

## Deal Protection Devices

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*In mergers and acquisitions transactions, a buyer and a seller will often agree to contractual mechanisms (deal protection devices) to deter third parties from jumping the deal and to compensate a disappointed buyer. With the help of auction theory, this Article analyzes various deal protection devices, while focusing on the two most commonly used mechanisms: match rights and target termination fees. A match right gives the buyer a right to “match” a third party’s offer so as to prevent the third party from snatching the target away, while a termination fee compensates the buyer when a third party acquires the target. Such mechanisms raise a number of important corporate and contract law questions. How effective are they in preventing third parties from competing for the target? Do they steer the target to be sold to a buyer who values the target less? Are the devices harmful to the target shareholders? To what extent can the negotiated deal price represent the target’s “fair value” when such devices reduce or eliminate the competition? This Article shows, foremost, that these devices can actually increase the target and buyer’s joint return and possibly the target’s stand-alone return. Match rights and termination fees function quite differently, however. While a large termination fee reduces the target’s stand-alone return and can lead to allocative inefficiency, an unlimited match right increases the target’s stand-alone return and promotes allocative efficiency. This Article argues that answering the corporate law questions ultimately turns on the question of how and why the target directors are utilizing the devices. If the devices are being deployed with the objective of maximizing the target shareholders’ return, not only can they be beneficial for the target shareholders, but their presence can also make the deal price a more reliable indicator of the target’s fair value. With an improper objective, not only do the devices undermine target shareholders’ return, but the court also should not use the deal price as evidence of fair value. This Article also analyzes stock and asset lockups and examines deal protection devices through the lens of contract law.*

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## INTRODUCTION

On April 12, 2018, two wholesale office supply companies, Genuine Parts Corporation (GPC) and Essendant, Inc., agreed to combine their office supply businesses in order to better compete against e-commerce sellers, such as Amazon.com, Inc.<sup>1</sup> The agreement contained several deal protection measures for GPC.<sup>2</sup> The

<sup>1</sup> See *Genuine Parts Co. v. Essendant, Inc.*, No. 2018-0730-JRS, 2019 WL 4257160, at \*1 (Del. Ch. 2019); *In re Essendant, Inc. S’holder Litig.*, No. 2018-0789-JRS, 2019 WL 7290944, at \*2 (Del. Ch. 2019).

<sup>2</sup> See *Essendant Inc., Agreement and Plan of Merger*, Dated as of April 12, 2018, by and Among Genuine Parts Company, Rhino SpinCo, Inc., Essendant Inc. and Elephant Merger Sub Corp. 53–56, 79, A-12 (Form 10-Q, Exhibit 10.5) (Apr. 25, 2018) [hereinafter *GPC-Essendant Merger Agreement*].

first was a nonsolicitation (“no-shop”) provision that prohibited Essendant from directly soliciting a third-party offer but that nonetheless allowed Essendant to negotiate with a third party in case an unsolicited, superior offer<sup>3</sup> were made (a “fiduciary out”).<sup>4</sup> The second was a match right: in the case that a third party made an unsolicited superior offer, Essendant was obligated to negotiate in “good faith” for three days with GPC so as to give GPC an opportunity to beat the third party’s offer.<sup>5</sup> The match right was unlimited: whenever a third party revised its offer or another party made an offer, a new three-day period would start.<sup>6</sup> The third was a termination fee, which required Essendant to pay \$12 million to GPC in the case that Essendant decided to merge with a third party.<sup>7</sup>

The merger was structured in such a way that the shareholders of GPC were to receive Essendant stock in return for their ownership interest in GPC’s office supply business.<sup>8</sup> Because Essendant had to issue a large amount of stock, Essendant had to schedule a special meeting of its shareholders to receive their approval.<sup>9</sup> Before Essendant was able to get the approval, however, a private equity firm, Sycamore (which owned Staples, another

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<sup>3</sup> The agreement defined “Superior Proposal” as

a written bona fide offer or proposal made by a third party . . . on terms and conditions that the [Essendant board] determines, in its good faith judgment, after consulting with a financial advisor of internationally recognized reputation and external legal counsel, and taking into account all legal, financial and regulatory and other aspects of the proposal, including availability of financing, and any changes to the terms of this Agreement proposed by GPC in response to such offer or proposal, or otherwise, to be (a) more favorable from a financial point of view, to the stockholders of [Essendant] than the Merger and (b) reasonably expected to be consummated.

*Id.* at A-12 to -13.

<sup>4</sup> See *id.* § 7.03(a), at 53 (nonsolicitation provision); *id.* § 7.03(c), at 54 (fiduciary out).

<sup>5</sup> See *id.* § 7.03(d), at 54–56.

<sup>6</sup> See *id.* § 7.03(d)(ii)(2), at 56.

<sup>7</sup> See GPC-Essendant Merger Agreement, *supra* note 2, § 9.03(a)(ii), at 79; *id.* at A-13.

<sup>8</sup> The transaction was structured as a “spin merger”—specifically, a Reverse Morris Trust transaction, see Young Ran Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-offs*, 10 U.C. IRVINE L. REV. 1, 11 (2019)—in which GPC was to spin off its wholly owned subsidiary, S.P. Richards Co. (SPR), in the first step and, in the second step, Essendant’s wholly owned subsidiary was to merge with SPR. In order to receive the necessary tax benefits, the shareholders of GPC had to own more than 50% of the combined entity. See GPC-Essendant Merger Agreement, *supra* note 2, Recitals, at 1; *id.* art. II, at 2–5; see also Essendant Inc., Current Report (Form 8-K) (Apr. 12, 2018).

<sup>9</sup> See GPC-Essendant Merger Agreement, *supra* note 2, § 7.02, at 53. Under New York Stock Exchange regulations, when a company issues more than 20% of its outstanding stock as part of a merger or an acquisition, the company has to receive its shareholders’ approval. See NYSE LISTED COMPANY MANUAL § 312.03 (2019).

office supply company), made a competing offer on April 29, 2018, of \$11.50 per share for all of Essendant's outstanding stock.<sup>10</sup> Deciding that this offer was likely to be superior to the merger with GPC, Essendant notified GPC, thereby triggering GPC's three-day match right. While protesting that the offer from Sycamore was not "[s]uperior,"<sup>11</sup> GPC nonetheless decided to "match" the offer by increasing its consideration by about \$4 per share.<sup>12</sup> When Sycamore came back with a sweetened offer, thereby triggering another three-day match period, however, GPC declined to match.<sup>13</sup> On September 10, 2018, after some further negotiations, Essendant accepted Sycamore's final bid of \$12.80, and upon the termination of the agreement with GPC, GPC collected the \$12 million termination fee.<sup>14</sup>

While deal protection measures—such as no-shop clauses, match rights, and termination fees, as seen in the GPC-Essendant story—have been fairly common in mergers-and-acquisitions

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<sup>10</sup> See *Genuine Parts*, 2019 WL 4257160, at \*4. While I am trying to use the GPC-Essendant transaction as a motivating example, the actual story is a bit more complex. In fact, Sycamore made an all-cash offer of \$11.50 per share on April 17, 2018, and Essendant's board initially determined that this earlier offer was not likely to lead to a superior proposal. On April 29, 2018, Sycamore made a "renewed" proposal at the same cash amount of \$11.50, but it also indicated that it might make a higher bid upon receiving Essendant's nonpublic information. This time, however, Essendant's board concluded that Sycamore's new offer was reasonably likely to lead to a superior offer and notified GPC in accordance, thereby triggering the first three-day match period. *Id.*

<sup>11</sup> *Id.* While the cash offer from Sycamore was easy to value, valuing the consideration from SPR, GPC's wholly owned subsidiary, was not as straightforward. Using a discounted cash flow analysis, GPC argued that the consideration offered by Sycamore was significantly lower than the share price implied from the GPC-Essendant merger. *Id.*

<sup>12</sup> *Id.* The \$4 increase was not in the form of cash but was in the form of a "contingent value right" that Essendant shareholders would be able to receive once stipulated contingencies had been satisfied. *Id.* Note here that after GPC matched Sycamore's offer, Essendant did not have an obligation to accept GPC's matching offer. Essendant was free to propose GPC's matching offer to Sycamore in the hopes of inducing Sycamore to sweeten its proposal. This is an important difference from the conventional right of first refusal. For a more detailed analysis and comparison, see *infra* Part III.B.1.

<sup>13</sup> See *In re Essendant*, 2019 WL 7290944, at \*4.

<sup>14</sup> *Id.* Notwithstanding its acceptance of the \$12 million termination fee, GPC has brought suit against Essendant arguing, among other things, that Essendant breached its contractual obligations, especially the nonsolicitation (no-shop) provisions. *Genuine Parts*, 2019 WL 4257160, at \*9. Because the argument is based on a breach of the nonsolicitation provision, GPC argued that it is entitled to full expectation damages. According to the GPC-Essendant Merger Agreement, "in the event that the Termination Fee is paid in accordance with [ ] Section 9.03, the payment of the Termination Fee shall be the sole and exclusive remedy of GPC." GPC-Essendant Merger Agreement, *supra* note 2, § 9.03(e), at 81. On September 9, 2019, the Delaware Court of Chancery denied Essendant's motion to dismiss. See *Genuine Parts*, 2019 WL 4257160, at \*11.

transactions for quite some time,<sup>15</sup> the law's treatment of them has gone through some significant changes. Judicial attitudes toward deal protection devices can roughly be divided into three periods: initial hostility during the active takeover period of the late 1980s and early 1990s, followed by a more permissive stance, and finally, the recent, renewed examination stemming from appraisal cases.<sup>16</sup> Initially, courts were quite unfavorable to deal protection devices, as seen in the seminal cases, such as *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>17</sup> and *Paramount Communications Inc. v. QVC Network Inc.*<sup>18</sup> The courts were concerned about whether agreeing to certain deal protection devices would constitute a breach of the target directors' fiduciary duties and also undermine the target shareholders' return. In subsequent cases, however, such as *In re Toys "R" Us*,

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<sup>15</sup> The story of Dollar Thrifty Automotive Group, Inc. (a car rental company), is also quite instructive. On April 25, 2010, Dollar Thrifty and Hertz Global Holdings, Inc., entered into an agreement, pursuant to which Dollar Thrifty shareholders were entitled to receive \$41 per share (80% cash and 20% Hertz stock). See *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 592 (Del. Ch. 2010). The agreement contained, among other things, a match right for Hertz. *Id.* at 593. A few days later, however, Avis Budget Group, Inc., made a competing offer of \$46.50 per share (part cash and part stock). *Id.* at 594. Although the size of the consideration seemed more attractive than the offer from Hertz, Dollar Thrifty's board determined that Avis's offer did not constitute a "Superior Proposal" due, in large part, to the concern over whether they will be able to get the necessary antitrust approval on a timely basis and the fact that Avis did not offer any reverse termination fee. *Id.* More recently, 21st Century Fox, Inc., declined to entertain an offer from Comcast Corp. due to antitrust and lack of reverse termination fee concerns, even though Comcast's offer was higher than that of Walt Disney Co. See Shalini Ramachandran & Ben Fritz, *Fox Rejected Higher Comcast Bid Due to Antitrust Concerns*, WALL ST. J. (Apr. 19, 2018), <https://perma.cc/JHH8-8GZH>; see also Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VAND. L. REV. 1161, 1206–18 (2010) (examining the risk allocation role played by reverse termination fees); Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 872–76, 922 (2010) (examining the role played by liquidated damages, such as reverse termination fees, in mergers and acquisitions transactions); Brian J.M. Quinn, *Optionality in Merger Agreements*, 35 DEL. J. CORP. L. 789, 809–13, 824–27 (2010) (empirically comparing reverse termination fees with target termination fees and arguing that symmetric termination fees may be inefficient); Albert H. Choi & Abraham Wickelgren, *Reverse Breakup Fees and Antitrust Approval* 8–15 (May 25, 2020) (unpublished manuscript) (analyzing the role played by reverse breakup fees in securing antitrust approval). The shareholders of Dollar Thrifty later rejected the agreement with Hertz and the deal fell apart. A few years later, Dollar Thrifty and Hertz managed to successfully complete the new deal at a consideration of \$87.50 for each Dollar Thrifty share. See Michael J. de la Merced & Peter Lattman, *After Long Pursuit, Hertz to Buy Dollar Thrifty for \$2.3 Billion*, N.Y. TIMES (Aug. 26, 2012), <https://perma.cc/RUD9-T57H>.

<sup>16</sup> See *infra* Part I for a more detailed review of the historical development over deal protection devices.

<sup>17</sup> 506 A.2d 173 (Del. 1986).

<sup>18</sup> 637 A.2d 34 (Del. 1994).

*Inc. Stockholder Litigation*,<sup>19</sup> *Ryan v. Lyondell Chemical Co.*<sup>20</sup> (*Lyondell I*), and *C & J Energy Services v. City of Miami General Employees' & Sanitation Employees' Retirement Trust*,<sup>21</sup> the courts took a much more permissive stance toward deal protection devices.

Although the question whether agreeing to certain deal protection devices can constitute a breach of fiduciary duty has not been fully resolved,<sup>22</sup> the recent controversy over appraisal has breathed new life into the subject. In an appraisal litigation, target shareholders, who are dissenting to the merger, ask the court to determine the “fair value” of the shares.<sup>23</sup> One prominent issue was whether the court could use the deal price itself as an indicator of fair value.<sup>24</sup> In cases such as *DFC Global Corp. v. Muirfield Value Partners*,<sup>25</sup> *Dell, Inc. v. Magnetar Global Event Driven Master Fund*,<sup>26</sup> and *Verition Partners Master Fund v. Aruba Networks*,<sup>27</sup> the Delaware Supreme Court stated that when an acquisition is done at “arms’ length” and when there is sufficient competition for the target, either before or after the agreement has been signed, the deal price is a reliable indicator of the fair value of the target’s shares.<sup>28</sup> In determining whether a

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<sup>19</sup> 877 A.2d 975 (Del. Ch. 2005).

<sup>20</sup> No. 3176–VCN, 2008 WL 2923427 (Del. Ch. 2008); *see also* *Lyondell Chem. Co. v. Ryan (Lyondell II)*, 970 A.2d 235, 243–44 (Del. 2009).

<sup>21</sup> 107 A.3d 1049, 1069–70 (Del. 2014).

<sup>22</sup> Notwithstanding the general permissiveness toward deal protection devices in fiduciary duty cases, by no means is the debate over. Plaintiffs are still raising, and Delaware courts are still grappling with, the issue of whether entering into certain deal protection devices can constitute a breach of fiduciary duty. Skepticism against deal protection devices gets especially heightened when there are other indicia that the target directors may have breached their fiduciary duty. *See, e.g., In re PLX Tech. Inc. S’holders Litig.*, No. 9880-VCL, 2018 WL 5018535, at \*44 (Del. Ch. 2018) (stating that when there are “undisclosed conflicts of interest” among the directors, match rights and a 3.5% termination fee that are “otherwise reasonable” can trigger judicial skepticism); *see also In re MeadWestvaco S’holders Litig.*, 168 A.3d 675, 686–87 (Del. Ch. 2017); *van der Fluit v. Yates*, No. 12553-VCMR, 2017 WL 5953514, at \*10–11 (Del. Ch. 2017).

<sup>23</sup> The controversy over appraisal stemmed, in large part, from the emergence of “appraisal arbitrage,” where institutional investors, such as hedge funds, would purchase the target’s shares, sometimes even after the merger has been announced, primarily for the purpose of exercising the appraisal remedy. For background information, see Albert H. Choi & Eric Talley, *Appraising the “Merger Price” Appraisal Rule*, 34 J.L. ECON. & ORG. 543, 543–44 (2018).

<sup>24</sup> *Id.*

<sup>25</sup> 172 A.3d 346 (Del. 2017).

<sup>26</sup> 177 A.3d 1 (Del. 2017).

<sup>27</sup> 210 A.3d 128 (Del. 2019).

<sup>28</sup> *DFC Global*, 172 A.3d at 366 (noting that “the sale value resulting from a robust market check will often be the most reliable evidence of fair value,” but declining to create

transaction satisfies such a standard, the presence or the absence of deal protection devices, not surprisingly, became a salient issue. For instance, in *In re AOL Inc.*,<sup>29</sup> the Delaware Court of Chancery declined to use the deal price to determine the fair value when, among other things, the deal was subject to buyer-friendly deal protection measures, including an unlimited match right.<sup>30</sup>

The line of cases from *Revlon* and *Paramount v. QVC*, through *In re Toys “R” Us* and *C & J Energy Services*, and into the recent appraisal cases such as *In re AOL*, raises interesting and important questions about deal protection devices. When the transacting parties (such as GPC and Essendant) are trying to “lock up” the deal, to what extent are deal protection measures successful in ensuring that a competing buyer (such as Sycamore) will not try to “jump” the deal? How do they affect a third party’s (Sycamore’s) incentive to compete? For instance, if the buyer (GPC) has an unlimited match right, given that the buyer can match a third party’s offer as many times as it desires, can this substantially deter a third party (such as Sycamore) from competing against the buyer (GPC)?<sup>31</sup> What if the target has an

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a jurisprudential presumption to that effect); see also *Dell*, 177 A.3d at 35 (explaining that the deal price should be given “heavy weight” when there is “evidence of market efficiency, fair play, low barriers to entry, [and] outreach to all logical buyers”); *Verition Partners*, 210 A.3d at 138 (explaining that a deal price that is “informed by the efforts of arm’s length buyers of the entire company” is “likely to be indicative of so-called fundamental value”).

<sup>29</sup> No. 11204–VCG, 2018 WL 1037450 (Del. Ch. 2018).

<sup>30</sup> *Id.* at \*9 (finding that a deal price could not be used as a measure of fair value because potential competing bidders would have been deterred by the no-shop provision and “unlimited three-day matching rights,” evidence that the CEO had already committed to the buyer, and informational disadvantages).

<sup>31</sup> Professors Brian Quinn and Guhan Subramanian have argued, for instance, that an unlimited match right can substantially exacerbate what’s known as the “winner’s curse problem” and deter a competing buyer from emerging. See Fernán Restrepo & Guhan Subramanian, *The New Look of Deal Protection*, 69 STAN. L. REV. 1013, 1058–59 (2017) (“The match right [] 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. Looking forward and reasoning back, a third party is unlikely to bid.”); Brian J.M. Quinn, *Re-Evaluating the Emerging Standard of Review for Matching Rights in Control Transactions*, 36 DEL. J. CORP. L. 1011, 1027 (2011) (stating that when there is a match right, “the second bidder risks falling victim to the winner’s curse problem”). More recently, in a series of articles, Professor Subramanian argues that “an exclusive pre-signing negotiation followed by a go-shop process in which the buyer gets an unlimited match right would probably not qualify for deference to the deal price.” Guhan Subramanian, *Appraisal After Dell*, in THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 222, 226 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019); accord Guhan Subramanian & Annie Zhao, *Go-Shops Revisited*, 133 HARV. L. REV. 1215, 1275 (2020). This Article argues that a competition between

obligation to pay a large termination fee? From the target shareholders' perspective, do the deal protection devices undercut their return?<sup>32</sup> Finally, in the context of an appraisal remedy, does the presence of deal protection devices undermine the reliability of the deal price as an indicator of fair value? Should the presence of an unlimited match right, for instance, make the deal price unreliable evidence?<sup>33</sup> What factors do we need to consider in answering these questions?

This Article analyzes deal protection devices,<sup>34</sup> focusing, in particular, on match rights and termination fees, with the help of

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multiple buyers when the inside buyer has a match right should be thought of as replicating an English auction, and in that setting, the winner's curse problem is unlikely to arise. And this will be true even when the inside bidder has an informational advantage vis-à-vis outside bidders. For a more general discussion of the winner's curse problem in auctions, see *infra* Part III.D.

