documented in this Part.

---

bidder to go from $1.50 per share to $3.38 per share); Terra Industries, Inc./CF Industries Holdings, Inc., announced on March 2, 2010 and completed on April 15, 2010 (100%+ premium from an overbid). Information on these deals is available in the Factset MergerMetrics database. *See also* infra TAN 149-157 (describing bidding contests for 3PAR and Retek that yielded very high overbids).

[105] 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 BRIDGE LOAN FORBEARANCE AGREEMENT §§ 1(b) & 2(b) (Additional Prepayment Amount defined as "the amount by which the Converted Share Value exceeds the value of the Obligations.").

[106] Coates & Subramanian, supra note 1, at 345 (Figure 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 *Revlon* and *Macmillan* 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 to this question.

## IV. A Proposed Approach to Deal Protections

Part III identifies four developments in the deal protection landscape: the end of termination fee creep; the proliferation of match rights; the re-emergence 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, match rights, asset lockups, and financing arrangements have appeared to fill the gap.

This Part proposes how Delaware doctrine should respond. We propose three refinements to existing deal protection doctrine. 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 protection ("if it walks like a duck, it is a duck"), meaning that collateral provisions that have a deal protection effect should be scrutinized under deal protection doctrine, even if these agreements have some colorable business purpose as well.

### A. Resolving the *Unocal*/*Revlon* Ambiguity

As every student of corporate law will know, *Unocal Corp. v. Mesa Petroleum Corp.*,[107] *Unitrin v. American General Corp.*[108] and *Revlon v. MacAndrews & Forbes Holdings, Inc.*[109] provide the basic framework for analyzing the target board's fiduciary duties in mergers and acquisitions. *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). 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 shareholders.[110] Given this risk, the court formulated two conditions that must be satisfied before the business judgment rule applies to the board's defensive actions: (i) the directors must show that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) the defensive measures must be "reasonable in relation to the threat posed."[111]

Approximately ten years later, in *Unitrin v. American General Corp.*,[112] the Delaware Supreme Court clarified what "reasonable in relation to the threat posed" meant for the purposes of the intermediate standard articulated in *Unocal*. *Unitrin* involved a hostile tender offer by American General Corp. (AmGen) for Unitrin. 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 20% of Unitrin's outstanding shares.[113] The Delaware Supreme Court held that "if 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."[114] In this way *Unitrin* added important gloss to the proportionality requirement of *Unocal*.

*Revlon* also addressed the measures implemented by an incumbent board to resist an undesired bidder, but this time the board attempted to pursue an alternative transaction, thus giving rise to a "sale" scenario. The Delaware Supreme Court held that when a

---

[107] 493 A.2d. 946 (Del. 1985).

[108] 651 A.2d 1361 (Del. 1995).

[109] 506 A.2d 173 (Del. 1986).

[110] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[111] *Id.* at 955.

[112] 651 A.2d 1361 (Del. 1995).

[113] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1366 (Del. 1995)

[114] *Id.* at 1390 (emphasis added).

"sale" or "break-up" of a company becomes "inevitable," the duty of the board of directors is to maximize short-term value for the target shareholders.[115] As part of this principle, the court concluded that the defensive measures adopted by the board to defend against undesired bidders must be "reasonable."[116] The Court then struck down the asset lockup (as noted in Part III.C), because "the result of the lockup was not to foster bidding, but to destroy it."[117]

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.[118] In this analysis, if the deal protections are not "coercive" or "preclusive," the inquiry shifts to whether they are in the "range of reasonableness."[119] 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*/*Untrin* in order 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*.[120]

---

[115] *Revlon v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986).

[116] *Id.* at 180.

[117] *Id.* at 183.

[118] McMillan v. Intercargo Corp., 768 A.2d 492, 506 n. 62 (Del. Ch. 2000) (Strine, V.C.) ("'[D]eal 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.") (citations omitted) (emphasis in original).

[119] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995).