<sup>32</sup> Some practitioners and jurists have argued that deal protection measures are necessary to entice the initial buyer to undertake costly due diligence and to make a bid, working as a compensation mechanism. By inducing the initial buyer to make a proposal, the devices can increase target shareholders' value. See *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 45 (Del. 1997); *In re Toys "R" Us*, 877 A.2d at 1017; see also Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1546–47 (1996) (arguing that lockups can incentivize a potential buyer to participate in a bidding competition); Yeon-Koo Che & Tracy R. Lewis, *The Role of Lockups in Takeover Contests*, 38 RAND J. ECON. 648, 660–62 (2007) (analytically examining the circumstances under which lockups can facilitate the emergence of a bidder); Restrepo & Subramanian, *supra* note 31, at 1018. Although this may be true, unless a lost opportunity cost (which is presumed to be difficult to estimate) is quite high, a better mechanism in dealing with this may be through an expense reimbursement provision (or some measure of reliance damages). By generously compensating the disappointed buyer with various expenses (including financial and legal advisor fees), expense reimbursement can function relatively well to compensate the buyer. Also, such a rationale seems to be weak with respect to a match right, especially when a termination fee provision is present.

<sup>33</sup> See, e.g., Subramanian, *supra* note 31, at 226 (stating that "an exclusive pre-signing negotiation followed by a go-shop process in which the buyer gets an unlimited match right would probably not qualify for deference to the deal price").

<sup>34</sup> About thirty years ago, Professor Ian Ayres started a heated debate on deal protection devices with his provocative thesis that moderately sized stock lockups generate no allocative inefficiency. See Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 696–97 (1990). Numerous scholars have since then analytically and empirically examined the impact of various deal protection devices. See, e.g., Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1803–04 (1994); David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564, 572–80 (1996); Kahan & Klausner, *supra* note 32, at 1546–64; John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 314–37 (2000); Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1963–70 (2003); Che & Lewis, *supra* note 32, at 650–63; Shmuel Leshem, *A Signaling Theory of Lockups in Mergers*, 47 WAKE FOREST L. REV. 45, 53–54, 60–61 (2012); Steven M. Davidoff & Christina M. Sautter, *Lock-up Creep*, 38 J. CORP. L. 681, 686–89, 695–98 (2013). All the formal analyses of deal protection devices, except for Che & Lewis, *supra* note 32, and



auction theory.<sup>35</sup> The initial judicial hostility was against stock and asset lockups, but such deal protection devices are being used much less frequently, while termination fees and match rights have become quite prevalent.<sup>36</sup> This Article foremost argues that, while deal protection devices can impede the target from being sold to the buyer with a higher valuation (i.e., they can generate allocative inefficiency), they can also increase the joint profit of the target and the inside buyer (the beneficiary of deal protection measures).<sup>37</sup> Termination fees and match rights function quite

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Leshem, *supra*, however, assume (expressly or implicitly) that the inside buyer (beneficiary of the deal protection device) and outside buyers are symmetrically informed of the respective valuations or only informally discuss the possibilities of private information. When we move away from the symmetric information assumption, important differences emerge among various deal protection devices. Also, as far as I am aware, this is the first Article to more formally analyze match rights using auction theory. Finally, when deal practitioners speak of deal protection devices or lockups, they also include many other mechanisms, such as no-shop (or go-shop) clauses, standstill agreements, information rights, and voting agreements. *See, e.g.*, Davidoff & Sautter, *supra*, at 682, 711 (discussing a variety of lockups and arguing that the courts should broaden their analysis to other types of lockups). For the sake of brevity, this Article shies away from discussing these other mechanisms.

<sup>35</sup> Auction theory has been used to analyze acquisitions and takeovers for quite some time. *See generally* Alan Schwartz & Peter Cramton, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27 (1991); Che & Lewis, *supra* note 32; Choi & Talley, *supra* note 23.

<sup>36</sup> According to Professors Lou Kling, Eileen Nugent, and Brandon Van Dyke, stock and asset lockups “have become [virtually] non-existent: asset lock-ups, because they generally fail the test of not unduly impeding the ability of third parties to make competing bids, and stock [lock-ups] because of the limitations placed on the economics of deal protection devices by the case law and the elimination of pooling accounting.” 1 LOU R. KLING, EILEEN T. NUGENT & BRANDON A. VAN DYKE, *NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS* § 4.04[6][b], at 4-93 (1992 & Supp. 2019) (citations omitted); *see also* Coates & Subramanian, *supra* note 34, at 356–57 (analyzing the tax difference for the first and second bidder); Davidoff & Sautter, *supra* note 34, at 686–87 (documenting the rise of match rights); Restrepo & Subramanian, *supra* note 31, at 1023, 1031–32 (showing that “match rights have gone from approximately 60% of deals in 2003 to virtually 100% of deals by 2015” among public company targets with deal value of \$50 million or more); Subramanian & Zhao, *supra* note 31, at 1226–29 (demonstrating that in a recent sample of private equity acquisitions, 100% of the deals had a match right). It is not entirely clear, however, why asset and stock lockups, in general, would be unduly impeding third parties, particularly when compared to a large termination fee. With respect to an asset lockup, an important difference is that the valuations of physical assets may differ among buyers. For a stock lockup, unlike a fixed termination fee, the size of the compensation for the disappointed buyer depends directly on how much an outside buyer pays for the target. These differences, along with their implications, are more closely examined in Part III.E.

<sup>37</sup> In a seminal work, Professors Philippe Aghion and Patrick Bolton showed how a supply contract with a termination fee can allow an existing seller and a buyer to erect a barrier against entry and also to extract rent from a more efficient entrant. Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388, 391 (1987). There are many other areas where a bilateral contract can be used to extract rent from a

differently, however. Both a sizable termination fee and an unlimited match right can increase the joint return of the target and the inside buyer, but a large termination fee is likely to generate allocative inefficiency, while an unlimited match can actually promote allocative efficiency. Furthermore, in order to boost the target's stand-alone return, a large termination fee requires a price concession from the inside buyer (i.e., a higher deal price) while an unlimited match will likely increase the target's stand-alone return even without a price concession.

The basic insight can be explained as follows: With a termination fee, the target has to pay a fee in order to accept a more attractive offer from a third party. This not only forces a third party to pay more for the target (i.e., the size of pie gets bigger), but a chunk of that additional payment flows to the inside buyer as the promised fee. As the termination fee gets larger, the target's return gets further depressed while the inside buyer enjoys a higher return. In order for the target to share that additional return, therefore, the target needs to receive a concession from the inside buyer through a higher deal price. The story is different with a match right. When a match right is limited (i.e., the inside buyer has an option to match a third party's offers only a few times), given that there are no equivalent limitations on third-party buyers and the target is not obligated to accept the buyer's matched offer, this puts the inside buyer at a competitive disadvantage. With this uneven competition, the target's return will be lower. When the match right is unlimited, by contrast, there will be more even competition between the inside buyer and third-party buyers. Furthermore, unlike a termination fee, the higher proceeds go directly to the target, thereby increasing the target's stand-alone return.

The primary setting utilized in this Article is that of a "private value" auction, in which each buyer knows how much it is willing to pay for the target. This Article also looks at the possibility of the "winner's curse" problem in an interdependent valuation setting, where each buyer does not know—but only gets a signal about—how much it is willing to pay for the target. An interdependent valuation setting does create the possibility of the "winner's curse" problem, and this is likely to happen either when

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noncontracting third party. *See, e.g.*, Albert Choi, *Golden Parachute as a Compensation-Shifting Mechanism*, 20 J.L. ECON. & ORG. 170, 173–74 (2004) (explaining that golden parachutes benefit both executives and shareholders because "the burden of takeover compensation is partly born[e] by the buyer through a higher purchase price").

there is a sizable termination fee or with a limited match right. With a sizable termination fee, a third-party buyer is forced to make a “jump” bid, a bid that is substantially higher than the deal price. Similarly, a limited match right forces the inside buyer to make a jump bid so as to preempt a third party’s follow-up bid. When concerned about the possibility of overpaying for the target, the bidder who is forced to make a jump bid may decline to participate. By contrast, when there is no (or a small) termination fee or when the match right is unlimited, even in an interdependent valuation setting, the “winner’s curse” problem is unlikely to arise. This Article then briefly extends the analysis to the scenario where the inside buyer has an informational advantage vis-à-vis third-party buyers, and it also examines stock and asset lockups.

Based on these findings, this Article argues that answering the questions (1) whether deal protection devices can maximize target shareholders’ return and (2) whether their presence undermines the reliance on deal price as an indicator of fair value in appraisal proceedings ultimately depends on whether the target directors (and managers) are properly incentivized to maximize the target shareholders’ return. If they are, termination fees and match rights can be utilized to enhance the return for the target shareholders. Furthermore, with the proper incentives in place, compared to the case without any deal protection measures, the deal price would be higher for the target shareholders, which, in turn, increases the confidence with which the court can use the deal price as evidence of fair value.<sup>38</sup> At the opposite end of the incentive spectrum, when the target directors (and managers) are pursuing their own private gains at the expense of the target shareholders (e.g., when they are conflicted), such devices can be used to harm target shareholders, and the court should no longer rely on the deal price to determine the fair value of the target’s shares.

This Article also examines deal protection devices from the perspective of contract law. Foremost, given that the devices can undermine competition between the inside buyer and a third party, under contract law, the court can inquire into whether they should be struck down as imposing “unreasonable” restraints on

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<sup>38</sup> This statement should not, however, be construed as a wholesale endorsement of using the deal price as evidence of fair value. There could be many reasons to suspect that the deal price, even as a product of an arm’s-length negotiation, would not protect the interest of the target shareholders. *See generally* Choi & Talley, *supra* note 23.

trade (or, more broadly, being against public policy). This type of reasoning has been used to cut down onerous noncompete clauses<sup>39</sup> and unreasonably large liquidated damages. This Article argues that such a public policy concern is higher with a large termination fee than with an unlimited match right. So long as the termination fee is relatively small (i.e., less than the expected return for the inside buyer under the deal terms), it does not engender any allocative inefficiency. A large termination fee, by contrast, raises the specter of unduly undermining the competition between the inside buyer and a third party and steering the target to be sold to the initial buyer even when the initial buyer values the target less. An unlimited match right, by contrast, actually promotes more competition. This Article discusses factors that the court can utilize in determining whether a termination fee is “unreasonably” large.

This Article is organized as follows: Part I offers a brief overview of the case law, focusing primarily on corporate law cases that examine deal protection devices. The overview starts from the seminal hostile takeover cases of *Revlon* and *Paramount v. QVC* and ends with very recent appraisal cases: *DFC Global, Dell, Aruba*, and their progeny (including *AOL, In re Appraisal of Columbia Pipeline Group*,<sup>40</sup> and *In re Stillwater Mining Co.*<sup>41</sup>). Part II shows how match rights and termination fees are deployed in practice. To aid the discussion, Part II looks at actual acquisition agreements used in recent transactions, including Nexstar Media Group’s acquisition of Tribune Media and Google LLC’s acquisition of Fitbit Inc. Part III presents an auction theory-based analysis to examine various deal protection mechanisms, including termination fees, match rights, and stock and asset lockups. Part III demonstrates how certain devices can be used to maximize the target and initial buyer’s joint return by allowing the target and the initial buyer to extract surplus from a potential third-party buyer. The analysis is laid out with the help of numerical examples. The numerical examples will highlight how match rights function differently from termination fees, and also how stock and asset lockups will likely generate allocative

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<sup>39</sup> See generally ORLY LOBEL, TALENT WANTS TO BE FREE: WHY WE SHOULD LEARN TO LOVE LEAKS, RAIDS AND FREE RIDING (2013); Jonathan M. Barnett & Ted Sichelman, *The Case for Noncompetes*, 87 U. CHI. L. REV. 953 (2020).

<sup>40</sup> No. 12736-VCL, 2019 WL 3778370 (Del. Ch. 2019).

<sup>41</sup> No. 2017-0385-JTL, 2019 WL 3943851 (Del. Ch. 2019).

inefficiency. Part IV, applying the analysis from Part III, discusses possible implications in both corporate and contract law.

### I. A BRIEF CASE LAW HISTORY OF DEAL PROTECTION DEVICES

This Part offers a brief overview of the cases that address deal protection devices in mergers and acquisitions. The overview is divided into two clusters. The first starts with the hostile takeover cases in the late 1980s and early 1990s and the courts' examination of deal protection devices in the context of satisfying target directors' (and managers') fiduciary duties. This line of cases ends with more recent permissive approaches that can be seen through cases such as *Lyondell Chemical* and *C & J Energy Services*. The other line of cases deals with the more recent controversy over appraisal litigation and how the courts have attempted to decide whether the presence of certain deal protection devices undermined the desirability of using the deal price itself as an indicator of fair value. The primary focus will be on the Delaware Supreme Court's decisions in *DFC Global*, *Dell*, and *Aruba*, and how the Delaware Court of Chancery has applied the principles in later cases.

#### A. Fiduciary Duty Cases

The dispute and controversy over deal protection devices came to the fore during the hostile takeover era of the late 1980s and the early 1990s. The cases primarily focused on whether agreeing to certain deal protection measures led to a breach of fiduciary duties by the target directors. As evidenced by cases such as *Revlon* and *Paramount v. QVC*, the target and buyer corporations attempted to exclude possible third-party bidders using deal protection devices, sometimes along with a poison pill. The devices that attracted the most attention were stock and asset lockups and termination fees. In *Revlon*, for instance, in order to thwart a hostile takeover attempt by MacAndrews & Forbes, Revlon (the target) brought in Forstmann Little (a private equity shop) as a "white knight" defender while promising, among other things, an asset lockup that allowed Forstmann Little to acquire some of Revlon's most valuable businesses at a below-market price in case Forstmann Little was unable to acquire Revlon.<sup>42</sup> In

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<sup>42</sup> Under the asset lockup provision of the agreement, if a third party acquired 40% or more of Revlon's stock, Forstmann Little would be entitled "to purchase Revlon's Vision Care and National Health Laboratories divisions for \$525 million, some \$100–175 million

*Paramount*, favoring Viacom Inc. over QVC Network Inc. as the deal partner, Paramount Communications Inc. (the target) promised Viacom a right to acquire Paramount stock at a below-market price (a stock lockup) in case Viacom was unable to close the transaction.<sup>43</sup> Viacom could also collect a \$100 million termination fee.<sup>44</sup> In both cases, the Delaware Supreme Court viewed the deal protection devices quite harshly, ultimately forcing the target corporations to eliminate them and try to run a fair auction among the buyers.<sup>45</sup>

The height of judicial hostility against deal protection devices was represented by the case of *Omnicare, Inc. v. NCS Healthcare, Inc.*<sup>46</sup> The Delaware Supreme Court, in that case, struck down a combination of deal protection devices, including a no-shop clause, a termination fee, and a force-the-vote provision (which did not have a fiduciary out termination right) as breaching the fiduciary duties of NCS Healthcare's (the target's) directors.<sup>47</sup>

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below the value ascribed to them by Lazard Freres" (Revlon's financial advisor). See *Revlon*, 506 A.2d at 178. Part III.E.2 analyzes asset lockups in more detail and shows how an asset lockup, to the extent that it reduces an outside buyer's reservation value more than an inside buyer's reservation value (due, for instance, to the loss of synergy value), is more problematic than other deal protection devices, not only because it can engender allocative inefficiency but also because it is quite unlikely to allow the target to increase its return from sale.

<sup>43</sup> *Paramount*, 637 A.2d at 39.

<sup>44</sup> See *id.* There were three important deal protection devices used in the deal. First was the no-shop provision. Second was the termination fee of \$100 million, which would be triggered if (a) there were a competing transaction; (b) Paramount shareholders rejected the merger; or (c) the Paramount board recommended a competing transaction. Third was the stock option agreement, under which Viacom had an option to purchase about 19.9% of Paramount's outstanding stock at \$69.14 per share if any of the triggering events of the termination fee occurred. "Viacom was permitted to pay for the shares with a senior subordinated note of questionable marketability instead of cash," or could require Paramount to pay in cash "the difference between the purchase price and the market price of Paramount's stock" (the "put feature"). *Id.* Given that both QVC and Viacom were offering about \$90 per share for Paramount's stock, being able to acquire Paramount stock at \$69.14 (with subordinated debt and put options) was a very attractive option for Viacom. See Part III.E. for an auction theory-based analysis of stock lockups.

<sup>45</sup> See *Revlon*, 506 A.2d at 185 (upholding the lower court injunction of the deal protection measures); *Paramount*, 637 A.2d at 51 (invalidating the no-shop and stock option provisions of Paramount's contract with Viacom). According to Professors Subramanian and John Coates, the incidence of asset lockups and stock lockups dropped significantly after *Revlon*, *Paramount*, and *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989). See Coates & Subramanian, *supra* note 34, at 326–30.

<sup>46</sup> 818 A.2d 914 (Del. 2003).

<sup>47</sup> *Id.* at 925–26, 936. The case is unique in the sense that there was a group of controlling shareholders (defendants Jon Outcalt and Kevin Shaw, who were both directors and officers of NCS Healthcare, Inc., and owned 65% of the voting power) who also entered into a voting agreement with Genesis (the initial buyer), under which Outcalt and Shaw granted

Perhaps in response to the judicial hostility, stock and asset lock-ups would gradually disappear over time (at least) in public company mergers. Termination fees, however, would remain in the landscape.<sup>48</sup> In *Brazen v. Bell Atlantic Corp.*,<sup>49</sup> the Delaware Supreme Court permitted a termination fee as a proper means of compensating a disappointed buyer.<sup>50</sup> Even though the termination fee (to be paid by the target Bell Atlantic) was \$550 million, the court ruled that it did not violate the directors' fiduciary obligations nor contract law's antipenalty principle, partly because the fee constituted only about 2% of Bell Atlantic's market capitalization. In subsequent cases, while being lenient toward the presence of a termination fee, courts have been a bit more vigilant toward its size. For instance, in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,<sup>51</sup> the Delaware Court of Chancery criticized a 6.3% termination fee as "seem[ing] to stretch the definition of range of reasonableness . . . beyond its breaking point."<sup>52</sup> More recently, in *In re Comverge, Inc.*,<sup>53</sup> the Delaware Court of Chancery characterized a 5.6% termination fee as "test[ing] the limits of what this Court has found to be within a reasonable range for termination fees."<sup>54</sup>

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Genesis Health Ventures, Inc., an irrevocable proxy. *Id.* at 926. Without a fiduciary termination right (which would have allowed NCS Healthcare to cancel the shareholders' meeting when consistent with their fiduciary obligations), even if the directors of NCS Healthcare were to change its recommendation to the shareholders, which, in fact, they did, due to the voting agreement, Genesis would still have been able to close the deal. *Id.* at 936.

<sup>48</sup> See *supra* note 36 and accompanying text.

<sup>49</sup> 695 A.2d 43 (Del. 1997).

<sup>50</sup> *Id.* at 50. According to Coates and Subramanian, the incidence of termination fees jumped from 33% to 65% after the case. See Coates & Subramanian, *supra* note 34, at 331.

<sup>51</sup> Nos. CIV.A. 17398, CIV.A. 17383, CIV.A. 17427, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999).

<sup>52</sup> *Id.* at \*2.

<sup>53</sup> No. 7368-VCP, 2014 WL 6686570 (Del. Ch. Nov. 25, 2014).

<sup>54</sup> *Id.* at \*14. As Subramanian and Professor Fernán Restrepo summarize:

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

Dealmakers also began experimenting with other types of deal protection devices, one of which was a match right. As seen in the GPC-Essendant transaction, a match right, when requested by the buyer (the right holder), obligates the target corporation to negotiate in good faith in allowing the buyer to match the third party's offer so as to render the third party's offer no longer superior. An important doctrinal development took place in *In re Toys "R" Us*. When Toys "R" Us, Inc. (the target), agreed to sell most of its toy business to Kohlberg Kravis Roberts & Co. (KKR), they agreed to various deal protection mechanisms, including a 3.75% termination fee and an unlimited three-day match right.<sup>55</sup> Under the latter, Toys "R" Us had an obligation to negotiate in good faith with KKR for three business days to allow KKR to revise its offer, and there was no limit on how many times KKR could exercise the right.<sup>56</sup> When the shareholders of Toys "R" Us challenged the deal protection measures, the Delaware Court of Chancery upheld their validity, stating: "[N]either a termination fee nor a matching right is per se invalid. Each is a common contractual feature that, when assented to by a board fulfilling its fundamental duties of loyalty and care for the proper purpose of securing a high value bid for the stockholders, has legal legitimacy."<sup>57</sup> Resting upon the holdings of *Brazen* and *Toys "R" Us*, by now the two most frequently used deal protection

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Restrepo & Subramanian, *supra* note 31, at 1025–26 (citations omitted). While the size of the termination fee raises some interesting issues, there does not seem to be a clear-cut guideline from the cases. At the same time, practitioners seem to have converged on the range of 3 to 5% (of the deal price) as being reasonable. *See id.* at 1026. One factor that drives the size presumably is the respective bargaining power between the buyer and the seller. *See* Adam B. Badawi & Elisabeth de Fontenay, *Is There a First-Drafter Advantage in M&A?*, 107 CALIF. L. REV. 1119, 1154–55 (2019) (showing how one party having the first-drafter advantage affects various deal provisions).