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

Delaware courts have not answered this question definitively. On one hand, courts have suggested that deal protections must not be preclusive/coercive in order to survive *Revlon* reasonableness scrutiny.[121] On the other hand, none of these courts have actually found the deal protections to be preclusive, leaving open the question of what would have happened if they were. The question boils down to the following: 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

---

[121] *See, e.g.*, McMillan v. Intercargo Corp., 768 A.2d 492, 505 (Del. Ch. 2000) ("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); *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 615 (Del. Ch. 2010) (Del. Ch. 2010) (Strine, C.) ("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 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); *In re* Smurfit-Stone Container Corp. S'holder Litig., No. Civ.A. 6164-VCP, 2011 WL 2028076, at *16 (Del. Ch. May 20, 2011), as revised (May 24, 2011) (Del. Ch. 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 RockTenn these deal protections."); *In re* BioClinica 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* Comverge, Inc., No. CV 7368-VCP, 2014 WL 6686570, at *17 (Del. Ch. Nov. 25, 2014) (Del. Ch. 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.").

post-signing market check and deal protections equivalent to 30% of the deal equity value.[122] 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 preclude a higher bid. Plaintiff shareholders challenge the deal protections under *Revlon* and *Unocal*. What result?

In our opinion, deal protections should be subject 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.

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, which in turn causes a well-advised acquirer to not make such 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%. 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.[123] One might reasonably ask why not: For the same reasons that Delaware law might want to facilitate an offer conditioned on 30% deal protection, Delaware law might 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 the result produced by a negligent or captured board.[124] Knowing this, acquirers accept that their offer must gain approval

---

[122] In our opinion the analysis does not change, in this hypothetical, if the company is fully shopped before the offer is accepted.

[123] *See* DEL. GEN. CORP. L. § 251(c) (non-waivable shareholder vote requirement).

[124] *Cf.* 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); Singh v. Attenborough, No. 645, 2015, 2016 WL 2765312, at *1 (Del. May 6, 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);

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 are not preclusive or coercive stands separate from *Revlon*'s requirement that the board takes 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-fashion (i.e., hard asset) asset lockups are well within the expertise of the courts, commercial agreements generally are not. Consider a 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.

### B. Applying Basic Game Theory

Delaware courts should also apply basic game theory to deal protection. While game theory can often be theoretical, the core insight 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 decision-making.

This core insight has two implications for the new look of deal protection identified in Part III. 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 on the magnitude of the deterrence 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, Delaware courts should examine the competitive dynamic created by new-economy asset lockups, in order to identify situations where even an asset lockup struck at fair market value can have a deal protection effect. We discuss each of these in turn.

---

*In re* Volcano Corp. S'holder Litig., No. CV 10485-VCMR, 2016 WL 3626521, at *15 (Del. Ch. June 30, 2016) (holding that "the 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.").

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.[125] 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 prospective 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 high.[126] Looking forward and reasoning back, a third-party is unlikely to bid. [127]

---

[125] *See*, *e.g.*, The Lear Defendants' Answering Brief in Opposition to Plaintiffs' Motion for Preliminary Injunction, *In re* Lear Corp. S'holder Litig., 2007 WL 4944556 (Del.Ch.) (arguing that match rights "[do] not chill topping bids").

[126] *See* GUHAN SUBRAMANIAN, DEALMAKING: THE NEW STRATEGY OF NEGOTIAUCTIONS, at 172-73 (2011) (analyzing the LBO of Toys "R" Us LBO, which included a 4% termination fee and a 3-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.") (citations omitted).

[127] 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, the seller has different ("private") values for each potential acquirer. This is usually the case of transactions involving strategic buyers, where each bidder knows only its valuation of the seller because there are specific synergies that depend on the characteristics of each bidder. In a common value setting, the seller has a single value for all bidders (although each bidder has a different estimate of the seller's value due to informational differences). This 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. *See* R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699, 704-05 (1987); Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27, 33-45 (1991). 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 has greater incentives to bid (even in the presence of match rights) due to the

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 deterrence effect of a match right is amplified by risk aversion, because the bid on the table is a known quantity while the full willingness-to-pay of the first bidder is an unknown quantity.[128] While (well-advised) first bidders no longer make claims like Sumner Redstone's famous statement that Viacom's deal to buy Paramount could only be thwarted by a "nuclear attack,"[129] 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 (i.e., *ex post* effects), but also to deter third-party bidders from emerging in the first place (*ex ante* effects). This commonsensical point also explains the rapid proliferation of match rights: if they had no deterrent effect, as some practitioners claim, then they should not have proliferated as quickly as they did.