<sup>55</sup> *In re Toys "R" Us*, 877 A.2d at 997. The final merger agreement

contained four deal protection measures: 1) a fixed termination fee of \$247.5 million, equal to 3.75% of equity value or 3.25% of enterprise value—payable for the most part only if the Company terminated the merger agreement in order to sign up another acquisition proposal within a year [a tail period]; 2) an agreement to pay up to \$30 million in documented expenses after a naked no vote [i.e., if the Toys "R" Us shareholders vote down the proposal even in the absence of a competing proposal]; 3) a relatively non-restrictive no-shop clause that permitted the consideration of unsolicited bids; and 4) a temporally-limited [three-day] match right.

*Id.* In the deal, the match right was given as part of the fiduciary out exception to the no-shop covenant. *Id.* at 996–97.

<sup>56</sup> *Id.* at 997. For a more detailed discussion of match rights, see *infra* Part II.B.

<sup>57</sup> *In re Toys "R" Us*, 877 A.2d at 1017.



devices in acquisition transactions with publicly traded target corporations seem to be a right to match a third party's bid and a termination fee.<sup>58</sup>

A couple of subsequent cases seemed to put the courts in a more lenient posture regarding deal protection in answering whether the target directors might have breached their fiduciary duties. In *Lyondell Chemical*, the buyer, Basell AF, controlled by Leonard Blavatnik, made an offer to cash out all the shares of Lyondell Chemical Co. at \$48 per share, thereby putting the deal in the *Revlon* mode.<sup>59</sup> The merger agreement also included various deal protection measures, including a \$385 million termination fee (which constituted about 3% of the equity value of the transaction), a no-shop clause with a fiduciary out, and a match right for Basell.<sup>60</sup> When the plaintiff-shareholders challenged the transaction, arguing, among others, that the deal protection measures were preclusive and coercive, and the defendants moved for summary judgment, the Delaware Court of Chancery denied the motion, stating that whether the directors breached their fiduciary duties under *Revlon* raised various questions of fact.<sup>61</sup> The Delaware Supreme Court reversed, however.<sup>62</sup> While not specifically focusing on the deal protection measures, the Court stated that “there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. Thus, the directors’ failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties.”<sup>63</sup>

Similarly, in *C & J Energy Services*, which also involved a match right and a \$65 million termination fee, the Delaware Supreme Court overturned the Chancery Court’s injunctive order for the target (C & J Energy Services) to actively shop itself. While not focusing specifically on the deal protection measures, the Court stated:

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<sup>58</sup> See *supra* note 36 and accompanying text; see also Fernán Restrepo & Guhan Subramanian, *The Effect of Prohibiting Deal Protection in Mergers and Acquisitions: Evidence from the United Kingdom*, 60 J.L. & ECON. 75, 88 (2017) (empirically examining the effect of the U.K.’s banning of deal protection devices on mergers and acquisitions activities); Coates & Subramanian, *supra* note 34, at 331 (outlining an earlier empirical study of buy-side lockups).

<sup>59</sup> See *Lyondell I*, 2008 WL 2923427, at \*6.

<sup>60</sup> *Id.* at \*8 & n.35.

<sup>61</sup> *Id.* at \*18.

<sup>62</sup> See *Lyondell Chem. Co. v. Ryan (Lyondell II)*, 970 A.2d 235, 244 (Del. 2009).

<sup>63</sup> *Id.* at 243.

*Revlon* and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties. . . . When a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal, we cannot conclude that the board likely violated its *Revlon* duties.<sup>64</sup>

Finally, with respect to the question whether deal protection devices can deter third parties from competing against the buyer (i.e., undermine a post-signing market check), the Court stated that a post-signing market check is effective “so long as interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal.”<sup>65</sup>

In sum, the line of fiduciary duty cases, from *Revlon* and *Paramount v. QVC* to *Lyondell Chemical* and *C & J Energy Services*, seems to indicate that when the transaction is viewed from the issue of whether the target directors have breached their fiduciary duties (under *Revlon* or *Unocal*), over time the courts seem to have taken a more permissive approach toward deal protection measures. At the same time, the *Omnicare* case (along with *Revlon* and *Paramount*) tells us that it is possible for certain (combinations of) deal protection measures to be “preclusive and coercive”<sup>66</sup> or to constitute a breach of directors’ fiduciary duty.<sup>67</sup> Unfortunately, however, where that line is has yet to be answered in a satisfactory manner.<sup>68</sup>

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<sup>64</sup> *C & J Energy Servs.*, 107 A.3d at 1053.

<sup>65</sup> *Id.* at 1067–68.

<sup>66</sup> *Omnicare*, 818 A.2d at 936.

<sup>67</sup> *Paramount*, 637 A.2d at 51–52.

<sup>68</sup> According to Kling, Nugent, and Van Dyke, a crucial aspect to this question is whether the deal protection devices can “unduly” deter third parties from making competing bids:

[T]he economics of the executed agreement must be such that it does not *unduly* impede the ability of third parties to make competing bids. Types of arrangements that might raise questions in this regard include asset lock-ups, stock lock-ups, no-shops, force-the-vote provisions, and termination fees. The operative word is “unduly;” the impact will vary depending upon the actual type of device involved and its specific terms.

KLING, NUGENT & VAN DYKE, *supra* note 36, at 4-91 (emphasis in original).

## B. The Recent Appraisal Controversy

While the fiduciary duty case law has taken a more permissive direction on deal protection measures, a recent controversy surrounding target shareholders' right to an appraisal has breathed a new perspective into the issue.<sup>69</sup> Unlike the previous line of cases that focused on the target directors' fiduciary duties (including *Revlon* duties), appraisal cases raise a different set of questions: What is the fair value of the target's shares, and how should courts determine that fair value? The recent controversy on the appraisal remedy had to do with whether, and under what circumstances, the court can use the deal price itself as an indicator of fair value. Long dissatisfied with the perceived arbitrariness in how the courts determined fair value (which, on occasion, substantially exceeded both the deal price<sup>70</sup> and the preannouncement stock price), certain practitioners and scholars have advocated that the court use the deal price itself as an indicator of fair value in an "arm's-length" transaction. The Delaware Supreme Court, in *DFC Global* and *Dell*, largely agreed. In *Dell*, for instance, the Court noted that when there is a large public float of the target company's (Dell's) stock with many analysts following, when the deal is done on an arm's-length basis, and when the deal is shopped with numerous potential buyers, the Chancery Court will be abusing its discretion by not using the deal price (or even the pre-signing market price) as a "relevant factor" in determining fair value.<sup>71</sup>

In short, *DFC Global* and *Dell* seem to dictate that courts use the deal price as an indicator (but perhaps not an exclusive indicator) of fair value when certain conditions are met, although neither case seems to clearly lay out what the sufficient or necessary conditions are. And, this is where deal protection devices come into play: in determining if there has been sufficient competition

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<sup>69</sup> In Delaware, target shareholders who dissent from (or do not vote in favor of) certain types of mergers are entitled to ask the Chancery Court to appraise the fair value of their shares and receive that value in cash from the surviving corporation. See DEL. CODE ANN. tit. 8, § 262 (2020). For an overview and how using the deal price (merger price) can decrease target shareholders' expected return, see generally Choi & Talley, *supra* note 23.

<sup>70</sup> See Choi & Talley, *supra* note 23, at 564 (finding under an auction-theoretic model that fair-value assessments tend to exceed the deal price). For instance, in the case of *Dell*, the Delaware Court of Chancery, applying the discounted cash flow analysis, determined that the fair value of Dell's shares was \$17.62, substantially higher than the deal price of \$13.75, which, in turn, was about 37% higher than the company's 90-day-average unaffected stock price. See *Dell*, 177 A.3d at 5.

<sup>71</sup> *Dell*, 177 A.3d at 20–21.

for the target corporation (especially after the agreement has been signed).<sup>72</sup> Presumably, if the deal is too tightly locked up, so as to deter any interested third-party buyer from competing against the inside buyer, there is no market for the target corporation and the deal price (agreed to between the inside buyer and the target without any external market pressure) would become much less reliable in determining what the fair value of the target stock is.

The case of *In re AOL* directly addresses this issue. The Delaware Court of Chancery, in determining the fair value of AOL Inc.'s stock, declined to use the deal price as an indicator of fair value due to, among other things, the presence of deal protection devices. The acquisition agreement between Verizon Communications Inc. (the buyer) and AOL (the target) included a no-shop provision, a 3.5% termination fee of \$150 million, and an unlimited three-day matching right for Verizon.<sup>73</sup> Although AOL was entitled to accept a "superior proposal" from any third party (a standard fiduciary out exception to a no-shop clause), no competing buyer emerged.<sup>74</sup> The court, citing the presence of deal protection devices and other problematic issues, such as a statement by Tim Armstrong (AOL's CEO) that he was "committed to doing the deal with Verizon,"<sup>75</sup> concluded that the sale process was not "*Dell* Compliant,"<sup>76</sup> and the deal price could not be used as relevant

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<sup>72</sup> In this sense, the issue addressed in appraisal cases is different from that raised in fiduciary duty cases. In appraisal cases, the relevant question with respect to deal protection devices is whether their presence leads to our confidence in using the deal price as an indicator of fair value. By contrast, in fiduciary duty cases, the relevant question is whether their presence indicates the target directors' breach of fiduciary duties (including *Revlon* duties). Notwithstanding the difference, some have argued that the analysis should be similar. See, e.g., Lawrence A. Hamermesh & Michael L. Wachter, *Finding the Right Balance in Appraisal Litigation: Deal Prices, Deal Process, and Synergies*, 73 BUS. LAW. 961, 962 (2018) (arguing that "the Delaware courts' treatment of the use of the deal price to determine fair value does and should mirror the treatment of shareholder class action fiduciary duty litigation"). Others have argued that the questions should be treated differently. See, e.g., Charles Korsmo & Minor Myers, *The Flawed Corporate Finance of Dell and DFC Global*, 68 EMORY L.J. 221, 269 (2018) (arguing that *Dell* and *DFC Global* "conflate questions of fiduciary [duty] liability with the valuation questions central to appraisal disputes").

<sup>73</sup> *In re AOL*, 2018 WL 1037450, at \*7.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at \*9.

<sup>76</sup> According to the court, a transaction is "*Dell* Compliant" when "(i) information was sufficiently disseminated to potential bidders, so that (ii) an informed sale could take place, (iii) without undue impediments imposed by the deal structure itself." *Id.* at \*8.

evidence of fair value.<sup>77</sup> The court, instead, applied the discounted cash flow analysis (as many courts have done in the past) to determine AOL's fair value.<sup>78</sup>

Three more recent cases, *Aruba*, *Columbia Pipeline*, and *Stillwater Mining*, all decided in 2019, put an additional interpretive wrinkle on deal protection devices in appraisal actions.<sup>79</sup> In all three cases, while there are some factual variations, the target corporation pursued a strategy of negotiating with one buyer (known as the "single-buyer strategy") and adopted deal protection measures that included both a termination fee and an unlimited match right.<sup>80</sup> In none of these cases did a competing buyer emerge after the agreement was signed. Notwithstanding the presence of deal protection devices, in all three cases, the court determined that, after closely examining the respective negotiation history, the price was the reliable measure of fair value. In the process of coming to that conclusion, the *Columbia Pipeline* and *Stillwater Mining* courts focused on several indicia of reliability: (1) the fact that the merger was an arm's-length transaction; (2) the target directors did not face any (material) conflicts of interest; (3) the buyer conducted due diligence and received confidential information about the target's value; (4) the target negotiated with the buyer and extracted multiple price increases; and (5) most importantly, no bidders emerged during the postsigning phase.<sup>81</sup> Particularly with respect to the fifth factor, according to the *Stillwater Mining* court, the nonemergence of a

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<sup>77</sup> According to the court, "Armstrong's post-Agreement statements to the press about giving his 'word' to Verizon could reasonably cause potential bidders to pause *when combined with the deal protections here.*" *Id.* at \*9 (emphasis added). In *Dell*, the termination fee was about 1% of Dell's market capitalization, the buyer was given a one-time matching right, and there was a 45-day go-shop period. *Dell*, 177 A.3d at 12. By contrast, in *In re AOL*, the termination fee was about 3.5% of AOL's market capitalization and Verizon was given an unlimited matching right. According to the court, "[c]umulatively, these factors make for a considerable risk of informational and structural disadvantages disuading any prospective bidder." *In re AOL*, 2018 WL 1037450, at \*9.

<sup>78</sup> *In re AOL*, 2018 WL 1037450, at \*10.

<sup>79</sup> See *In re Panera Bread Co.*, No. 2017-0593-MTZ, 2020 WL 506684, at \*29 (Del. Ch. Jan. 31, 2020) (applying similar analysis to match rights and termination fees in an appraisal proceeding).

<sup>80</sup> For instance, in *Aruba*, the target (Aruba Networks, Inc.) had agreed to an unlimited match right, which gave the buyer (Hewlett-Packard Co.) five days to match the first superior offer and two days to match any subsequent increase. There also was a termination fee of \$90 million, representing 3% of Aruba's equity value. See *Verition Partners Master Fund, Ltd. v. Aruba Networks, Inc.*, No. 11448-VCL, 2018 WL 922139, at \*38 (Del. Ch. Feb. 15, 2018).

<sup>81</sup> *In re Stillwater Mining*, 2019 WL 3943851, at \*22-23; *Columbia Pipeline*, 2019 WL 3778370, at \*25-26.

competing buyer was deemed to be “highly significant” in its conclusion that the deal price was a reliable indicator.<sup>82</sup>

Two salient patterns seem to emerge from the recent appraisal cases. First, the courts seem to rely more on the deal price to determine fair value when certain conditions are satisfied. This is to the exclusion of other measures, such as the discounted cash flow measure or the unaffected (pre–merger announcement) market price. Second, and more importantly for our purposes, courts do not seem less inclined to use the deal price as an indicator of fair value when certain measures, such as a termination fee and a match right, are present. With respect to match rights, however, the debate remains. For instance, according to the Delaware Court of Chancery in the *Dell* appraisal litigation, an unlimited match right is a “powerful disincentive” against a third-party bidder’s making a topping bid.<sup>83</sup> According to Professor Guhan Subramanian, “[t]he match right [ ] fuels the winner’s curse problem: in any scenario where a third party bids and wins, it would know that a better-informed party (namely, the initial bidder) thought that the price was too high. Looking forward and reasoning back, a third party would be unlikely to bid.”<sup>84</sup> Furthermore,

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<sup>82</sup> *In re Stillwater Mining*, 2019 WL 3943851, at \*23. In emphasizing this factor, the court relied on the reasoning from *Aruba* and *Dell*. In *Aruba*, the Delaware Supreme Court had stated: “It cannot be that an open chance for buyers to bid signals a market failure simply because buyers do not believe the asset on sale is sufficiently valuable for them to engage in a bidding contest against each other.” *Aruba*, 210 A.3d at 136. Similarly, in *Dell*, the court had found that the absence of a (postsigning) higher bid meant “that the deal market was already robust and that a topping bid involved a serious risk of overpayment,” which “suggests the [deal] price is already at a level that is fair.” *Dell*, 177 A.3d at 33.

<sup>83</sup> See *In re Appraisal of Dell*, No. 9322–VCL, 2016 WL 3186538, at \*41 (Del. Ch. May 31, 2016); see also *Merion Cap. L.P. v. Lender Processing Servs., Inc.*, No. 9320–VCL, 2016 WL 7324170, at \*25 (Del. Ch. Dec. 16, 2016) (“[T]he existence of an incumbent trade bidder holding an unlimited match right was a sufficient deterrent to prevent other parties from perceiving a realistic path to success. . . . Without a realistic path to success, it made no sense to get involved.”); *Blueblade Cap. Opportunities LLC v. Norcraft Cos.*, No. 11184–VCS, 2018 WL 3602940, at \*22 (Del. Ch. Jul. 27, 2018) (citing Subramanian for the proposition that “unlimited match rights are typically perceived as limiting any ‘pathway to success.’ . . . [E]verybody agrees that match rights deter bids. It is not even a debated question” (alteration omitted)); *In re Panera Bread Co.*, 2020 WL 506684, at \*21 (citing an investment banker’s testimony that “even customary matching rights may discourage in a way and make it more challenging for other bidders to come forward” (quotation marks omitted)).

<sup>84</sup> See Subramanian & Zhao, *supra* note 31, at 1234. See *supra* note 31 for more discussion on winner’s curse problem associated with unlimited match right. For an analysis of how an unlimited match right can be modeled as an English auction and concluding that the winner’s curse problem does not arise in an English auction setting even if the outside buyer has an informational disadvantage compared to the inside buyer, see *infra* Part III.B, D.

courts are willing to rely more on the deal price when no competing buyer emerges after the agreement is signed. At least in theory, this is puzzling since the absence of a competing buyer can be the result of one of two things: either that the deal price is already sufficiently high so that no other third party is willing to offer more, or that even though the deal price itself is not sufficiently high, the deal protection devices successfully discourage other buyers from emerging.<sup>85</sup>

## II. MATCH RIGHTS AND TERMINATION FEES IN ACTION

This Part discusses, in more detail, how deal protection devices—match rights and termination fees in particular—are used in practice. While there are many different types of deal protection measures, we can roughly divide them into two categories. The first type (like a termination fee or a stock or asset lockup) tries to compensate the disappointed buyer, while the second type (like a match right or a no-shop provision) tries to more directly control the target's behavior. The first type of device allows the disappointed purchaser to receive some financial compensation from the target in case the deal does not close and the target is sold to a different buyer. Stock or asset lockups, for instance, allow a disappointed buyer to acquire the target corporation's stock or asset at a previously agreed-upon, favorable price.<sup>86</sup> A target termination fee would stipulate a dollar amount that the disappointed buyer can collect from the target in case the target is sold to a different buyer.<sup>87</sup>

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<sup>85</sup> Professor Subramanian has argued, for instance, that the presence of an unlimited match right can undermine the reliability of the deal price as an indicator of fair value. According to him, "an exclusive pre-signing negotiation followed by a go-shop process in which the buyer gets an unlimited match right would probably not qualify for deference to the deal price." See Subramanian, *supra* note 31, at 226.

<sup>86</sup> While the primary focus of this Article is on match rights and termination fees, I briefly examine the impact of stock and asset lockups in Part III.E. In theory, poison pills can also function as a deal protection device that compensate a disappointed buyer since, when triggered, they allow the inside buyer to purchase the target's stock at an attractive price.

<sup>87</sup> Sometimes, the purchaser corporation is obligated to make a fee payment to the target; this is known as the reverse breakup (or reverse or buyer termination) fee. Such a provision is most often used when the deal cannot close due to the purchaser's inability to satisfy the financing needs or inability to secure regulatory (such as antitrust or securities) approval. See, e.g., Choi & Wickelgren, *supra* note 15, at 1–2. Unlike a target termination fee, a reverse termination fee does not involve the presence of a third party buyer or seller. In that sense, a reverse termination fee functions more like an incentive device (to secure antitrust approval or line up necessary financing, for instance).

The second type of device attempts to influence or control the target's preclosing behavior. The mechanism used most often is known as the no-shop (or nonsolicitation) clause, which prohibits the target from directly (or indirectly) soliciting a competing bid from a third party.<sup>88</sup> Others include covenant provisions that require the target corporation to hold a shareholders meeting—regardless of whether the target board decides to change its recommendation to the shareholders (a “force the vote” covenant),<sup>89</sup> not to change its recommendation to the shareholders (a “no change in recommendation” covenant), or to exert necessary efforts, such as “best efforts,” in securing various approvals, such as those from the government entities or other contracting parties. At the same time, given that the target's directors owe fiduciary obligations to the corporation and their shareholders, it is common for no-shop or other protective clauses (such as the no change in recommendation covenant) to conditionally allow the directors to consider an unsolicited bid and engage with a third-party bidder in case the bid is more attractive. Another often-used device is a match right. Often combined with other covenants, such as a no change in recommendation or no-shop covenant, a match right allows the buyer to match a competing bid, so as to make the competing bid no longer more attractive to the target shareholders.

Given the emergence of termination fees and match rights as two of the most visible and frequently used deal protection mechanisms,<sup>90</sup> this Part focuses on them, with the help of some recent mergers and acquisitions transactions: Nexstar Media's acquisition

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<sup>88</sup> See, e.g., AM. BAR ASS'N, MODEL MERGER AGREEMENT FOR THE ACQUISITION OF A PUBLIC COMPANY § 4.4, at 148–50 (2011) [hereinafter ABA MODEL MERGER AGREEMENT]. At the other end of the spectrum, there is a “go-shop” clause, which allows or even obligates the target corporation to shop the deal around for a prespecified duration. Go-shop periods can kick in either before or after the agreement has been signed. See, e.g., *Dell*, 177 A.3d at 12. Although there is an interesting debate as to how effective a go-shop provision is and whether it allows the target directors to satisfactorily discharge their fiduciary duties (in getting the maximum price possible), this Article is focused on deal protection devices. For a recent analysis of go-shop provisions, see Subramanian & Zhao, *supra* note 31, at 1226–31.

<sup>89</sup> Under Delaware law, a target company can agree to such a provision even if its board were to change its recommendation to the shareholders. See DEL. CODE ANN. tit. 8, § 146 (2020).

<sup>90</sup> See *supra* note 36.



of Tribune Media<sup>91</sup> and Google's acquisition of Fitbit.<sup>92</sup> This Part also looks at the American Bar Association's Model Merger Agreement.<sup>93</sup> The transactions contemplate a reverse triangular merger structure, in which the purchaser (the "Parent") lets one of its wholly owned subsidiaries (the "Merger Sub") merge with a publicly traded target corporation (the "Company"), with the target corporation as the surviving entity. I will first closely examine the match rights used in the agreements and then turn to termination fees.

#### A. Target Termination Fee

In contrast to a match right, a termination fee does not attempt to directly influence the target's or the buyer's behavior. Rather, it allows a disappointed buyer to receive financial compensation when certain conditions are satisfied. The most common conditions are the target's consummation of an alternative or competing transaction or the target board's changing its recommendation to its shareholders due to the emergence of a competing bidder with a superior offer. As can be inferred from its name, a termination fee provision is intimately tied with the right to terminate the agreement.<sup>94</sup>

For instance, in the Nexstar-Tribune transaction, Nexstar is entitled to collect a \$135 million termination fee from Tribune if certain conditions are satisfied, the most important one of which is if Tribune enters into an alternative transaction with a third party.<sup>95</sup> For instance, § 9.1 of the agreement, titled "Termination," lays out the circumstances under which the agreement can be

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<sup>91</sup> See generally Nexstar Media Group, Inc., Agreement and Plan of Merger Among Tribune Media Company, Nexstar Media Group, Inc. and Titan Merger Sub, Inc. (Form 8-K, Exhibit 2.1) (Dec. 4, 2018) [hereinafter Nexstar-Tribune Merger Agreement].

<sup>92</sup> See generally Fitbit, Inc., Agreement and Plan of Merger by and Among Fitbit, Inc., Google LLC and Magnoliophyta Inc. (Form 8-K, Exhibit 2.1) (Nov. 1, 2019) [hereinafter Google-Fitbit Merger Agreement].

<sup>93</sup> See generally ABA MODEL MERGER AGREEMENT, *supra* note 88.

<sup>94</sup> Taking one step back, before one party has the right to terminate the contract, there is usually a nonsatisfaction of a condition. A change in the target board's recommendation, for instance, will first function as a nonsatisfaction of this condition, which will, in turn, give the purchaser the right to terminate the agreement and to collect a termination fee. See, e.g., ABA MODEL MERGER AGREEMENT, *supra* note 88, § 7.3(b), at 276–77.

<sup>95</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 9.3(a), at 78–79. By comparison, in the Google-Fitbit transaction, if Fitbit were to enter into a competing transaction or Fitbit's board were to change its recommendation to its stockholders, Google is entitled to receive a termination fee of \$80 million, which is roughly about 3.8% of the deal value of \$2.1 billion. See Google-Fitbit Merger Agreement, *supra* note 92, § 8.03(a)(i), at 86.

terminated. It allows Nexstar to terminate the agreement when a “Triggering Company Event” has occurred,<sup>96</sup> which is defined to include either Tribune’s board making a change in its recommendation to its shareholders (a “Company Adverse Recommendation Change”) or Tribune entering into a transaction with a third party (an “Alternative Company Acquisition Agreement”).<sup>97</sup>

With respect to the payment of the \$135 million termination fee, § 9.3(a)(i) states, in relevant part, that if the agreement is terminated for either of those reasons, “the Company shall pay to Parent . . . a fee in the amount of \$135 million (the “Company Termination Fee”) at or prior to the termination of this Agreement.”<sup>98</sup> In the previous Part, we saw that Tribune’s board is allowed to change its recommendation to the shareholders in response to a superior offer from a third party. Sections 9.1 and 9.3 impose an obligation on Tribune to pay a \$135 million termination fee if either Tribune’s board changes its recommendation in response to a third party’s offer or sells itself to a third party. Given the fact that as of the date of the merger announcement Tribune was valued at about \$4.1 billion, a \$135 million termination fee constituted about 3.3% of the deal value.<sup>99</sup>

An important condition with respect to the payment of a termination fee is that it expressly envisions the target entering into a competing transaction. Furthermore, when the condition is satisfied and the agreement has been terminated, the buyer is not simply entitled to recover its fees and expenses. In fact, the agreements usually stipulate other occasions when the buyer is entitled to only be reimbursed for its expenses. For instance, in the Nexstar-Tribune agreement, § 9.3(b) states that:

If this Agreement is terminated by Parent or the Company [in response to the Company shareholders’ failure to adopt the agreement], then the Company shall pay to Parent . . . an amount equal to the documented out of pocket costs and expenses, including any commitment fees under the Commitment Letter and the fees and expenses of counsel, accountants, investment bankers, Financing Sources, experts and

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<sup>96</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 9.1(c)(i), at 77.

<sup>97</sup> *Id.* § 1.1, at 3, 13.

<sup>98</sup> *Id.* § 9.3(a)(i), at 78 (emphasis omitted).

<sup>99</sup> See Tribune Media Co., Nexstar Media Group Enters into Definitive Agreement to Acquire Tribune Media Company for \$6.4 Billion in Accretive Transaction Creating the Nation’s Largest Local Television Broadcaster and Local Media Company (Form 8-K, Exhibit 99-1) (Dec. 3, 2018) [hereinafter Exhibit 99-1].

consultants, incurred by Parent in connection with this Agreement and the transactions contemplated by this Agreement in an amount not to exceed \$15,000,000 (the “Parent Expenses”) as promptly as practicable (and, in any event, within two (2) Business Days following such termination).<sup>100</sup>

As this section makes clear, if the proposal goes to a shareholder vote and the Tribune shareholders do not approve the merger, Nexstar is entitled to have only its expenses (broadly construed) reimbursed and the total reimbursement is capped at \$15 million, substantially below the termination fee of \$135 million in the event Tribune enters into a competing transaction with a third party.<sup>101</sup> A large termination fee that is triggered when a target enters into a competing transaction and allows the disappointed buyer to recover substantially more than its expenses and fees does much more than simply trying to make the disappointed buyer whole and to protect its reliance interest.<sup>102</sup>

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<sup>100</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 9.3(b), at 79. For the role of the shareholders’ vote in the right of either the Parent or the Company to terminate, see *id.* § 9.1(b)(iii), at 77.

<sup>101</sup> An important variation on the expense reimbursement in case the target shareholders reject the deal is what is known as the “naked no vote” or “no vote” fee. Under such a provision, the buyer will be entitled to collect a stipulated amount from the target. Unlike the Tribune-Nexstar deal, the Google-Fitbit transaction employs a naked no vote provision. Section 8.03(a)(ii) of the agreement states that, in case Fitbit shareholders do not approve the transaction and the agreement is terminated either by Fitbit or Google, “the Company shall pay . . . to Parent . . . an amount equal to \$21,000,000 (such amount, the ‘No Vote Fee’).” Google-Fitbit Merger Agreement, *supra* note 92, § 8.03(a)(ii), at 86–87 (emphasis omitted). The presence of a large naked no vote fee, unlike an expense reimbursement provision, raises the specter of whether the target shareholders would be “coerced” to vote in favor of the merger, particularly when there is no competing buyer that is offering a more attractive consideration, and how large a naked no vote fee can be. This issue remains unresolved. In the case of *In re Lear Corp. Shareholder Litigation*, 967 A.2d 640 (Del. Ch. 2008), the Delaware Court of Chancery had an opportunity to consider this provision. But relying in part on the factual findings that the target directors agreed to a naked no vote fee in return for a higher consideration (from \$36 per share to \$37.25 per share), and that the naked no vote fee of \$25 million was only 0.9% of the total deal value, the Court determined that the target directors did not breach their fiduciary duties and the naked no vote fee did not constitute a corporate waste. *See id.* at 641, 648, 656–57.

<sup>102</sup> In certain cases, the disappointed buyer is entitled to get both its expenses reimbursed and also collect a termination fee. The provisions from the *ABA Model Merger Agreement* are exemplary. For instance, § 7.1(e) allows the purchaser corporation to terminate the agreement when the target board has changed its recommendation to its shareholders. ABA MODEL MERGER AGREEMENT, *supra* note 88, § 7.1(e), at 259. When the agreement has been terminated in accordance with § 7.1(e), § 7.3(a)(ii) allows the purchaser corporation to recover its expenses and § 7.3(b)(i) allows the purchaser to collect the stipulated termination fee. *Id.* § 7.3(a)(ii), (b)(i), at 276. Sections 7.1(f) and 7.3(b)(ii) provide that the termination fee can also be triggered when the deal fails to close for other reasons, such as material inaccuracy in the target corporation’s representations and

Termination fees raise some difficult contract law issues as well, some of which have not been fully resolved. There is the question of whether a termination fee should be treated as liquidated damages and, if yes, whether the antipenalty doctrine should allow the court to strike down some of the fees.<sup>103</sup> According to the Second Restatement of Contracts, “[d]amages for breach by either party may be liquidated in the agreement. . . .”<sup>104</sup> But, an important condition here is that the liquidated damages must be for breach of contract. If the contract expressly allows one party to terminate the contract and also collect a termination fee, it is not entirely clear whether a breach has occurred.<sup>105</sup> A true breach happens presumably when one party does not abide by the terms of the agreement, for instance, when one party attempts to terminate a contract even in violation of the express terms of the contract. Since the primary goal of a merger agreement is to execute a merger, a termination fee could be thought of as setting up an alternative performance obligation for the target.

The distinction here is important because if a termination fee is classified as liquidated damages, under the antipenalty rule (doctrine) of contract law, it cannot be unreasonably large when compared to the actual or anticipated loss (by the purchaser).<sup>106</sup> If, on the other hand, a termination fee is not liquidated damages,

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warranties, the target’s failure to satisfy other covenants, or the target corporation’s consummation of a competing transaction within a specified period of time after the termination (known as the “tail period”). *See id.* §§ 7.1(f), 7.3(b)(ii), at 259, 276. In sum, the goal of the termination fee is to allow the disappointed purchaser to collect a financial reward when the target consummates a transaction with a different buyer.

<sup>103</sup> Another issue is whether a termination fee should be the exclusive remedy for the buyer. Acquisition agreements generally stipulate that, in case termination is triggered pursuant to the agreement, a termination fee is the exclusive remedy for the buyer. *See, e.g.,* GPC-Essendant Merger Agreement, *supra* note 2, § 9.03(e), at 81 (“[I]n the event that the Termination Fee is paid in accordance with this Section 9.03, the payment of the Termination Fee shall be the sole and exclusive remedy of GPC.”).

<sup>104</sup> RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (AM. L. INST. 1979); *see also* U.C.C. §§ 2-718 to -719 (AM. L. INST. & UNIF. L. COMM’N 2017).

<sup>105</sup> This issue is heightened by the fact that not all terminations lead to collection of a termination fee. For instance, if the deal falls apart due to the parties’ failure to receive necessary regulatory approval, the purchaser is not likely to collect a termination fee from the target corporation. Termination fees are much more closely associated with the presence of a competing transaction and this increases the possibility that the parties may be using termination fee so as to deter a third-party bidder and also to extract more rent from a third party.

<sup>106</sup> RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (AM. L. INST. 1979) (“Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.”).

presumably no such restriction would apply. Also, unless other problems, such as conflicts of interest on the part of the directors and managers, are present, a termination fee would only be subject to a deferential business judgment review under corporate law.

Notwithstanding this difficulty, the *Brazen v. Bell Atlantic Corp.* court treated a termination fee as liquidated damages and that holding still seems to control.<sup>107</sup> Perhaps in response to the *Brazen* line of cases, oftentimes, the transacting parties will expressly stipulate in their agreement that the termination fee should (or can) be treated as liquidated damages and, more importantly, the size of the termination fee is reasonable (i.e., it does not constitute a penalty). Here is an example from the Nexstar-Tribune transaction. Section 9.3(c) of the agreement states:

The Parties acknowledge that (i) the agreements contained in this *Section 9.3* are an integral part of the transactions contemplated by this Agreement, (ii) the *Company Termination Fee and Parent Expenses are not a penalty, but are liquidated damages, in a reasonable amount that will compensate Parent* in the circumstances in which *such fee is payable for the efforts and resources expended and opportunities foregone while negotiating this Agreement and in reliance on this Agreement* and on the expectation of the consummation of the transactions contemplated hereby, which amount would otherwise be impossible to calculate with precision and (iii) that, without these agreements, the Parties would not enter into this Agreement.<sup>108</sup>

What is interesting in the Nexstar-Tribune example is that, not only do the parties expressly state that the termination fee and

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<sup>107</sup> *Brazen*, 695 A.2d at 43. The court based its decision partly on the fact that the merger agreement itself (between NYNEX Corp. and Bell Atlantic Corp.) stated that the termination fee “constitute[s] liquidated damages and not a penalty.” *Id.* at 46 (emphasis omitted). According to the court,

the express language in section 9.2(e) of the agreement unambiguously states that the termination fee provisions “constitute liquidated damages and not a penalty.”

...

[W]e find no compelling justification for treating the termination fee in this agreement as anything but a liquidated damages provision, in light of the express intent of the parties to have it so treated.

*Id.* at 47–48. But deferring to the parties’ classification seems to invite possible opportunism.

<sup>108</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 9.3(c), at 79 (first emphasis in original).

the expenses constitute liquidated damages, but also that they are not a penalty.<sup>109</sup> This raises an interesting question. Assuming that the *Brazen* line of cases is correct in treating termination fees and expenses as liquidated damages, it is uncertain whether the courts will also honor the parties' express stipulation that the fees and expenses are "reasonable" liquidated damages and therefore do not constitute a penalty.<sup>110</sup> Furthermore, § 9.3(c) also

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<sup>109</sup> First and foremost, note that this language is quite similar to that used in the *Brazen* case. *Brazen*, 695 A.2d at 46. The agreement seems to treat these two concepts, liquidated damages and penalty, as being distinct, but this is likely incorrect. As mentioned earlier, the antipenalty doctrine would apply when a termination fee is treated as liquidated damages. Hence, assuming that the courts will honor the parties' designation of the termination fee (along with expense reimbursement) as liquidated damages, now they will be subject to the antipenalty doctrine. See RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (AM. L. INST. 1979):

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

See also U.C.C. § 2-718 (AM. L. INST. & UNIF. L. COMM'N 2017):

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

But see 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.18 (3d ed. 2004):

If [a stipulated damages provision] is condemned as a penalty, it is unenforceable. But the rest of the agreement stands, and the injured party is remitted to the conventional damage remedy for breach of that agreement, just as if the provision had not been included. If the provision is sustained as one for liquidated damages, both parties are bound by it.

<sup>110</sup> From the strategic perspective, stipulating that a termination fee constitutes liquidated damages doesn't seem to make a lot of sense, since, assuming that the court becomes more likely to honor that stipulation, the antipenalty doctrine would apply. It may make more sense from the parties' perspective to call a termination fee provision an alternative performance provision. By doing so, they become more likely to bypass the antipenalty doctrine. The relevant provision in the Google-Fitbit agreement is somewhat cleaner in this regard. Section 8.03(a)(iii), in relevant part, states:

[T]he *Company Termination Fee shall constitute liquidated damages*, and from and after such termination, Company shall have no further liability of any kind for any reason in connection with this Agreement or the termination contemplated hereby other than the payment of the Company Termination Fee . . . and such payments shall be *the sole and exclusive remedy* . . . against the Company . . . in the event of a termination of this Agreement giving rise to the payment of the Company Termination Fee.

Google-Fitbit Merger Agreement, *supra* note 92, § 8.03(a)(iii), at 87 (emphasis added). While stating that the termination fee will be the sole and exclusive remedy for Google if the agreement is terminated pursuant to the agreement, if the deal falls apart due to other

states that the termination fee is necessary to compensate Nexstar for the “efforts and resources expended and opportunities foregone” while it is negotiating the deal.<sup>111</sup> Presumably, though, such reliance costs would be present even when the transaction falls apart for other reasons, such as when Tribune’s shareholders reject the deal without a competing buyer. As we saw earlier, however, in case that happens, Nexstar would be entitled to get only its expenses reimbursed, up to the cap of \$15 million, only one-ninth of the termination fee of \$135 million.<sup>112</sup> What justifies such drastically different fees? An important difference, of course, is that the much higher termination fee kicks in when a third-party buyer acquires the target.<sup>113</sup> A termination fee, unlike a straightforward expense reimbursement provision, not only affects the buyer and the target but also the third party, and this contractual externality can have some interesting implications, as I examine in more detail in the next Part.

## B. Match Right

When an initial buyer is given a match right, once there is an offer from a third party that is considered to be superior to the

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reasons, Google will reserve the right to pursue other remedies, including expectation damages or specific performance. *See, e.g., id.* § 9.09, at 92–93 (stating that in case the provisions of the agreement “were not performed in accordance with their specific terms or were otherwise breached,” the parties would be entitled to seek specific performance); *see also* ABA MODEL MERGER AGREEMENT, *supra* note 88, § 7.2(b), at 273 (“[T]he termination of this Agreement shall not relieve any Party from any liability for fraud or any material inaccuracy in or breach of any representation or any material breach of any warranty, covenant, or other provision contained in this Agreement.”). A termination fee, with or without the “sole and exclusive remedy” clause, presents a classic example in which the parties are anticipating possible ex post disputes when they are drafting their contract. *See* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 *YALE L.J.* 814, 873–76 (2006); Albert H. Choi & George Triantis, *Designing and Enforcing Preliminary Agreements*, 98 *TEX. L. REV.* 439, 484–85 (2020).

<sup>111</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 9.3(c), at 79.

<sup>112</sup> *Id.* In the Google-Fitbit transaction, by comparison, the termination fee was \$80 million while the “no vote fee,” which is triggered if Fitbit shareholders reject the deal, was \$21 million. So, the termination fee was about 4 times larger than the “no vote fee.” *See* Google-Fitbit Merger Agreement, *supra* note 92, § 8.03(a), at 86–87; *see also supra* notes 95, 101.