All of this is Game Theory 101,[130] yet the trajectory of the Delaware courts has moved from a tailored consideration of the potential deal protection effect of match rights

---

particular synergies that might result from the transaction. *See* Sushil Bikhchandani, Steven A. Lippman & Reade Ryan, *On the Right of First Refusal*, 5 ADVANCES THEORETICAL ECON. 1 (2005); Brian J.M. Quinn, *supra* note 120, at 1027, 1039; Brian J.M. Quinn, *Bulletproof: Mandatory Rules for Deal Protection*, 32 J. CORP. L. 865, 870-71 (2007). 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 right-holder in the context of bidding processes. *See* Quinn, *supra* note 120, at 1025. Also emphasizing the importance of investigation costs in determining the ultimate effect of match rights, see Marcel Kahan et al., *First-Purchase Rights: Rights of First Refusal and Rights of First Offer*, 14 AM. LAW ECON. REV. 331 (2012).

[128] *See* McAffee & McMillan, *supra* note 127, at 719-20; Quinn, *supra* note 120,at 1025.

[129] Paramount Communications Inc. v. QVC Network Inc., 637 A.2d at 39 ("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.").

[130] Professor 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.

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.[131] In contrast, the more recent cases seem to have abandoned reasonableness analysis in favor of favor blank check approval of match rights.[132]

This trajectory ignores the way that bidders "look forward and reason back." 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 is a "ticking clock" imposed by a go-shop window[133] and/or when the first bidder partners with an insider, such as the context of management buyouts.[134]

In *In re Cogent Inc. Shareholders 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 right 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.[135]

---

Matching rights work to deter subsequent bids when held by an initial bidder." Brian J.M. Quinn, *Normalizing Match Rights*, HARV. BUS. L. REV. ONLINE, 7, 9 (2010).

131 *See, e.g.*, *In re* Toys "R" Us, Shareholders Litigation, 877 A.2d 975 (Del. Ch. 2005); *In re* Dollar Thrifty, Shareholders Litigation, 14 A.3d 573 (Del. Ch. 2010).

132 *See, e.g.*, *In re* 3Com S'holders Litig., 2009 WL 5173804, at *7 (Del. Ch. 2009) (holding that the no-solicitation provision, the match right, and the termination fee at issue in that deal "are standard merger terms, are not *per se* unreasonable, and do not alone constitute breaches of fiduciary duty."); *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.").

133 *See* Guhan Subramanian, *Deal Process Design in Management Buyouts*, HARV. L. REV. (forthcoming 2016).

134 *Id.*

135 *In re* Cogent, Inc. S'holder Litig., 7 A.3d at 502.

This reasoning is flawed. A match right does not "entice an acquirer to make a strong offer" in the same way that a termination fee might. In fact, a match right does the opposite: it allows the first bidder to "keep something in its pocket," knowing that it will have another look if a higher bidder comes along. [136]

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 an asset lockup struck at below fair market value in *Revlon v. MacAndrews & Forbes*, asset lockups disappeared.[137] When the Delaware Supreme Court struck down a stock option lockup in *Paramount v. QVC*, practitioners substituted away from stock option lockups to termination fees.[138] 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 at just below that level. And when the Delaware courts permitted match rights in *In re Toys "R" Us* and *In re Dollar Thrifty*, and then further accepted them as boilerplate in cases such as *In re 3Com* and *In re Cogent*, match rights proliferated.[139]

The Delaware courts should return to the old religion of evaluating the deal protections as a whole; and in this analysis courts should acknowledge that a match right

---

[136] *See also* Quinn, *supra* note 120, at 1025 (arguing that match rights can lead to an inefficient allocation of resources because the right-holder might make a "low-ball" initial bid and subsequent bidders with higher valuations of the target might decline to bid); Bikhchandani et al., *supra* note 127, at 10 (arguing that the seller places itself in a disadvantageous position by awarding match rights because the right-holder might buy the company even when its valuation is not the highest among all potential buyers); Leandro Arozamena & Weinschelbaum, *A Note on the Suboptimality of Right-of-First-Refusal Clauses*, 4 ECON. BULL. 1 (2006) (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); Albert H. Choi, *A Rent Extraction Theory of First Refusal*, 57 J. INDUS. ECON. 252, 263 (2009) (arguing that match rights decrease social welfare because they allow the right-holder to win the auction even when his value of the good is lower than that of the competing bidder).

[137] *See* Coates & Subramanian, *supra* note 1, at 314-315.