<sup>113</sup> One important implication of that difference is that when the target is sold to a different buyer, the initial buyer no longer has an option to try to execute the deal again in the future. That is, unlike the deal simply falling apart (due, for instance, to the target shareholders’ rejection), the third party’s jumping the deal leads to the initial buyer’s loss of that option value. *See supra* note 15 (discussing the story of Dollar Thrifty Automotive Group).

buyer's initial offer<sup>114</sup> (subject to certain conditions), the right allows the buyer (and obligates the target) to negotiate in good faith and revise the buyer's offer so that the third party's offer is no longer superior. Similar to other covenants, such as a no-shop provision, a match right attempts to directly influence the target's (or more precisely, target directors' and managers') behavior.

The following provision, from the merger agreement between Nexstar Media and Tribune Media, is illustrative.<sup>115</sup> In § 7.3, titled "No Solicitation by the Company," a match right can be triggered by the buyer, Nexstar Media (the "Parent"), before the directors of the target company, Tribune Media (the "Company"), can change its recommendation to their shareholders in response to, among other things, a more attractive offer coming from a third party. Subsection (f), in relevant part, states:

Prior to making any Company Adverse Recommendation Change or entering into any Alternative Company

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<sup>114</sup> According to the *ABA Model Merger Agreement*, "Superior Proposal" is defined as an unsolicited, bona fide written offer made by a third party to acquire, directly or indirectly, by merger or otherwise, all of the outstanding shares of Company Common Stock or all or substantially all of the assets of the Company and its Subsidiaries, which the Company Board determines in its reasonable judgment, taking into account, among other things, all legal, financial, regulatory, and other aspects of the proposal and the person making the proposal and an opinion of an independent financial advisor of nationally recognized reputation (a) is *more favorable from a financial point of view to the Company's stockholders than the terms of the Merger*, and (b) is *reasonably capable of being consummated; provided, however*, that any such offer shall not be deemed to be a "Superior Proposal" if any financing required to consummate the transaction contemplated by such offer is not committed and is not reasonably capable of being obtained by such third party.

ABA MODEL MERGER AGREEMENT, *supra* note 88, § 8.16, at 326 (last emphasis in original). Hence, "superiority" emphasizes the financial aspect for the target shareholders while conditioning on the fact that the necessary financing is either obtained or likely obtained. *See id.*

<sup>115</sup> On December 3, 2018, Nexstar Media Group and Tribune Media Company announced the merger, under which "Nexstar [would] acquire all outstanding shares of Tribune for \$46.50 per share" (plus some extra in case there was a preclosing dividend). Exhibit 99-1, *supra* note 99. The deal valued Tribune at about \$4.1 billion and the consideration constituted about a 15.5% premium above Tribune's closing price on November 30, 2018. *See Benjamin Mullin & Joe Flint, Nexstar Reaches Deal to Buy Tribune Media for \$4.1 Billion*, WALL ST. J. (Dec. 2, 2018), <https://perma.cc/266W-AT23>; Exhibit 99-1, *supra* note 99. The merger was subject to the approval of the Federal Communication Commission (FCC) and Tribune's shareholders. Tribune shareholders approved the deal on March 12, 2019. *See generally* Tribune Media Co., Current Report (Form 8-K) (Mar. 12, 2019). On September 13, 2019, the FCC approved the transaction. *See* Trib. Media Co., 34 FCC Rcd. 8436, 8463 (2019). The merger closed on September 19, 2019. *See generally* Tribune Media Co., Current Report (Form 8-K) (Sept. 19, 2019). No competing bidder emerged between the signing and the closing of the merger.



Acquisition Agreement, (i) the Company Board shall provide Parent at least four (4) Business Days' prior written notice of its intention to take such action; . . . (ii) *during the four (4) Business Days following such written notice, the Company Board and its Representatives shall negotiate in good faith with Parent . . . regarding any revisions to the terms of the transactions . . . in response to such Superior Company Proposal. . . After compliance with the foregoing sentence, the Company shall have no further obligations under the foregoing sentence, and . . . shall not be required to comply with such obligations with respect to any other Superior Company Proposal.*<sup>116</sup>

In accordance with the provision, after an unsolicited, superior proposal (a "Superior Company Proposal") has been made to the target by a third party, before Tribune Media's board can change its recommendation regarding its deal with Nexstar Media to its shareholders (a "Company Adverse Recommendation Change"), among other things Tribune Media must, to the extent Nexstar Media desires, negotiate in good faith with Nexstar Media for four business days so as to make the third party's offer no longer superior. Furthermore, the last emphasized sentence makes it clear that Nexstar Media can require Tribune Media to negotiate in good faith only once: this is a limited match right. What is also interesting is that when Nexstar matches a third party's offer, the agreement does not obligate Tribune to accept Nexstar's revised offer. If the third party were to sweeten its offer in response to Nexstar's revised offer, Nexstar would no longer be entitled to an exclusive match period.

By comparison, here are the relevant sections from the merger agreement between Google (the "Parent") and Fitbit (the "Company").<sup>117</sup> Under § 6.02, titled "Non-Solicitation; Acquisition

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<sup>116</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 7.3(f), at 65 (emphasis added). According to the merger agreement, "Superior Company Proposal" is defined as "a Company Acquisition Proposal from any Person . . . which the Company Board determines in good faith . . . to be more favorable, from a financial point of view, to the stockholders of the Company than the transactions contemplated by this Agreement." *Id.* § 1.1, at 12. "Company Acquisition Proposal," in turn, is defined as a proposal to acquire either 15% or more of the company's assets or business, or as when the company's shareholders "hold less than 85% of the equity interests or voting power" of the surviving corporation. *Id.* § 1.1, at 2-3.

<sup>117</sup> On November 1, 2019, Fitbit, Inc., and Google LLC (a subsidiary of Alphabet, Inc.) announced that Google would acquire all of the outstanding stock of Fitbit at \$7.35 in cash per share. Similar to the Tribune-Nexstar transaction, the Google-Fitbit deal was also structured as a reverse triangular transaction, where Magnoliophyta, Inc., a wholly owned subsidiary of Google, created for the sole purpose of the merger, was to merge into Fitbit,

Proposals,” Fitbit’s board, in response to a more attractive third-party offer (“Superior Proposal”), cannot change its recommendation (on the merger with Google) to its shareholders and also terminate the agreement:

(i) . . . [T]he Company shall not be entitled to terminate this Agreement . . . unless:

(A) the Company shall have provided to Parent four (4) Business Days’ prior written notice . . . advising Parent that the Company intends to take such action; . . . and

(B) [ ] during such four (4) Business Day period . . . the *Company shall have engaged in good faith negotiations with Parent . . . regarding changes to the terms of this Agreement intended to cause such Acquisition Proposal to no longer constitute a Superior Proposal. . . .*

(ii) . . . any [ ] revisions to the financial terms or any other material terms of a Superior Proposal . . . shall constitute a *new Acquisition Proposal and shall in each case require the Company to deliver to Parent a new [notice] and a new two (2) Business Day period shall commence thereafter.*<sup>118</sup>

Similar to the Nexstar-Tribune agreement, after an unsolicited, superior proposal has been made to Fitbit by a third party, before the Fitbit board can change its recommendation (regarding the existing deal) to its shareholders, the Fitbit board must (among other things) negotiate “in good faith” with Google for four business days so as to make the third party’s offer no longer superior.

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with Fitbit as the surviving corporation. *See* Fitbit, Inc., Current Report (Form 8-K) (Nov. 1, 2019). The merger consideration was about 19% above the latest Fitbit closing price. *See* Rob Copeland & Patrick Thomas, *Google to Buy Fitbit, Amping Up Wearables Race*, WALL ST. J. (Nov. 1, 2019), <https://perma.cc/ZX2M-24DZ>. On January 3, 2020, Fitbit shareholders held a virtual special shareholders meeting (via exclusive live webcast) and approved the merger. *See* Fitbit, Inc., Current Report (Form 8-K) (Jan. 6, 2020). Between the signing of the agreement and the shareholder approval, no competing buyer emerged.

<sup>118</sup> Google-Fitbit Merger Agreement, *supra* note 92, § 6.02(e), at 66–67 (emphasis added). According to the agreement, “Superior Proposal” is defined as

a bona fide written Acquisition Proposal . . . made by a Third Party that the Company Board determines in good faith, after consultation with the Company’s outside independent financial advisors and outside legal counsel, and considering all the terms of the Acquisition Proposal (including the legal, financial, financing and regulatory aspects of such proposal, the identity of the Third Party making such proposal, the conditions for completion of such proposal, and the timing and likelihood of consummation), to be more favorable to the holders of Company Common Stock from a financial point of view than the Merger.

*Id.* § 1.01, at 12–13.

Unlike the match right in the Nexstar-Tribune agreement, when a third party revises its offer, a new, two-business-day requirement gets triggered, and there is no restriction on how many times the match right will be triggered. This is an example of an unlimited match right.<sup>119</sup>

A match right presents interesting contract and corporate law questions of what additional obligations it actually imposes on the target (or what additional right it gives to the buyer). This issue can be examined in (at least) three different scenarios. First, even without an express match right with an express good faith obligation, the buyer can presumably always ask the target to modify the agreement in response to a third party's superior offer. Second, with a limited match right, when the inside buyer tries to sweeten its offer in response to a third party's offer after its match right has run out, the target is not prohibited from negotiating with the inside buyer. Third, when a third party makes a superior offer for the target either initially or after the initial buyer matches the third party's offer, the target is not prohibited from negotiating with the third party.

With respect to the first two issues, at least under contract law's default obligations, as far as the modification of an existing agreement is concerned, both the target and the buyer have an obligation to renegotiate in good faith.<sup>120</sup> If the target were to

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<sup>119</sup> The match right in the *ABA Model Merger Agreement* is also unlimited but more favorable for the acquirer. See *ABA MODEL MERGER AGREEMENT*, *supra* note 93, § 4.6(c), at 170–71. Notably, not only is the match right unlimited, whenever a competing offer gets revised, the buyer gets the same five-business-day period to negotiate with the target. *Id.* On occasion, the parties will also stipulate that the target has an obligation to negotiate with the buyer on an exclusive basis. See Subramanian & Zhao, *supra* note 31, at 1236.

<sup>120</sup> According to the Second Restatement, “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” *RESTATEMENT (SECOND) OF CONTRACTS* § 205 (AM. L. INST. 1979). More specifically with respect to modification, the Restatement states: “A promise modifying a duty under a contract not fully performed on either side is binding if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made. . . .” *RESTATEMENT (SECOND) OF CONTRACTS* § 89(a) (AM. L. INST. 1979). The Uniform Commercial Code (UCC) is more explicit with the duty to modify in good faith. While the UCC states that “[a]n agreement modifying a contract within this Article needs no consideration to be binding,” the official comment states that “modifications made [under § 2-209(1)] must meet the test of good faith imposed by this Act.” U.C.C. § 2-209(1) & cmt. 2 (AM. L. INST. & UNIF. L. COMM’N 2017). Although the contours of the good faith duty are not very clear, under the UCC, it embodies at least two elements: (1) subjective honesty (i.e., the parties must be honest with each other); and (2) commercial fair dealing (i.e., they must deal fairly with each other). U.C.C. § 2-103(1)(b) (AM. L. INST. & UNIF. L. COMM’N 2017); see also Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 675 (2007) (explaining that modern courts hold parties to a

simply refuse to renegotiate with the initial buyer who has no express match right or whose match right has run out, such a behavior may constitute a breach of the implied covenant of good faith and fair dealing under contract law.<sup>121</sup> Under corporate law, such a behavior can also constitute a breach of the target directors' fiduciary duties.<sup>122</sup> With respect to third-party buyers, given that the target may not be in any contractual relationship with them, the target presumably does not have a contract-law-based obligation to negotiate with them (in good faith).<sup>123</sup> On the other hand, again, under corporate law, refusing to negotiate with a

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commitment to negotiate in good faith once they have made a preliminary agreement); Cathy Hwang, *Deal Momentum*, 65 UCLA L. REV. 376, 394–97 (2018) (examining why deal lawyers say courts rarely enforce breaches of preliminary agreements); Choi & Triantis, *supra* note 110, at 446–47 (analyzing the good faith duty in the context of modifying non-binding preliminary agreements).

<sup>121</sup> Whether contract law imposes an affirmative obligation to not refuse to renegotiate is not entirely clear. For instance, according to comment 2 to U.C.C. § 2-209,

modifications *made* thereunder must meet the test of good faith imposed by this Act. The effective use of bad faith to escape performance on the original contract terms is barred, and the extortions of a “modification” without legitimate commercial reason is ineffective as a violation of the duty of good faith.

U.C.C. § 2-209, cmt. 2 (AM. L. INST. & UNIF. L. COMM'N 2017) (emphasis added). The UCC, therefore, seems to contemplate that, to the extent that a modification has been made, it must satisfy the good faith and fair dealing obligation. According to Professor Allan Farnsworth, on the other hand, the UCC's good faith obligation

gives the victim the right to recover damages if the other party's breach of the duty of good faith resulted in a *failure* to arrive at a modification. Damages should ordinarily be based on the victim's reliance losses, as in the analogous case of precontractual liability for breach of an agreement to negotiate in good faith.

FARNSWORTH, *supra* note 109, § 4.22 (emphasis in original). *But see* Choi & Triantis, *supra* note 110, at 455 & n.54 (showing that courts, even in New York and Delaware, have been willing to grant expectation damages for breach of duty to negotiate in good faith). Assuming that the courts would be hesitant in granting expectation damages or other remedies, such as specific performance, by expressly obligating the target to negotiate in good faith (and also stipulating the remedy), the agreement seems to make it substantially easier for the disappointed buyer to recover expectation damages or other remedies and not just reliance damages.

<sup>122</sup> Target directors' corporate law obligations will depend on whether the transaction is in “*Revlon* mode.” If it is, the directors will likely have to engage with any buyer (either initial or outside) that makes a superior proposal. A limited match right, in that setting, may not have as much a bite against the initial buyer.

<sup>123</sup> If, for instance, the target has entered into a confidentiality agreement with the third party, while negotiating with the third party so as to allow (assist) the third party to make a superior offer may not constitute a “modification” of an existing contract, the existence of a confidentiality agreement may impose some contract-based duties on the target and the third party. For more in-depth analyses on the precontractual duty to negotiate in good faith, see *supra* note 120.

third party who makes a superior offer can constitute a breach of the target directors' fiduciary duties.

What a match right seems to do, then, is to prevent the target from accepting a third party's offer without giving the initial buyer a reasonable chance to compete. It also lays out a specific time period (e.g., four business days in both the Nexstar-Tribune and Google-Fitbit transactions) during which the buyer is granted the right to (exclusively) negotiate with the target. Once the negotiation period is over, assuming that all the other conditions have been satisfied, the target is free to either change its recommendation to its shareholders or even terminate the agreement, presumably without having to worry about whether such behavior constitutes acting in bad faith under contract law or breaching fiduciary duties under corporate law. With a limited match right, as in the Nexstar-Tribune transaction, after the initial buyer has exhausted its match right, under contract law the target is much more free to accept a third party's offer without having to engage the initial buyer: Tribune "shall not be required to comply with [good faith negotiation] obligations with respect to any other Superior Company Proposal."<sup>124</sup> If Tribune refused to negotiate further with Nexstar after Nexstar's match right ran out, it would be difficult to argue that Tribune's behavior constituted a breach of the implied duty to modify (or negotiate) in good faith under contract law.<sup>125</sup>

A match right, in short, seeks to lay out some procedural safeguards that both the buyer and the target can rely on in making sure that the target will come to the negotiating table and can walk away once the obligation has been satisfied. While the default rules under contract law impose somewhat uncertain and open-ended obligations (e.g., the implied duty of good faith and fair dealing) on the contracting parties with respect to contract modification, a match right provides a more express guarantee (and a clearer guideline) to the initial buyer and the target that the initial buyer will be given the opportunity to meet the third party's offer and preserve the deal. Moreover, the target can switch sides once the specified opportunity has been satisfied with the initial buyer. Assuming that the target's legal obligations toward the third parties remain relatively stable through

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<sup>124</sup> Nexstar-Tribune Merger Agreement, *supra* note 91, § 7.3(f), at 65.

<sup>125</sup> While Nexstar may no longer have a strong contract claim against Tribune, it would be interesting to know whether such a behavior would lead to breach of Tribune's directors' fiduciary duties.

the competition and negotiation process, a limited or unlimited match right at least tilts the bargaining leverage toward or against the initial buyer.

### III. THE EFFECT OF DEAL PROTECTION DEVICES

Having examined a brief history of deal protection devices in practice, in this Part, I examine the impact of deal protection devices with the help of auction theory. As a preliminary observation, when an acquisition agreement is subject to a termination fee or a match right, it is not surprising that it becomes more difficult for a third-party buyer to enter the fray and successfully snatch the target away from the initial buyer. For instance, with a match right, even after a third-party buyer makes a superior offer to the target, within a contractually stipulated period of time, the initial buyer can require the target to negotiate in good faith, match the third party's offer, and render the third party's offer no longer attractive. A match right can potentially create an uneven auction format, where the initial buyer gets to observe the third party's offer before deciding whether to match the offer. However, as we will see shortly, whether a match right in fact creates an uneven playing field and whether either party will actually have an advantage depends significantly on whether the match right is limited or unlimited.

The story with a target termination fee is, by comparison, somewhat more straightforward. When a target has an obligation to pay a termination fee, this can substantially decrease the target board's incentive to accept a third party's offer. As a simple example, if the initial deal price is \$110 million but the agreement has a \$10 million termination fee provision, for the target board to seriously consider a third party's offer, the offer has to be at least \$120 million (and not simply \$110 million). If a third party's willingness to pay for the target falls between \$110 and \$120 million, in the presence of a \$10 million termination fee, the third party will decline to enter the competition, even though it is possible that the third party values the target more than the initial buyer (e.g., when the initial buyer values the target at \$115 million while the third party buyer values the target at \$118 million). In addition, being able to collect a sizable termination fee reduces the initial buyer's incentive to compete against a third party. If, for instance, the initial buyer values the target at \$120 million but can collect \$5 million in termination fees, the maximum the initial buyer would be willing to pay for the target is \$115 million

(and not \$120 million). With decreased competitiveness from the initial buyer, there is less vigorous competition when a competing buyer emerges, which, in turn, leads to a lower return for the target.

What is somewhat counterintuitive is the fact that such deal protection provisions can enhance both the initial buyer's and the target's expected joint return.<sup>126</sup> An important point to recognize here is that the deal protection provisions not only affect the affairs between two contracting entities—the initial buyer and the target—but also affect the third party. Deal protection provisions are a classic example of how a contract can generate an externality (a contractual externality) for a third party.<sup>127</sup> Furthermore, even though a third party may be harmed by the deal protection devices, the contracting parties can jointly benefit from them, which, in turn, creates an opportunity for the target board to increase the return for its shareholders. Finally, notwithstanding the possibility of increasing the return for the target shareholders, a deal protection mechanism can reduce efficiency by allocating the target corporation's assets to a buyer with lower valuation.<sup>128</sup> While a deal protection device harms the third party and reduces efficiency, it can increase the expected returns for the contracting parties. This point can be most easily seen with a few simple, numerical examples of a match right and a termination fee.

#### A. Target Termination Fee

Suppose there is a target corporation (*S*) with a valuation of \$100 million (target's stand-alone value). The target negotiates with an initial buyer (*BI*), who values the target at \$120 million, for a possible sale. In this case, the target and the initial buyer will execute an agreement at a price of *P* between \$100 and \$120 million. For simplicity, suppose they agree on a deal price of \$110 million ( $P = \$110$  million). After entering into the agreement, suppose that there is a 50% chance that a new buyer will

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<sup>126</sup> This is true even when we assume that deal protection devices are not necessary in inducing the initial buyer to investigate and make an offer for the target corporation.

<sup>127</sup> See *supra* note 37.