[138] *Id.*

[139] In the recent appraisal of Dell, Inc., the Delaware Chancery Court found that an unlimited match right (as distinct from a one-time match right) was a "powerful disincentive" to a prospective third-party bidder. *See* In re Appraisal of Dell, Inc., C.A. No. 9322-VCL at 91 (May 31, 2016). It is not clear why an unlimited match right should be a "powerful disincentive" in the appraisal context but accepted as boilerplate in the deal protection context.

can amplify the other deal protection devices.[140] 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 on a 5% unlevel playing field 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.

Delaware courts should also not endorse match rights simply because they are now "standard merger terms."[141] Not only has this argument been squarely rejected by the Delaware courts in other areas of corporate law,[142] 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.[143] Implicit in this analysis was the assumption that an asset lockup granted at fair market value cannot have a deal protection effect. Putting aside the difficulty of ascertaining whether an asset lockup was truly granted at fair market value,[144] 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

---

[140] *See also* Quinn, Quinn, *supra* note 120, at 1044 (arguing for a "contextualized" analysis of match rights, which includes an assessment of how they interact with other protection devices, the nature of the bidder [strategic versus financial] and timing considerations).

[141] *In re* 3Com S'holders Litig., 2009 WL 5173804, at *7 (Del. Ch. Dec. 18, 2009).

[142] *See, e.g.*, San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc., 983 A.2d 304, 306 & 319 n.45 (noting that poison puts are a "commonplace provision" but further 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.") (citations omitted) (Del. Ch. 2009). *Cf. Vaalco Energy Inc. Consolidated S'holder Litig.* (C.A. 11776) (Del. Ch. Dec. 21, 2015) (Laster, V.C.) (bench ruling) ("Just as 'all the other kids were doing it' was not a good argument for your mother, the idea that 175 other companies may have wacky provisions doesn't mean yours is valid.").

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

[144] In some cases there is evidence on how the parties thought about the asset lockup. In Parametric Sound, for example, the parties characterized the asset lockup as a "Break-Up Fee License Agreement." *See, e.g.*, PARAMETRIC PROXY STATEMENT 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 break-up fee) if it is struck at less than fair market value.

target companies).[145] The lesson from those cases was not that all asset lockups were invalid; just asset lockups that were struck at less than fair market value.[146] 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 – AuthenTec, NYSE, and Parametric Sound are all examples of these intangible asset lockups. With intangible asset lockups, even lockups that are granted at fair market value can create an unlevel playing field, and can potentially preclude higher-value bidders.

To see why, consider Apple's right to acquire a non-exclusive license to the New Technologies as part of its deal with AuthenTec. 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 non-exclusive 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.[147] Therefore, the asset lockup has the effect of

---

[145] 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* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 178 (Del. 1986). In *MacMillan*, the target company granted one of the bidders (KKR) an option to purchase seven Macmillan subsidiaries for $865 million. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1286 (Del. 1989)

[146] *See* Coates & Subramanian, *supra* note 1, at 328 n.54 (quoting Robert Spatt of Simpson Thacher: "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."); *see id.* (quoting Stephen R. Volk of Shearman & Sterling: "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.").

[147] *See also* STANLEY FOSTER REED ET AL., THE ART OF M&A: A MERGER ACQUISITION BUYOUT GUIDE (4th ed. 2007) at 779 ("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).

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 stand-alone basis at $100, and derives another $20 of value from keeping the New Technologies out of Samsung's hands.

(2) Samsung values AuthenTec on a stand-alone 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, we are aware of at least one instance in which the CEO of the target company advertised the deal protection effect of an intangible asset lockup ostensibly struck at fair market value.[148] 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.

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. In the Parametric-Turtle Beach 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 stand-alone 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.

---

[148] Confidentiality obligations prevent us from disclosing the name of the company.

The potency of an asset lockup as a deal protection device also depends on how much value there is in keeping the asset out of competitors' hands. When the 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 of keeping it out of a competitor's hands; and losing bidders "pay" by not getting the asset.

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. 3PAR was a leader in the emerging arena of "cloud" computing, an area where both Dell and HP were perceived to have strategic gaps. Sure enough, HP decided almost immediately to make an overbid; and the HP board authorized management to make new bids as needed to "thwart their rival's every possible move."[149] HP bid $24 per share, Dell counter-offered at $24.30, HP answered with $27, Dell matched at $27, and HP answered again with $30. On September 2, 2010, Dell increased its offer to $32 per share, and HP responded with $33. Dell declined to continue bidding and accepted a $72 million breakup fee (amounting to approximately 3.1% of the final deal value) from 3PAR.[150]

HP had bid less for 3PAR before it learned that Dell was the other suitor.[151] HP's entry was motivated by an interest to block Dell's move to gain ground in data storage, where HP was weak.[152] For HP, acquiring 3PAR improved its high-end data storage, but the deal was not a "must have."[153] For Dell, in contrast, the acquisition would have had a much larger impact due to Dell's lack of a high-end data storage business at the time.[154] As a result, 3PAR was seen as a "critical prong" in Dell's efforts to expand its business beyond PCs.[155]

---

[149] Anupreeta Das & Ben Worthen, *H-P Outguns Dell in Takeover Duel*, WALL ST. J. (Sep. 2, 2010).

[150] Aaron Ricadela, *HP Wins Bidding War for 3Par; Dell Walks Away*, BLOOMBERG (Sep. 2, 2010).

[151] Joseph Menn, *HP to Buy 3Par as Dell Pulls Out of Rac*e, FIN. TIMES (Sep. 3, 2010).

[152] *Id.*

[153] Michael Corkery, *Who Needs 3PAR More: H-P or Dell?*, WALL ST. J. (Aug. 26, 2010).

[154] *Id.*

[155] *Id.* It appears that Dell got more sophisticated and aggressive about deal protections in the aftermath of the 3PAR situation, as both inside and outside bidder. For example, when Dell acquired Compellent shortly after losing 3PAR, it tried to avoid making the same mistake twice by putting in "aggressive" deal protection measures; these deal protection measures were subsequently modified in a settlement with plaintiff's counsel. *In re* Compellent Techs., Inc. S'holder Litig., 2011 WL 6382523 (Del. Ch. Dec. 9, 2011). And in the Quest Software

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. The 3PAR board rejected the proposal, because "Dell's proposed OEM 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."[156]

The 3PAR-HP-Dell case illustrates how all-pay structures can cause bidders to both enter a bidding contest and bid more than they would otherwise pay, and even potentially more than the stand-alone value of the asset.[157] Intangible asset lockups, even when struck at fair market value, can shut down this potential dynamic.

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, the deterrent effect can become even more significant to the extent that an asset lockup is not granted at fair market value. The Delaware Chancery Court has indicated that a 6.3% valuation wedge between a first bidder and potential second-bidders

---

MBO, 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* PRESS RELEASE: QUEST SOFTWARE ANNOUNCES RECEIPT OF SUPERIOR PROPOSAL (Form 8-K), at Exhibit 99.1 (June 14, 2012).

156 *See* 3PAR INC. SCHEDULE 14D-9, at 31 (Sept. 7, 2010) ("After careful deliberation, the [3PAR] board of directors unanimously determined that the terms of Dell's proposed OEM 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. . . . Accordingly, the board of directors unanimously determined to reject Dell's August 31st acquisition proposal.").

157 The Oracle-SAP-Retek bidding contest also illustrates the point. SAP announced it would buy Retek for $8.50 per share in February 2005. In early March, Oracle topped SAP's bid with a $9 per share offer. SAP responded with an $11 "best and final" offer; Oracle answered just a few hours later with $11.25 per share. Retek's board accepted Oracle's offer and paid SAP a $25 million termination fee (amounting to approximately 3.9% of the deal value). *See* Laurie J. Flynn, *Oracle Raises Offer to Retek, Topping Bid by German Rival*, N.Y. TIMES (Mar. 19, 2005). Retek software provides a merchandising system that fills an important gap in enterprise retail by streamlining finance, supply, human resources, data management, etc. In pursuing Retek, Oracle wanted to protect its top data management position in North America, which was being threatened by SAP. SAP would have had access to key names in retail, including Gap and BestBuy, thereby becoming a top retail database and applications provider. Lisa DiCarlo, *Why are Oracle and SAP Fighting Over Retek?*, FORBES (Mar. 18, 2005). Oracle thwarted this strategy but paid full value, as the all-pay auction structure would predict.

is likely to be preclusive, and therefore impermissible under Delaware corporate law.[158] 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 stuck at $6 million less than 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.