<sup>128</sup> An important assumption underlying this inefficiency result is that there is some impediment to efficient (ex post) bargaining or renegotiation, such as asymmetric information. When a new buyer with a higher reservation value emerges and when all three parties are fully informed of the respective valuations, rather than preventing the new buyer from purchasing the target corporation, they can renegotiate the contract to take down the deal protection devices and let the new buyer purchase the target corporation. However, if the target and the initial buyer are unaware of the new buyer's valuation, as is assumed in our examples throughout, such a renegotiation will no longer be feasible.

appear.<sup>129</sup> With the other 50% probability, no new buyer appears. While the new buyer's valuation is at least \$110 million, for ease of analysis, let's assume that there is a 20% chance that *B2*, which values the target at \$115 million, appears, and with the other 30% chance, *B3*, which is willing to pay up to \$130 million for the target, appears. Throughout, we will assume that the target's stand-alone value and the terms of the initial agreement are known to all players (based, for instance, on the target's publicly observed market capitalization and the public filing of the agreement), but that a buyer's reservation value is known only to that player.<sup>130</sup> For simplicity, though, we assume that *B1* knows that the outside buyer's valuation is either \$115 or \$130 million with respective probabilities: that is, the inside buyer knows the distribution of the outside buyer's valuation.<sup>131</sup>

1. The case with no termination fee.

Suppose there is no termination fee. With the initial deal price of \$110 million, for the new buyer (either *B2* or *B3*) to successfully break up the deal, the new buyer will have to offer at

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<sup>129</sup> Throughout the examples, we are assuming that the probability that a third-party buyer appears to compete against the initial buyer is fixed. This assumption is made to simplify the analysis. One obvious contractual choice that can potentially affect the probability that a competing bidder emerges is whether the agreement has either a no-shop or a go-shop clause. With a go-shop clause (under which the target actively solicits third-party offers), one can imagine that the chance that a competing bidder emerges on the scene is higher. Especially when such a clause will tilt the probability of a high-valuation buyer (*B3*) emerging, the contracting parties have an even stronger incentive to adopt a large termination fee so as to increase their joint profit.

<sup>130</sup> Two points need to be made regarding the assumptions. First, given that the outside buyers get to observe the deal price of \$110 million, the outside buyers may be able to reverse engineer and find out that the inside buyer's reservation value is \$120 million, or at least get more information about it. The substantive analysis on termination fees will remain the same, however. If the outside buyers observe that the inside buyer's valuation is \$120 million, with no termination fee, *B2* will simply decline to compete against *B1*, whereas *B3* will submit a competing bid of (slightly more than) \$120 million and acquire the target, rather than going through an ascending-bid auction process. Second, and more generally, we are assuming that, while the buyers (and the target) do not observe other buyers' valuations, they know their own while their valuations may be correlated. This assumption sets up a private value auction. For a more detailed discussion, see *infra* Part III.D.

<sup>131</sup> More specifically, we assume that this outside buyer's valuation and the probabilities are common knowledge. That is, all the players in the model know that the outside buyer's valuation will be either \$115 or \$130 million and their attendant probabilities. This assumption will substantially simplify the analysis without taking away the main thesis. Otherwise, we will have to start with a more general (possibly continuous) distribution. The assumption also gives the inside buyer an informational advantage against the outside buyer.



least \$110 million to the seller. Furthermore, given that the initial buyer (*B1*) is willing to pay up to \$120 million for the target, we can imagine that, upon the entry of a new buyer, a bidding competition between the buyers (either between *B1* and *B2* or between *B1* and *B3*) will ensue. While there are many different ways one can model the competition, the simplest and the most tractable way to think about this is to imagine that the buyers engage in an ascending-bid English auction in which the initial bid starts at \$110 million. That is, the initial (commonly observed) price starts at \$110 million and keeps rising until only one bidder remains in the competition and the last remaining bidder becomes the winner who pays the last observed price to the target.

When *B2* (with a reservation value of \$115 million) enters the fray, for instance, the bidding competition between *B1* and *B2* will result in *B1* acquiring the target corporation at a price of (slightly more than) \$115 million. To see this, when the commonly observed bid starts at \$110 million, each buyer is willing to stay in the auction until the bid reaches its reservation value. Given that the initial buyer (*B1*) is willing to pay up to \$120 million for the target while the competing buyer (*B2*) is willing to pay only up to \$115 million, when the bid reaches \$115 million, *B2* drops out of the auction, the (commonly observed) price stops, and *B1* is declared the winner. Using the same logic, when *B3* (with a reservation value of \$130 million) appears, *B3* will be able to win the auction and acquire the target at (slightly more than) \$120 million.

What is the implication of the competition? First, from the perspective of the target (*S*), there are three possible scenarios: (1) a 50% chance no new buyer appears, and *S* is sold to *B1* at \$110 million; (2) a 20% chance *B2* emerges and competes, and *S* is sold to *B1* at \$115 million; and (3) a 30% chance *B3* enters and competes and wins against *B1*, and *B3* acquires *S* at \$120 million. When we combine these three possibilities, the target's expected net profit is \$14 million.<sup>132</sup> For *B1*, its expected profit is \$6 million.<sup>133</sup> For *B2* and *B3*, conditional on their entering the competition, their profits are \$0 and \$10 million (= \$130 million – \$120 million), respectively. Finally, whenever a new buyer appears on the scene, the target is sold to the buyer with the higher valuation: allocative efficiency is achieved. The results are summarized in the second column in Table 1.

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<sup>132</sup>  $0.5 * (\$110 \text{ million} - \$100 \text{ million}) + 0.2 * (\$115 \text{ million} - \$100 \text{ million}) = \$14 \text{ million}.$

<sup>133</sup>  $0.5 * (\$120 \text{ million} - \$110 \text{ million}) + 0.2 * (\$115 \text{ million} - \$110 \text{ million}) = \$6 \text{ million}.$

## 2. The case with a termination fee.

Now suppose the target (*S*) and the initial buyer (*B1*) set the initial purchase price at \$110 million but with a termination fee of \$4 million:  $(P, T) = (\$110 \text{ million}, \$4 \text{ million})$ . The termination fee is about 3.6% of the deal price. With the purchase price of \$110 million and the termination fee of \$4 million, the minimum the outside buyer (*B2* or *B3*) will have to bid is now \$114 million (= \$110 million + \$4 million). At the same time, *B1* can underbid *B2* or *B3* by (slightly less than) \$4 million and *B1*'s bid will still be more attractive to *S*. The competition becomes uneven (the auction becomes "asymmetric") and the termination fee forces the outside buyer to make the initial bid higher than the deal price at least by the size of the termination fee: it forces the outside buyer to make a "jump bid."

Notwithstanding the uneven competition, so long as the size of the termination fee is relatively small, competition will ensure that the target will be sold to the buyer that values the target more. The uneven playing field, however, will redistribute the profit from the target to the initial buyer. When *B2* enters the competition by bidding (slightly more than) \$114 million, *B1* will still be able to acquire the target at (slightly more than) \$111 million. When *B3* enters the competition, on the other hand, *B3* will win at a price of (slightly more than) \$120 million. Compared to the case with no termination fee, the expected profit for *S* goes down to \$12 million.<sup>134</sup> At the same time, the expected profit for *B1* increases to \$8 million.<sup>135</sup> The expected profits for *B2* and *B3* stay the same as before. In short, allocative efficiency is preserved, but the distribution of the pie shifts in favor of the initial buyer (*B1*) against the target (*S*).

In fact, it is easy to show that as the target termination fee rises and the initial deal price stays constant, the target's expected return goes down while the inside buyer's expected return improves. So long as the size of the termination fee is equal to or less than the expected return from closing the deal for the initial buyer (in our case, \$10 million), we can ensure allocative efficiency: the outside buyer will be able to acquire the target only when it values the target more than the inside buyer. A larger

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<sup>134</sup>  $0.5 * (\$110 \text{ million} - \$100 \text{ million}) + 0.2 * (\$111 \text{ million} - \$100 \text{ million}) + 0.3 * (\$120 \text{ million} - \$100 \text{ million} - \$4 \text{ million}) = \$12 \text{ million}.$

<sup>135</sup>  $0.5 * (\$120 \text{ million} - \$110 \text{ million}) + 0.2 * (\$120 \text{ million} - \$111 \text{ million}) + 0.3 * \$4 \text{ million} = \$8 \text{ million}.$

termination fee creates a purely distributional effect. It simply shifts the return from the seller to the inside buyer. When the size of the termination fee is larger than the inside buyer's expected return from closing the deal (under the initial terms), on the other hand, allocative efficiency is no longer guaranteed. In addition, the target and the inside buyer can actually increase their expected joint return.

To see this, suppose, for instance, the target and the inside buyer agree to a deal price of \$116 million and a termination fee of \$8 million, which is about 6.9% of the deal price. Now, for an outside buyer to compete against the inside buyer, it will have to bid at least \$124 million. This means that an outside buyer, like *B2*, who values the target at \$115 million, would simply decline to enter the competition. Even if *B2*'s valuation were \$123 million, *B2* would still decline to compete, even though it values the target more than the inside buyer. A sizable termination fee (along with the deal price) is generating an allocative inefficiency. At the same time, for *B1*, given that closing the deal under the initial terms produces an expected profit of (only) \$4 million, whenever a third party makes a bid of (slightly higher than) \$124 million, it is in *B1*'s interest to not compete and simply collect the termination fee of \$8 million. That is, if *B3* were to emerge and bid (slightly higher than) \$124 million, *B1* will decline to compete, and *B3* will acquire the target at \$124 million. The expected profit for the target, then, becomes \$16 million.<sup>136</sup> The expected profit for *B1* is \$5.2 million.<sup>137</sup> The expected profits for *B2* and *B3* are, respectively, \$0 and \$6 million. The results are tabulated in the fourth column of Table 1.

### 3. A comparison.

When we compare these scenarios, a few salient observations bubble up. Foremost, when the initial price remains unchanged at \$110 million, with a \$4 million termination fee, compared to the case with no termination fee, the target's expected return is strictly lower while the inside buyer's (*B1*'s) expected return is strictly higher. These results are not surprising: with a \$4 million termination fee, *B1* can afford to be much less aggressive in competing against an outside buyer and can still win the competition. When *B2*

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<sup>136</sup>  $0.7 * (\$116 \text{ million} - \$100 \text{ million}) + 0.3 * (\$124 \text{ million} - \$100 \text{ million} - \$8 \text{ million}) = \$16 \text{ million}.$

<sup>137</sup>  $0.7 * (\$120 \text{ million} - \$116 \text{ million}) + 0.3 * \$8 \text{ million} = \$5.2 \text{ million}.$

emerged, *BI* was able to acquire the target at \$111 million, instead of at \$115 million. This implies that agreeing to pay a termination fee to the initial buyer is a costly enterprise from the target's perspective. More generally, holding the deal price the same, as the termination fee gets larger, the target's return gets smaller while the initial buyer's expected return gets larger.<sup>138</sup> At the same time, so long as the termination fee is smaller than *BI*'s expected return from closing the deal under the initial terms (\$10 million in the numerical example), the joint profit of the target and *BI* stay the same and there is no allocative inefficiency.

TABLE 1: THE EFFECT OF A TERMINATION FEE

	No Termination Fee ( $P, T$ ) = (\$110, \$0)	With Termination Fee and Same Price ( $P, T$ ) = (\$110, \$4)	With Termination Fee but Higher Price ( $P, T$ ) = (\$116, \$8)
Target ( <i>S</i> ) Expected Profit (Res. Value = \$100)	\$14 million	\$12 million	\$16 million
Initial Buyer ( <i>BI</i> ) Expected Profit (Res. Value = \$120)	\$6 million	\$8 million	\$5.2 million
Target and Initial Buyer Joint Profit	\$20 million	\$20 million	\$21.2 million
New Buyer ( <i>B2</i> ) Profit (Res. Value = \$115)	\$0	\$0	\$0
New Buyer ( <i>B3</i> ) Profit (Res. Value = \$130)	\$10 million	\$10 million	\$6 million
Possible Inefficient Sale of Target?	No	No	Yes

When the termination fee is larger than *BI*'s expected return under the initial terms, by comparison, not only will the joint profit of the target and *BI* increase, but there is also the danger of allocative inefficiency. This was seen in the example in which the deal price was \$116 million and the termination fee was \$8 million. Compared to the case with no or a moderate (\$4 million) termination fee, the joint profit of the target and the inside buyer is strictly higher: \$21.2 million versus \$20 million. The additional

<sup>138</sup> Conditional on deal price, therefore, as the target's bargaining leverage increases, the target would prefer to set a lower termination fee. See Badawi & de Fontenay, *supra* note 54, at 1149–51.

joint return comes from the fact that the duo extracts a higher bid from the high valuation outside buyer (*B3*). Since *B3* enters the scene with 30% probability and *B3* wins the competition with a \$4 million higher payment, this translates to an expected increase of \$1.2 million ( $= 0.3 * \$4$  million). A large termination fee also creates a possible allocative inefficiency. If an outside buyer's valuation is higher than \$120 million but below \$124 million, for instance, even though the outside buyer values the target more than *B1*, it will simply decline to compete against *B1*. In short, a large termination fee will allow the target and the inside buyer to realize a higher expected return while potentially prohibiting an outside buyer who values the target more than the inside buyer from acquiring the target.

### B. Match Right

As we saw earlier, when an inside buyer is given the right to match an outside buyer's offer, the target, after receiving a superior proposal from an outside buyer, must allow the inside buyer to match the outside buyer's offer (i.e., negotiate in good faith with the inside buyer) so as to make the outside buyer's offer no longer superior. Given that a match right allows the existing buyer to match a new bidder's offer and consummate the transaction, at least in theory, it is similar to another commonly observed contractual mechanism, the right of first refusal.<sup>139</sup> Simply stated, when the target corporation grants a right of first refusal to the initial buyer, whenever an outside buyer emerges and makes an offer to acquire the target, the right holder (the initial buyer) can simply match the outside buyer's offer and acquire the target. With a properly structured right of first refusal, both the target corporation (grantor of the right) and the initial buyer (the right holder) can increase their expected joint returns at the expense of the new buyer.<sup>140</sup>

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<sup>139</sup> For a more detailed, auction-theory-based analysis, see generally Albert H. Choi, *A Rent Extraction Theory of Right of First Refusal*, 57 J. INDUS. ECON. 252 (2009); see also Restrepo & Subramanian, *supra* note 31, at 1061 n.213 (comparing a match right to a right of first refusal); Quinn, *supra* note 31, at 1027 & n.95 (same).

<sup>140</sup> When a right of first refusal is in place, the right holder can basically engage in "cream-skimming": declining to exercise the right (i.e., not matching a third party's offer) only when a third party's offer is higher than the right holder's valuation for the property. When a third party acquires the property, then, the joint (gross) return for the right-holder and the property owner is higher than the right holder's valuation. By contrast, without a right, the joint profit will be equal to the right holder's valuation. See Choi, *supra* note 139, at 254.

1. A comparison to a right of first refusal.

A right of first refusal functions as a dynamic reserve price in auctions, where the reserve price (the minimum price that starts the auction process) is determined *ex post* by the outside buyer's bid.<sup>141</sup> The reason a right of first refusal can increase the joint profit of the target and the initial buyer is fairly straightforward. With a right of first refusal in place, the initial buyer will decline to match the outside buyer's offer only when the outside buyer offers more than the initial buyer's reservation value (\$120 million in our example). Hence, when the initial buyer exercises the right of first refusal and wins the competition, the joint gross return (for the target and the initial buyer) will be \$120 million. On the other hand, when the initial buyer does not exercise the right of first refusal, the joint gross return will be higher than \$120 million. By contrast, had an evenhanded auction process (such as an English auction) been held, whether or not the inside buyer wins the contest, the joint gross return for the target and the inside buyer would be \$120 million: (1) in case the inside buyer wins, they realize a gross return of \$120 million; (2) but if the outside buyer wins, the outside buyer pays the inside buyer's valuation of \$120 million.<sup>142</sup> In short, a right of first refusal, much like a termination fee, can function as a surplus extraction mechanism against outside buyers.

While it may be tempting to equate a match right used in a mergers and acquisitions setting to a right of first refusal—especially since, under both mechanisms, the inside buyer is given the right to match an outside buyer's offer—there are some important differences. Under a conventional right of first refusal, once the inside buyer matches an outside buyer's bid, the competition ends and the inside buyer acquires the target. With a match right, however, the inside buyer's matching of an outside buyer's bid does not end the competition. The outside buyer, after observing the inside buyer's matching bid, is free to come back with another, more attractive offer for the target.<sup>143</sup> In fact, while the inside

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<sup>141</sup> The reserve price is the minimum price that the bidders must submit to be able to participate in the auction process. With the right of first refusal, the right holder's reservation value functions as a reserve price.

<sup>142</sup> If an English (or second price) auction is not being used, the gross return for the target and the inside buyer may be lower than the inside buyer's valuation when an outside buyer wins the auction.

<sup>143</sup> This is subject to the caveat that the target does not have an obligation to negotiate in good faith with a third-party buyer, with whom the target does not have a contractual

buyer may be contractually limited in how many times it may be able to exercise the right, there is no formal constraint on how many times the outside buyer may be able to come back with a revised offer for the target. Furthermore, even if the inside buyer were to match an outside buyer's offer, unlike the conventional right of first refusal, the match right does not obligate the target to accept the inside buyer's matching offer. The target can take the matching offer and negotiate with the outside buyer to entice the outside buyer to sweeten its offer. In short, a match right used in a mergers and acquisitions setting, in some sense, turns the conventional right of first refusal on its head.<sup>144</sup> A limited match right, in particular, constrains the inside buyer's behavior for the benefit of the outside buyer.

## 2. Limited match right.

To be able to more concretely examine the impact of a match right, let's examine a simple numerical example. Just as in the previous example, let's assume that the target's reservation value is \$100 million, the initial buyer's reservation value is \$120 million, and the parties agree on the initial deal price of \$110 million. Also, after the initial agreement has been entered into, there is a chance that a new buyer will appear who will attempt to jump the deal and purchase the target. Just as before, we will assume that there is a 50% chance that a new buyer does not appear, with a 20% chance that a new buyer with a valuation of \$115 million (*B2*) will appear, and with a remaining 30% chance that the new buyer's (*B3*'s) valuation is \$130 million. As before, we continue to assume that the buyers do not observe the others' valuations,<sup>145</sup>

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relationship. See *supra* Part II.B. Of course, the target directors may have a fiduciary obligation to engage with the third party when the third party's revised offer is more attractive than the initial buyer's matched offer.

<sup>144</sup> There are also a few other differences between a conventional right of first refusal and a match in a mergers and acquisitions context. First, in a mergers and acquisitions context, the initial buyer has already agreed to purchase the target corporation at an agreed-upon price. By contrast, in a conventional right of first refusal setting, no such price has been determined between the property owner and the right holder. Second, in a conventional right of first refusal setting, though not always, there often is a preexisting relationship between the property owner and the right holder. The most common case is that between an owner-landlord and tenant. See Choi, *supra* note 139, at 252–54, 256.

<sup>145</sup> We are assuming that the inside buyer knows that the outside buyer's reservation values will be either \$115 or \$130 million, while the outside buyer only knows the distribution of the inside buyer's reservation value. If we assume that, based on the deal price of \$110 million, the outside buyers can infer the inside buyer's valuation of \$120 million while the substantive analysis will remain the same, in the case with an unlimited match

but *BI* knows that the outside buyer's valuation is either \$115 or \$130 million, with respective probabilities.

Now, suppose that the initial agreement contains a match right. To focus on the match right, let's assume that there is no termination fee. We will discuss later the implication of having both. The match right can be of two types: limited ( $M < \infty$ ) or unlimited ( $M = \infty$ ). If the match right is unlimited, there is no limitation on how many times the initial buyer can match the new buyer's offer. If the match right is limited, on the other hand, the number of times that the initial buyer can exercise the right will be capped in the agreement. Although, in theory, this cap can be any number, to make the analysis simple, we will focus on the case where the initial buyer can exercise the match right only once: the cap is set at 1 ( $M = 1$ ).<sup>146</sup> In sum, when the match right is unlimited, the initial buyer (the right holder) can exercise the right as many times as it desires; whereas if the match right is limited, the initial buyer can exercise it only once. We will see later that as the cap rises, a limited match right will become more like an unlimited match right.

Suppose the initial buyer has a limited match right, subject to which the initial buyer can match the new buyer's offer only once ( $M = 1$ ). If, after matching the new buyer's initial bid, the outside buyer offers a more (financially) attractive offer as its second bid, the initial buyer will be out of luck and the target will be sold to the new buyer.<sup>147</sup> An important difference between the initial and the outside buyers is that, while the new buyer is free to revise and increase its earlier bid, the initial buyer is constrained to match the outside buyer's bid only once. A limited match right creates an uneven playing field in favor of the outside buyer and against the initial buyer. When the outside buyer is aware of the fact that the initial buyer can match its offer only once (while the outside buyer is free to revise its offer), it is readily apparent that

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right the inside buyer will benefit while the target will suffer. In that case, if the outside buyer has a valuation of \$115 million, rather than triggering an auction, it will simply decline to participate. This will allow the inside buyer to acquire the target at \$110 million (rather than at \$115 million).

<sup>146</sup> As we saw in Part II.B, allowing the buyer to match a third party's offer only once seems to be the most common type of limited match right. I have not been able to find a real-life example in which a limited match right allowed the buyer to match more than once.

<sup>147</sup> I am, of course, taking a simplified and stylized view of how match rights work for the purposes of presenting a simple numerical example. For a more detailed legal analysis, see *supra* Part II.B.



the outside buyer has no incentive to start the competition by making an offer that is substantially more attractive than the initial price.

For instance, suppose the outside buyer's reservation value is \$130 million (which, as assumed, happens with 30% probability). The outside buyer (*B1*) will start the competition by making an offer that is slightly higher than the initial price of \$110 million. When the initial buyer is asked to match that offer, we can see that, no matter what the matching bid is, the initial buyer (*B1*) will lose the competition and the \$130 million buyer (*B3*) will be able to acquire the target. Given that the initial buyer (*B1*) values the target at \$120 million, the initial buyer's matching offer will be below its reservation value of \$120 million and *B3* will be able to acquire the target by revising its offer to be slightly higher than the initial buyer's revised offer. For instance, suppose, *B3* makes an offer at \$111 million and *B1* makes a "matching" bid of \$117 million. *B3* will now be able to purchase the target by offering \$118 million. The bottom line is that when the outside buyer's reservation value is \$130 million, (1) the target will always be sold to the outside buyer; and (2) the final sale price will be (at least slightly) lower than the initial buyer's reservation value (\$120 million).

What if the outside buyer's reservation value is, instead, \$115 million? Just like the outside buyer with a \$130 million valuation, the buyer (*B2*), knowing that it can increase its bid ex post in response to the initial buyer's match, will start the bidding at slightly above the current price of \$110 million. From the initial buyer's perspective, it does not know whether the topping bid is coming from the buyer with a \$130 or \$115 million valuation. But, it does know that if it were coming from the buyer (*B3*) with \$130 million valuation, it will lose the bidding for certain, whereas if it were coming from the buyer (*B2*) with \$115 million valuation, it may be able to prevail in the competition. The best strategy for the initial buyer, therefore, is to match the outside buyer's bid by bidding slightly higher than \$115 million. By doing so, the initial buyer (*B1*) retains the chance of winning the auction at least 40% of the time, conditional on there being an outside bidder. When the initial buyer bids at slightly above \$115 million (say, \$116 million), the \$130 million valuation buyer (*B3*) will top

that bid (with, say, \$117 million) while the \$115 million buyer (*B2*) will decline to increase its bid above \$115 million.<sup>148</sup>

### 3. Unlimited match right.

Now, suppose the initial buyer is given an unlimited match right ( $M = \infty$ ). That is, whenever an outside buyer revises its initial offer, the initial buyer will be able to come back and match the revised offer from the outside bidder. Unlike the case with a limited match right, with an unlimited match right, the initial buyer and the outside buyer will have even standing in an auction. As each revises its bid, the other is able to top the competitor's bid. An unlimited match right replicates a proper English auction. When a competing buyer (*B2* or *B3*) emerges, given that the existing price is equal to \$110 million, knowing that both parties will be able to continue matching the other's bid, the topping bid will start at a little above \$110 million<sup>149</sup> and will continue rising until one bidder decides to drop out. For instance, if the outside buyer's (*B2*'s) valuation for the target is \$115 million, the initial buyer (*B1*), with a higher valuation of \$120 million, will be able to continue "matching" the outside buyer's (*B2*'s) offer until the bid rises to the outside buyer's valuation of \$115 million. The inside buyer wins the auction process at a price equal to (or

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<sup>148</sup> More precisely, we can construct a pooling equilibrium in the following way. Working backwards, first, suppose either *B2* or *B3* are to submit a follow-up bid after observing *B1*'s matching bid. The optimal strategy for *B2* and *B3* is to submit a follow-up bid that is slightly higher than *B1*'s matching bid so long as *B1*'s matching bid is below \$115 million and \$130 million, respectively. Otherwise, the bidder drops out. Second, suppose it is *B1*'s turn to submit a matching bid. If the outside bidder's type has not been revealed in the earlier stage, *B1*'s optimal strategy is to (1) bid slightly above \$115 million if the outside bid is anywhere between \$110 and \$115 million and (2) bid slightly above any outside bid above \$115 million so long as the outside bid is below \$120 million. Third, turning to the initial stage, the optimal strategy for *B2* and *B3* is to submit the initial bid between \$110 and \$115 million. So, in a pooling equilibrium, both *B2* and *B3* submit the initial bid that is between \$110 and \$115 million; *B1* submits a matching bid slightly above \$115 million; *B3* comes back with a bid slightly above *B1*'s matching bid; and *B2* drops out after observing *B1*'s matching bid.

<sup>149</sup> If the third-party buyer knew (1) how much the initial buyer valued the target and (2) that the initial buyer's valuation is larger than the third party's valuation, the third party would not trigger the bidding competition. See Subramanian & Zhao, *supra* note 31, at 1234 ("When the first bidder has an unlimited match right, a third party will bid only if it believes it can beat the first bidder in a bidding contest."). In the absence of such knowledge, given that the third party rationally believes that the initial buyer's valuation can be anywhere above the deal price (of \$110 million), that the third party does not know whether it can beat the initial buyer for certain, and that the third party can always come back with a revised offer, the optimal strategy is to start the bidding process at slightly above the deal price.

slightly higher than) the outside buyer's ( $B2$ 's) reservation value of \$115 million. Similarly, when the outside buyer's ( $B3$ 's) valuation is \$130 million, the inside buyer and the outside buyer will be able to compete against each other in an even auction competition until the bid reaches the inside buyer's valuation of \$120 million.

In either case, whether  $B2$  or  $B3$  appears on the scene, as in a standard English auction, the target gets sold to the buyer with the higher valuation at a price equal to the valuation of the losing bidder: with the \$115 million outside buyer ( $B2$ ), the target gets sold to the existing buyer at \$115 million; and with the \$130 million outside buyer ( $B3$ ), the target is sold to the outside buyer at \$120 million. Since the target is being sold to the buyer with the higher valuation, unlike in the case with a limited match right, there is no allocative inefficiency. Furthermore, and more importantly, the target's and the initial buyer's joint expected profits and the target's stand-alone expected profits will be higher, too. For instance, with a limited match right ( $M = 1$ ), when the outside buyer's valuation is equal to \$130 million, because the initial buyer ( $B1$ ) was matching the bid at (slightly above) \$115 million, the target is sold to the outside buyer at a price strictly below the initial buyer's valuation of \$120 million. By contrast, with an unlimited match right, the target is sold to the outside buyer ( $B3$ ) at the inside buyer's valuation of \$120 million. This increases both the joint profit of the initial buyer and the target and also the stand-alone profit of the target.

#### 4. Some generalizations and comparisons.

The numerical example has, so far, assumed that the initial buyer knows exactly what the likely valuations of the outside buyers are: it would be either \$130 or \$115 million. In a more realistic scenario when the distribution of the outside buyer's valuation isn't as simplistic, while the findings above will still remain correct, it creates three variations. First, when the inside buyer has a limited match right, the target may be sold to a lower valuation buyer: an allocative inefficiency may result. Second, unlike the case with a termination fee, where the inside buyer's stand-alone profit always increased as the termination fee got larger, the inside buyer's ( $B1$ 's) stand-alone profit may be higher or lower with an unlimited match right. Third, with a more generalized distribution, low valuation of the outside buyer's ( $B2$ 's) stand-alone

profit will be higher when the inside buyer has a limited, rather than unlimited, match right.

First and foremost, suppose the outside buyer's valuation can range anywhere between \$110 and \$130 million, the inside buyer has a limited match right ( $M = 1$ ), and the outside buyer starts the bidding process at slightly above \$110 million. Suppose also that the initial buyer (*BI*), without knowing how much the outside buyer is willing to pay for the target, matches the bid at anywhere between the new bid and its own valuation of \$120 million, say, at \$116 million. Unlike the case with two-point distribution (of either \$115 or \$130 million), now, any time the outside buyer's valuation falls between the initial buyer's (*BI*'s) matching bid (of \$116 million) and the buyer's valuation (of \$120 million), the outside buyer will be able to win the auction even though the outside buyer values the target less than the initial buyer. For instance, if the outside buyer values the target at \$118 million, after observing the initial buyer's matching bid of \$116 million, the outside buyer will be able to come back with a more attractive bid of, say, \$117 million, and win the auction even though its valuation of the target is lower than the inside buyer's. In short, in a more realistic setting, a limited match right can create allocative inefficiency. The last row of Table 2 reflects this possibility.

TABLE 2: EFFECT OF A MATCH RIGHT

	Limited Match Right <sup>150</sup> ( $P = \$110; M = 1$ )	Unlimited Match Right ( $P = \$110; M = \infty$ )
Target ( $S$ ) Expected Profit (Res. Value = \$100)	\$12.5 million	\$14 million
Initial Buyer ( $B1$ ) Expected Profit (Res. Value = \$120)	\$6 million (Likely lower with more general distribution)	\$6 million
Target and Initial Buyer Joint Profit	\$18.5 million	\$20 million
New Buyer ( $B2$ ) Profit (Res. Value = \$115)	\$0 (Higher with more general distribution)	\$0
New Buyer ( $B3$ ) Profit (Res. Value = \$130)	\$15 million	\$10 million
Possible Inefficient Sale of Target?	Yes	No

Second, while the result will depend on the assumption of the outside buyer's valuation distribution, the inside buyer's stand-alone profit will likely decrease as we shift from limited to unlimited match rights. In the numerical example, because the outside buyer's valuation was limited to being either \$115 or \$130 million, and with a limited match right, the inside buyer was matching the outside buyer's bid at (slightly above) \$115 million, the expected profit of the inside buyer stayed the same at \$6 million: a 50% chance it acquires the target at \$110 million (for a profit of \$10 million) and a 20% chance it acquires the target at (slightly above) \$115 million (for a profit of \$5 million). But this is because

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<sup>150</sup> As discussed above, with a limited match right, when  $B2$ 's valuation is not fixed at \$115 million but is on a continuum between \$110 and \$120 million, for instance,  $B2$ 's profit will be strictly larger than \$0 while  $B1$ 's stand-alone expected profit may be higher or lower than \$6 million.

the inside buyer knew exactly what *B2*'s valuation of the target was and managed to shut out *B2* from winning the auction. If, for instance, the outside buyer's valuation was on a continuum between \$110 and \$130 million, not only would the inside buyer's matching bid possibly be higher or lower than \$115 million, but the inside buyer's probability of winning will also differ. While this could either increase or decrease the inside buyer's (*B1*'s) stand-alone expected profit, given that, in case the outside buyer's valuation falls between \$110 million and \$120 million, the inside buyer is no longer guaranteed to win the bidding competition, it will likely reduce the inside buyer's stand-alone profit.<sup>151</sup>

Finally, under the current setup, where *B2*'s valuation is fixed at \$115 million, *B2* is always shut out from being able to purchase the target (because of *B1*'s strategy of submitting the matching bid of \$115 million). But when *B2*'s valuation isn't fixed at \$115 million and *B1*'s match right is limited, *B2*'s stand-alone profit will increase. For instance, imagine *B2*'s valuation can be anywhere between \$110 and \$120 million. Now, in response to *B2*'s starting the bidding process at \$110 million, *B1* will submit a matching bid that is between \$110 million and \$120 million and *B2*, whose valuation is above *B1*'s matching bid, will now be able to win the auction and realize a profit. When *B1* had an unlimited match right, *B2*'s winning the auction was not possible. *B2*'s ex ante profit will be higher when the inside buyer has a limited match right than an unlimited match right. The second column of Table 2 summarizes these findings.

### C. Termination Fees Versus Match Rights

When comparing these two deal protection devices, some interesting similarities and differences emerge. As we moved (in Part III.A) from no termination fee to a positive (and substantial) termination fee, the joint profit of the target and the inside buyer increased while the outside buyer's expected profit decreased. Similarly, as we moved (in Part III.B) from a limited match right to an unlimited match right, the joint profit of the target and the inside buyer went up while the outside buyer's expected profit went down. Consistent with the practitioners' observations,

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<sup>151</sup> For instance, if *B2*'s valuation is uniformly distributed between \$110 and \$120 million (while *B3*'s valuation is anywhere above \$120 million), it is fairly easy to show that the optimal strategy for the inside buyer is to submit a match bid of \$115 million. In that case, while *B1*'s profit margin stays the same, *B1*'s probability of winning, conditional on *B2*'s appearance, decreases by half, thereby lowering *B1*'s expected profit.

unlimited match rights and termination fees are generally bad for the competing buyer. To the extent that the outside buyer has to spend (possibly substantial) resources in participating in the bid, the lower expected profit can potentially translate to a lower rate of participation. At the same time, however, as the numerical examples show, an important goal of agreeing to either a termination fee or an unlimited match right is to extract more surplus from a high-valuation outside buyer (such as *B3*). And to the extent that an outside buyer's valuation for the target is substantially high, the reduction in auction participation may be less likely or unlikely. After all, the numerical examples already show how these deal protection devices can shut out low-valuation buyers (such as *B2*), whose expected profit may not justify their participation costs.

There are also some important differences between the two devices. First and foremost, as we moved (in Part III.A) from no termination fee to a positive and substantial termination fee, allocative efficiency suffered: if the outside buyer had only moderately higher valuation than the inside buyer, the outside buyer was shut out from competition. As the size of termination fee got larger, the outside buyers were subject to a larger disadvantage vis-à-vis the inside buyer. By contrast, when we moved (in Part III.B) from a limited match right to an unlimited match right, allocative efficiency actually improved: by creating a more even playing field among the inside buyer and the outside buyer, an unlimited match right created an English auction-like environment. Another important difference is on the target's stand-alone expected profit. Holding the initial deal price constant, when the target agreed to a termination fee, its stand-alone profit suffered. By contrast, even with the same deal price, when we switched (in Part III.B) from a limited match right to an unlimited match right, the target's stand-alone expected profit actually increased.

Finally, consider the possibility of the transacting parties utilizing both a termination fee and a match right. In such a case, the interaction between the two deal protection devices can produce some interesting results. For instance, with a limited match right, because a termination fee increases the reserve price in the auction, a higher termination fee can mitigate (or even eliminate) the potential inefficiency that stems from the limited match right. This will especially be the case when the termination fee is equal to the difference between the initial buyer's reservation value and

the deal price. When the initial buyer values the target at \$120 million, the deal price is \$110 million, and the termination fee is \$10 million, for instance, a third-party buyer will enter the competition only when it values the target at more than \$120 million, and when it does so, the initial buyer will decline to match: the target will be sold to a third-party buyer only when the third-party buyer values the target more. By contrast, when the match right is unlimited, so long as the termination fee is less than the difference in the initial buyer's valuation and the deal price, allocative efficiency is not affected.<sup>152</sup>

#### D. Interdependent Valuation and the "Winner's Curse" Problem

So far, the numerical examples have assumed that while the buyers and the target do not observe other buyers' valuations, they know their own (although their valuations may be correlated). This assumption sets up a private value auction.<sup>153</sup> Alternatively, we could have assumed a more "interdependent" or "common" valuation structure, in which each buyer does not know its own valuation and only gets a "signal" about the valuation.<sup>154</sup> While the assumption of an interdependent valuation raises the possibility of what is known as the "winner's curse" problem<sup>155</sup>—in which the winner of the auction ends up paying more for the target than it values—this possibility does not arise when the parties engage in an ascending-bid English auction. The primary reason is that when the bidders observe whether the other competing bidders are participating in the auction, they can infer the signals that the other bidders have gotten and the informational issues disappear or are (substantially) mitigated.<sup>156</sup> In the case of

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<sup>152</sup> Whether or not the match right is limited, when the termination fee is higher than the difference between the initial buyer's valuation and the deal price, allocative inefficiency will result. See *supra* Part III.A.2.

<sup>153</sup> See VIJAY KRISHNA, AUCTION THEORY 13–28 (2002).

<sup>154</sup> *Id.* at 83–102. As an example of a common-value setting, suppose both an inside buyer (*B1*) and an outside buyer (*B2*) get respective signals about valuation (*X1* and *X2*), *B1* only observes *X1* and *B2* only observes *X2*, and the common value for the target is given by  $V = 0.5 * X1 + 0.5 * X2$ . In this setting, for *B1*, for instance, even after drawing a very high signal (a realization of *X1*), it does not know the true value of the target without knowing the realization of *X2*. It's possible that if the realization of *X2* is sufficiently low, its true valuation is substantially lower than what the realization of *X1* indicates.

<sup>155</sup> *Id.* at 84–85.

<sup>156</sup> *Id.* at 85. When the bidders are competing in a sealed-bid, first-price auction, by contrast, the fact that one has won the auction (without knowing others' signals) implies



no termination fee or an unlimited match right, the optimal strategy for the outside buyers (*B2* or *B3*) is to start the bidding process by offering a price that is slightly more than the deal price

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that the winner has likely drawn the highest possible signal and the true value of the asset is likely lower (given that others have drawn lower signals).

Some commentators have argued that because the initial buyer has an informational advantage against an outside buyer, the presence of an unlimited match right can substantially impede the outside buyer from competing against the inside buyer. See *supra* note 84 and accompanying text. There are three issues to consider with respect to this concern:

First, while this may be true in a sealed-bid first-price auction setting (e.g., where the outside buyer has to make a onetime bid and the inside buyer is given the right to either match or not match the bid), in an English auction setting, where the bidders can observe the others' behavior and they continue bidding against one another (and infer the others' valuation signals), this will not be true. The fact that the informational advantage does not per se create a winner's curse problem in an English auction setting can be seen using the following, simple example. Suppose both an inside buyer (*B1*) and an outside buyer (*B2*) get a respective signal about valuation (*X1* and *X2*): *B1* only observes *X1* and *B2* only observes *X2*. Suppose also that *B1*'s valuation is given by  $V1 = X1$  while *B2*'s valuation is given by  $V2 = \delta X1 + (1 - \delta)X2$ , where  $\delta \in (0,1)$ . By assumption, therefore, *B1* knows its valuation for certain, while *B2*'s valuation depends on both its own signal *X2* and *B1*'s signal *X1*. *B1* has an informational advantage against *B2*. (We can impose some distributional structure here, but for the sake of simplicity, we skip that discussion.) It is easy to show that the dominant strategy for *B1* is to stay in the auction until the price reaches *X1*. The optimal strategy for *B2* is, then, to stay in the auction until the price is equal to *X2* (or possibly some price that is higher than *X2*). With these equilibrium bidding strategies, there are two possibilities. Suppose *B2*'s strategy is to stay in the auction until the price reaches *X2*. First, suppose  $X2 > X1$ . As the price rises, *B1* drops out when the price reaches *X1*; and *B2* wins the auction at price equal to *X1*. *B2* acquires the target at *X1* and realizes a strictly positive surplus of  $V2 - X1 > 0$ . The auction achieves allocative efficiency. Suppose, instead,  $X1 > X2$ . In this case, *B2* drops out when the price hits *X2* and *B1* wins the auction. Again, allocative efficiency is achieved. In sum, even with the informational disadvantage, *B2* does not suffer the winner's curse problem.

Second, in fact, given that the inside buyer has already signaled its willingness to purchase the target through the acquisition price (\$110 million in our example), the informational advantage may actually be reversed to the extent that the price of the agreement can (at least partially) reveal the inside buyer's valuation.