All of this is not to say that companies cannot negotiate a license agreement (or other commercial agreement) on a "clear day." In that scenario, the parties would be negotiating at arms-length, and both sides would have every incentive to achieve fair market value. But we return to the definition of a "lockup" put forward in Coates & Subramanian (2000): "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." [159] Admittedly, there may be grey areas in applying this principle in particular cases. But in our opinion, all of the licensing agreements and financing arrangements described in Parts III.C and III.D 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 an arms-length deal goes away: both Parametric and Authentec, for example, have an incentive to offer the license agreement for less than fair market value in order to deliver deal certainty for its preferred buyer. We can no longer rely on arms-length bargaining to protect shareholders' interests, and *Unocal*/*Unitrin* scrutiny, as described in Part IV.A, is warranted.

### 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, i.e., "if it walks like a duck, it is a duck."[160] With respect to the new look of deal protection documented in Part III, this principle means that licensing agreements and financing arrangements that have a deal protection effect should not be given a free pass because they might have some colorable

---

[158] Phelps Dodge Corp. v. Cyprus Amax Minerals Co. No. Civ.A. 17398,1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999) ("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.") (Chandler. C.).

[159] Coates & Subramanian, *supra* note 1, at 310 n. 2.

[160] *See* McMillan v. Intercargo Corp., 768 A.2d 492, 506 n.52 (Del. Ch. 2000) (Strine, V.C.) ("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.") (citations omitted).

business purpose as well.[161] One corollary of this approach is that courts should look outside the four corner of the merger agreement to identify devices that put up an impediment to a potential third-party bid.[162]

To our knowledge, the only Delaware opinion to assess the new generation of deal protections is the 2012 *Complete Genomics* decision, which examined the financing arrangement in the BGI Shenzhen-Complete Genomics deal described in Part III.D.[163] 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 into 22% of the target's shares at the deal price.[164] The Court began its ruling by explicitly declining to establish any precedent through the analysis.[165] With that caveat, the Court then examined the potential preclusive effect of the termination fee and the bridge loan conversion right:

---

[161] Note that financing arrangements can easily be structured to not have a deal protection effect; in this scenario there would be no need to apply deal protection doctrine. *See, e.g.*, METALICO, INC. DEFINITIVE PROXY STATEMENT (Form DEF-14A) (July 24, 2015), at 25-26 ("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.

[162] *Compare* Coates & Subramanian, *supra* note 1, at 310 n.2 ("[W]e 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.") *with* Davidoff & Sautter, *supra* note 7, at 681-682 ("Lock-ups are contractual devices that buyers and sellers negotiate *in an acquisition agreement*.") (emphasis added).

[163] *In re* Complete Genomics, Inc. S'holder Litig., C.A. No. 7888-VCL (Del. Ch. Nov. 9, 2012) (transcript ruling).

[164] *Id.* at *11 (Del. Ch. Nov. 9, 2012) (transcript ruling). In the discussion of the protections in the *Complete Genomics* transaction (Part III.C), 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.

[165] *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.").

> [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.[166]

However, the Court then distinguished the stock option lockup in *Paramount-QVC* because "[t]he bridge loan provided substantial benefit to Genomics in the form of much needed cash."[167] 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. 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."[168]

While the Court explicitly disavowed any broader principles to be derived from *Complete Genomics*, the decision seems to endorse a functional approach to deal protections. Specifically, even though the bridge loan in *Complete Genomics* had a colorable business purpose (namely, providing "much needed cash"), the Court did not ignore its deal protection effect, because the bridge loan was the functional equivalent of a stock option lockup. Subsequent Delaware doctrine should endorse the functional approach to deal protections that is implicit in *Complete Genomics*.[169]

To see the risks of the alternative approach, consider Kirkland & Ellis' memo to clients on the new-style deal protections:

---

[166] *Id.* at 11-12.

[167] *Id.* at 16.

[168] *Id.* at 16.

[169] 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 their 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 created by it.

> [I]n appropriate circumstances there may be room in the dealmaking toolkit for modern and creative variations on traditional lockup arrangements (more so when 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.[170]

If "ample discussion and documentation of the reasoning and justification" would permit a get-out-of-jail-free card from deal protection doctrine, then practitioners would readily provide such documentation in order to deliver an (e.g.) 8% wedge to its favored bidder.[171] That is, in the absence of a functional approach to deal protections (calling a duck a duck), practitioners will engage in a kabuki dance with their clients and the courts to figure out exactly what is required to deliver deal certainty, which then would subvert well-established principles inherent in *Unocal/Unitrin* and *Revlon*.

While we applaud the Court's functional approach to deal protections in *Complete Genomics*, we take issue with how the approach was applied to the particular deal protections at issue in that case, for two reasons. First, the Court calculated the deterrent effect of a bridge loan conversion using a 5% overbid assumption.[172] In *In re Compellent Technologies*,[173] just one year prior to *Complete Genomics*, the Court used an 11.4% overbid assumption. This 11.4% assumption would be more consistent with the weight of the academic evidence, which documents average overbids in the range of 10-15%.[174]

---

[170] DANIEL WOLF, DAVID FEIRSTEIN, JOSHUA ZACHARIAH, KIRKLAND & ELLIS MEMORANDUM TO CLIENTS, CROWN JEWELS – RESTORING THE LUSTER TO CREATIVE DEAL LOCK-UPS, at 2 (February 14, 2013).

[171] 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% pre-payment 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."

[172] *Complete Genomics* at *11.

[173] *In re* Compellent Techs., Inc. S'holder Litig., No. CIV.A. 6084-VCL, 2011 WL 6382523, at *24 (Del. Ch. Dec. 9, 2011).

[174] *See, e.g.*, Coates & Subramanian, *supra* note 1, at 350 n.124 (using average overbid of 14.9% to calculate the potency of stock option lockups); G. William Schwert, *Markup Pricing in Mergers and Acquisitions*, 41 J. FIN. ECON. 153, 164-65 (1994) (calculating 10.5% average post-bid markup); Robert Comment & G. William Schwert, *Posion or Placebo? Evidence on*

Using an 11.4% overbid assumption, the cost imposed on a third-party bidder would be $3.4 from loan conversion, compared to the Court's estimate of $1.5 million.[175]

Second, the Court added the value of a full bridge loan conversion to the denominator, which had the effect of reducing the deal protection from 6.1% to below 5%.[176] 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 there is no change to the intrinsic value of the company that is being acquired. The numerator would increase by $1.25 million, assuming a 5% overbid.[177] By adding a convertible bridge loan, then, the magnitude of the deal protection goes down, from 6% to 5.7% of the original deal value,[178] even though the actual deal protection has increased (not decreased).

When our two methodological adjustments are applied to the facts of *Complete Genomics*, the deal protections amount to 7.1% of the new deal value.[179] This level of deal protection would be very high among comparable transactions, and higher than anything the Delaware courts have previously endorsed. In our opinion, applying the correct methodology shifts the deal protections in the case from "a closer case than it otherwise might be"[180] to a case that is probably over the line on permissible deal protections. The analysis illustrates how seemingly small choices in methodology can change the ultimate conclusion in deal protection doctrine.

---

*the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 47 (1995) (11.37% average overbid); Randall A. Heron & Erik Lie, *On the Use of Poison Pills and Defensive Payouts by Takeover Targets*, 79 J. BUS. 1783, 1804-05 (2006) (15% average overbid).

[175] An 11.4% overbid would be $3.15 × 1.114 = $3.51. Therefore, profits from selling into the overbid would be: ($3.51 - $3.15) × 9.5 million shares = $3.4 million.

[176] *Complete Genomics* at *16.

[177] Calculated as: $25 million multiplied by the 5% overbid assumption, or $1.25 million

[178] Calculated as: $3 million termination fee / $50 million deal value = 6% of deal value; ($3 million termination fee + $1.25 million from note conversion) / $75 million deal value = 5.7% of deal value.

[179] Calculated as: ($3.4 million + $5.2 million) / (1.114 × $108 million).

[180] *In re* Complete Genomics at *16.

## V. Conclusion

Dick 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."[181] This Article presents evidence that when Delaware courts indicated that 4-5% was the limit on termination fees, practitioners took the hint, and termination fees/expense reimbursement provisions capped out at just below the 4-5% level. But (as Beattie observes) lawyers want to be able to do what their clients want, which means providing more than 4-5% of an advantage for their client trying to get a deal done. The proliferation of match rights, the re-emergence of asset lockups, and the emergence of financing agreements that have a deal protection effect may be manifestations of this dynamic.

Just as the Delaware courts 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, without actually striking down deal protections, but providing clear guidance on how the courts will approach the new look of deal protection devices. In this Article we propose 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 these agreements have some colorable business purpose as well. The result would be greater allocational efficiency in the M&A marketplace, which improves overall social welfare.

---

[181] Interview with Dick Beattie, Chairman, Simpson Thacher & Bartlett, in New York, N.Y. (July 23, 1999), *cited in* Coates & Subramanian, *supra* note 1, at 310.