The third point respects information rights. According to Kling, Nugent, and Van Dyke, in order to make sure that a deal protection device does not unduly impede third parties from competing against the initial buyer, the target should be able to

disclose confidential information to any third party who has on its own (i.e., not been solicited) "shown up" in the sense that it has submitted a proposal or, at a minimum, an indication of interest which is, or which the target believes is, reasonably likely to lead to (and who is capable of consummating) a higher competing bid. In this regard, the target should also be able to negotiate with such third parties. This removes any informational advantage that the (initial) anointed purchaser may have.

KLING, NUGENT & VAN DYKE, *supra* note 36, § 4.04[6][b], at 4-94 to -95 (citations omitted). The presence of such information right will also likely eliminate (or substantially reduce) the initial buyer's informational advantage. See Quinn, *supra* note 31, at 1042-43 (discussing various information rights given to the initial bidder can exacerbate the problem of information asymmetry).

and to continuously update and match *B1*'s bid. After all, the outside buyers know that *B1* at least values the target at the deal price, and being able to observe *B1*'s competing offer allows them to update their information on how much *B1* values the target. With an even playing field and with an ascending-bid, English-auction structure, the winner's curse problem does not arise.

When the playing field is uneven, on the other hand, there is a possibility that, concerned about the potential winner's curse problem, either the outside or the inside buyer may decline to participate. This can happen when the deal structure contains a (large) positive termination fee or when the inside buyer has only a limited match right. Recall that, in either situation, either the outside buyer (when there is a termination fee) or the inside buyer (with a limited match right) is forced to submit a jump bid. For instance, when the deal price is \$110 million but the deal is subject to a \$10 million termination fee, for *B2* or *B3* to compete against *B1*, they have to submit an initial competing bid that is higher than \$120 million. If, for instance, *B2*'s or *B3*'s valuation also depends on the information that *B1* has (the valuations are interdependent) and the outside buyers are sufficiently concerned about whether their true valuation falls below \$120 million (but above \$110 million), they may decline to compete against *B1*. This may be so, even though *B2*'s or *B3*'s true valuation of the target is higher than *B1*'s valuation. Similarly, when *B1* can match outside buyer's bid only once, and *B1* is unsure about its true valuation for the target (because its valuation depends also on the information that *B2* or *B3* has), concerned about the possible winner's curse problem, it will no longer be able to make an aggressive jump (matching) bid. This can, in turn, make it more likely that the target is sold to an outside buyer even though *B1* may have a higher valuation.

In sum, when moving to a more general, interdependent valuation structure, there is a potential winner's curse problem, but in a way that renders both termination fees and limited match rights worse for achieving allocative efficiency. In both cases, the possible inefficiency results from forcing either the outside or the inside buyer to make a jump bid. With a positive termination fee, the outside buyer has to submit a jump bid, whereas with a limited match right, the inside buyer has to submit a matching bid that may be substantially higher than the outside buyer's competing bid. By contrast, when there is no termination fee or the inside buyer has an unlimited match right, the concerns over

suffering a winner's curse will be substantially mitigated or eliminated with interdependent valuations and this, in turn, can better promote allocative efficiency.

#### E. Other Deal Protection Devices

So far, my principal focus has been on match rights and termination fees. But the auction-theory-based analysis can be easily extended to other deal protection mechanisms, notably stock and asset lockups.<sup>157</sup> In the case of a stock lockup, the inside buyer is entitled to purchase a fraction of the target's outstanding stock at a contractually stipulated price in case the target is sold to a competing buyer, whereas with an asset lockup, the inside buyer is entitled to acquire the target's asset (or division) at a predetermined price. Although both mechanisms are facially similar to a breakup fee (in the sense that they compensate a disappointed buyer), there are some important differences. Notably, while the size (or the value) of a termination fee is independent of how much the outside buyer pays for the target, the value of a stock lockup is proportionate to the outside buyer's purchase price. This provides an incentive to the inside buyer to be more aggressive in its bidding against the outside buyer. With aggressive bidding, allocative inefficiencies can arise. With an asset lockup, unlike a breakup fee, the value of the pledged asset can differ across the buyers, and this will affect how much each buyer would be willing to pay for the target. In this Section, I will demonstrate this with a few extensions of the previous numerical examples.

##### 1. Stock lockup.

Recall that the inside buyer (*BI*) valued the target at \$120 million and initially agreed to acquire the target at \$110 million. Now, suppose *BI* is also given the right to purchase 10% of the target's outstanding stock based on a valuation of \$100 million (*P*) in case the target is sold to a different buyer. With the strike price of \$100 million, if the target gets sold to another buyer at \$130 million, for instance, *BI* will be able to realize a profit of \$3 million (= 0.1 \* (\$130 million - \$100 million)) by

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<sup>157</sup> While there are other deal protection mechanisms, such as no-shop clauses, standstill and voting agreements, and information rights, they are not discussed for the sake of brevity. See Quinn, *supra* note 31, at 1016 (discussing, in more detail, various information rights that come with match rights); Davidoff & Sautter, *supra* note 34, at 711 (arguing that the courts should broaden their analysis of other protective measures).

exercising this stock lockup option and (immediately) reselling the stock to the winning buyer. Given that *B1* is willing to pay up to \$120 million for the target, in case *B1* wins the auction at price  $P$ , it will realize a profit of \$120 million  $- P$ . On the other hand, in case *B1* loses the auction and the winning bid is  $P$ , it gets to realize a profit of  $0.1 * (P - \$100 \text{ million})$ .<sup>158</sup> Even this simple example shows an important difference between a termination fee and a stock lockup. With a termination fee, the proceeds that the disappointed *B1* receives are fixed (at  $T$ ). With a stock lockup, however, the compensation for *B1* depends directly on the winning bid: the higher the winning bid, the higher the compensation for the inside buyer. This provides a strong incentive to *B1* to try to increase the winning bid as much as it can.

How much *B1* can push up the winning price depends, in part, on how much the outside buyer is willing to pay for the target when *B1* has the stock lockup. Using the example, suppose the outside buyer values the target at either \$115 million (by *B2*) or \$130 million (by *B3*). Knowing that *B1* is entitled to sell 10% of the target stock at \$100 million to the winning outside buyer, in case *B2* or *B3* wins the auction at  $P$ , the outside buyer has to pay  $P + 0.1 * (P - \$100 \text{ million})$ . That is, for 10% of the outstanding stock, the winning outside bidder has to pay an additional difference of  $P - \$100 \text{ million}$ . This will naturally reduce the maximum price the outside buyer would be willing to pay for the target. *B2*, for instance, would now be willing to stay in the auction until  $P \approx \$113.64 \text{ million}$ ; and *B3* would be willing to stay in the auction until  $P \approx \$127.27 \text{ million}$ .<sup>159</sup> At the same time, for *B1*, given that it will be able to realize a profit of  $0.1 * (P - \$100 \text{ million})$  in case it loses the competition and it values the target at \$120 million, *B1* will be willing to stay in the auction *at least* until the price reaches  $P \approx \$118.18 \text{ million}$ .<sup>160</sup>

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<sup>158</sup> More generally, if the inside buyer is entitled to purchase a fraction,  $a \in (0,1)$ , of the target's outstanding stock at the exercise price of  $P_0$ , the inside buyer's profit if it loses the competition and the winning bid is equal to  $P$  is  $a(P - P_0)$ . See *supra* Part I.A (discussing *Paramount v. QVC* and the use of a stock lockup).

<sup>159</sup> These numbers are calculated as follows: When an outside buyer values the target at  $R_i$  and the inside buyer is entitled to a fraction,  $a$ , of the target stock at  $P_0$ , the outside buyer would be willing to pay up to  $P$  such that  $R_i = P + a(P - P_0)$ . When we solve for  $P$ , we get  $P = (R_i + aP_0) / (1 + a)$ .

<sup>160</sup> With the reservation value of  $R_I$ , the inside buyer would be willing to stay in the auction until  $R_I - P = a(P - P_0)$ . When we solve for  $P$ , we get  $P = (R_I + aP_0) / (1 + a)$ . Note that the stock lockup affects the de facto "reservation values" of the inside and the outside buyers by the exact same proportions. Hence, when the bidders are aware of each other's reservation values, the presence of a stock lockup does not affect who will be able to

But will the inside buyer drop out of the race when the price reaches \$118.18 million? The answer is no. Recall that the assumption was that each buyer only knows its own valuation but not the valuations of others. The example made a further simplifying assumption that while *B2* or *B3* did not know *B1*'s valuation, *B1* knew that the outside buyer's valuation was either \$115 or \$130 million. This implies that when the auction price reaches \$118.18 million, rather than dropping out of the competition, the optimal strategy for *B1* is to stay in the auction until it reaches (slightly less than) \$127.27 million. With the stock lockup, while dropping out at \$118.18 million would have produced a profit of about \$1.82 million ( $\approx 0.1 * (\$118.18 \text{ million} - \$100 \text{ million})$ ), pushing the winning bid up to \$127.27 million allows *B1* to realize a higher profit of about \$2.73 million ( $\approx 0.1 * (\$127.27 \text{ million} - \$100 \text{ million})$ ). Obviously, the assumption that *B1* knew that the outside buyer's valuations were either \$115 or \$130 million is extreme. But the point is that when buyers do not know other buyers' valuations and when one buyer is given a stock lockup, because the size of the lockup increases with the winning bid, the lockup recipient will have an incentive to be more aggressive in its bidding.<sup>161</sup>

The result that a stock lockup makes the recipient more aggressive in its bidding strategy leads to a couple of important implications. The first is that it can sometimes lead to allocative inefficiency by shutting out an outside buyer who values the target only marginally or moderately more than the inside buyer. From the example, if an outside buyer valued the target only slightly more than the inside buyer, say, at \$121 or \$122 million, when the inside buyer becomes more aggressive and pushes up the auction price, even though the outside buyer values the target more, it will be shut out from the competition. Another implication is that, with a stock lockup, both the target's stand-alone profit and the joint profit of the inside buyer and the target can actually increase. By pushing up the (expected) winning auction price, although an outside buyer who values the target only moderately more than the inside buyer will be shut out, the target and the inside buyer can extract more rent from the outside buyer who values the target considerably more. The effect is similar to promising a

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purchase the target (i.e., there is no allocative inefficiency). In this symmetric information setting, the target will, on the other hand, realize a lower profit. This replicates Professor Ayres's principal finding. Ayres, *supra* note 34, at 695.

<sup>161</sup> For a more general analysis, see Che & Lewis, *supra* note 32, at 653–54.

large termination fee as seen earlier, when the target and the inside buyer can increase their joint profit by extracting more rent from a high-valuation outside buyer.<sup>162</sup>

## 2. Asset lockup.

When the target grants an asset lockup to a buyer, the recipient is entitled to purchase the target's promised asset (or a division) at a predetermined price when a competing buyer acquires the target.<sup>163</sup> Although the mechanics are quite similar to a termination fee, unlike with cash, buyers can assign different valuations to the asset, and an asset lockup can create allocative inefficiency. Coming back to the numerical example, suppose *B1* is given the right to purchase a target's asset that is worth \$10 million to *B1* at \$5 million (the exercise price). However, due to the synergies that the asset creates for the target's remaining assets, once the asset is taken out of the target, outside buyers' valuations go down by \$15 million. With the \$5 million cash payment from *B1*, the net reduction in valuation for the outside buyers would be \$10 million. Given that the asset lockup allows *B1* to realize a profit of \$5 million in case it loses the target, *B1* would be willing to bid only up to \$115 million for the target. Similarly, *B2* and *B3* would be willing to pay only up to \$105 million and \$120 million, respectively.

With the asset lockup in place and the initial deal price of \$110 million (between *B1* and *S*), now *B2* will no longer participate in the auction. When *B3* enters the competition, after bidding *B3* will be able to acquire the target (minus the asset) at (slightly more than) \$115 million, the maximum *B1* is willing to pay for the target. Compared to the case without any lockups, the target clearly suffers (because of *B2*'s lack of participation and lower proceeds from *B3*'s winning), while *B1* clearly gains. Although it seems as though allocative efficiency is preserved, because of the asset lockup, \$5 million in value is being destroyed. Without any lockup, the target would have generated a gross value of \$130 million (in *B3*'s hands). With the asset lockup, the gross value of the target plus the asset is \$125 million (= \$115 million + \$10 million). An asset lockup can also prevent a higher-value bidder from

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<sup>162</sup> The effect is quite similar to that of granting the inside buyer a right of first refusal. See generally Choi, *supra* note 139 (showing how a right of first refusal allows an inside buyer and a seller to extract rent from a higher-valuing outside buyer).

<sup>163</sup> See *supra* Part I.A (discussing *Revlon* and the use of an asset lockup).

acquiring the target. If, for instance, *B3*'s gross valuation of the target had been \$124 million (instead of \$130 million), because *B3* would have been willing to pay only up to \$114 million for the target (minus the asset) when *B1* had the asset lockup, *B3* would be unable to win the competition even though *B3* would have valued the target (as a whole) more than *B1*.<sup>164</sup>

There is one important difference that distinguishes an asset lockup from other deal protection measures. While it is plausible that other deal protection devices, including termination fees, match rights, and stock lockups, can under certain conditions increase the target and inside buyer's joint profit, this is quite unlikely with respect to an asset lockup. The primary mechanism through which a deal protection device can enhance the joint profit is through the extraction of additional surplus from an outside buyer with a high valuation. In the case of a termination fee, this is achieved through a large fee. A stock lockup or a match right creates additional profit by enhancing the competitive posture of the inside buyer. Because an asset lockup, by contrast, actually lowers an outside buyer's reservation value (and the potential surplus that the target and inside buyer can attempt to capture), it is quite unlikely that an asset lockup can increase the joint profit of the target and inside buyer, let alone the target's stand-alone profit. An asset lockup is the most problematic of all in potentially undermining both efficiency and the target's return.

#### IV. CORPORATE AND CONTRACT LAW IMPLICATIONS FOR DEAL PROTECTION DEVICES

The analysis in the previous Part showed that, when properly structured, deal protection devices, such as a termination fee and a match right, can enhance the joint expected return of a target and an inside buyer. But the issue whether a deal protection device can enhance the target shareholders' return is more subtle. As seen earlier, holding the initial deal price fixed, when the target agrees to a larger termination fee, the target's stand-alone profit decreases while the inside buyer's expected return increases. By contrast, when the target agrees to an unlimited match right, both the target's and the inside buyer's returns (are likely to)

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<sup>164</sup> When the size of the asset lockup is substantial, it can also deter a higher-value bidder from entering the competition. For instance, if an outside buyer values the target at \$122 million (\$2 million higher than *B1*) but losing the asset would cost the bidder (in net) more than \$12 million, given the initial deal price of \$110 million, the bidder would decline to compete against *B1*.

increase. Similarly, with a stock lockup, both the target's and the inside buyer's returns increase. In these cases, the joint profit of the target and the inside buyer go up as deal protection devices become stronger.

#### A. Target Directors' Role in Deploying Deal Protection Devices

For the target to share the benefit of increased joint profit, in the case of a termination fee, the directors (and the officers) of the target corporation have to negotiate with the buyer to increase the deal price. As seen earlier, by agreeing to a termination fee of \$8 million while receiving a corresponding increase in the deal price from \$110 million to \$116 million, the target is able to realize a higher profit of \$16 million. With respect to a match right, while successfully convincing the inside buyer to agree to an unlimited match right can increase the target's profit, to the extent that the inside buyer may also benefit from an unlimited match right, the issue is whether the target directors can receive further concessions from the inside buyer. Nonetheless, the issue of extracting a bigger deal premium isn't as important as in the case with a large termination fee. A similar argument would also apply to a stock lockup.

Ultimately, then, whether deal protection devices can benefit or harm the target shareholders depends on the target directors' and officers' incentives. Properly incentivized directors and officers will utilize deal protection devices to increase the return for the target shareholders, while unincentivized directors and officers can deploy the same devices to favor one buyer over another and to the detriment of the target shareholders. Presumably, the latter scenario is more likely, when the agents are to receive substantial private benefits from promoting one buyer over another. There are a number of possible scenarios. For instance, the target directors and the officers may be guaranteed post-merger employment by the initial buyer.<sup>165</sup> There also could be other types of side agreements between the target directors and the officers with the initial buyer, such as a consulting or financing agreement. Still another possibility is that the target directors and the officers, as investors or employees of the initial buyer, could receive direct

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<sup>165</sup> Although the top executives are often entitled to receive severance payments, often known as golden parachutes, upon change of control, thereby inducing the top executives to possibly prefer selling the company, it is unlikely that such severance payments are structured so as to favor one buyer over another.



pecuniary benefits from consummating the merger with the initial buyer. Perhaps the agents are under the influence of a block holder (including a controlling shareholder) who may be pursuing a different agenda. Finally, even if they are not pursuing their own private benefits, when they are indifferent about shareholder welfare, they could accede too easily to the initial buyer's demands. In all of these scenarios, by agreeing to deal protection devices (especially a large termination fee) with the initial buyer without demanding anything in return, the target directors and officers can increase the chances of closing the deal with the initial buyer to the detriment of competition.<sup>166</sup>

#### B. Deal Protection Devices and Determination of "Fair Value" in Appraisal

Another dimension in which the directors' and officers' incentives matter is with respect to the question whether the court can use the deal price as (reliable) evidence of fair value in an appraisal proceeding. The deal price issue can be examined from both *ex ante* and *ex post* perspectives. From the *ex ante* perspective, as seen in the earlier analysis, when the target directors are maximizing the returns for the target shareholders, they will be able to negotiate a higher deal price in return for agreeing to a generous deal protection. When this is the case, to the extent that a court would consider an arm's-length, negotiated deal price to be probative of fair value, that evidentiary weight would be high. With agents maximizing the return for the shareholders, the presence of a deal protection device should actually encourage, not discourage, the court to use the deal price as an indicator of fair value. This is true even when there is no topping bid.

Even from the *ex post* perspective, we saw that the presence of a termination fee or an unlimited match right is more likely to produce a higher *ex post* deal price. For instance, when the high-valuation buyer (*B3*) appears, an unlimited match right forces the outside buyer to pay the inside buyer's valuation to acquire the target, thereby producing a higher *ex post* deal price. In short, when there is a topping bid and subsequent competition among

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<sup>166</sup> With respect to a termination fee, another possibility is that, in the absence of a competing bid, a large termination fee that gets triggered when the shareholders vote against the deal can meaningfully discourage the target shareholders from voting against the deal. Such a "naked no vote" termination fee (as seen in the *Toys "R" Us* case), is different from the usual termination fees that are triggered upon consummation of a competing deal. For a discussion, see *supra* Part I.A.

the buyers, using the winning bid as evidence of fair value will substantially enhance the target shareholders' returns.<sup>167</sup> When the directors' and managers' incentives are not properly aligned, on the other hand, there is no guarantee that the deal protection device will increase the deal premium, and the deal price becomes less reliable in determining fair value of the target shares.<sup>168</sup> In such a setting, it would be better for the court to require an actual competition among buyers before using the final deal price in assessing fair value. Table 3 summarizes the arguments.

TABLE 3: TARGET DIRECTORS' BEHAVIOR AND ITS IMPLICATIONS

	Target Directors' Incentives Are Aligned	Target Directors' Incentives Are Not Aligned
Incidence of Deal Protection Devices	Likely	Likely
Initial Deal Price (Deal Premium)	Higher	Lower
Return (Ex Ante) for the Target Shareholders	Higher	Lower
Deal Price as Evidence of Fair Value?	More Reliable	Less Reliable

### C. Contract Law Considerations

Deal protection devices also raise interesting contract law problems. Given that the devices can discourage (or even prohibit) a new bidder from competing against the inside buyer and can reduce the new bidder's return, they impose a negative (contractual) externality on the new bidder. A deal protection device, especially a large termination fee, can function like a noncompete

<sup>167</sup> For more in-depth analysis on the importance of an actual auction among competing buyers (where there are multiple bids, as opposed to simple expressions of interest) in enhancing target shareholders' returns (and also in promoting efficiency), see Choi & Talley, *supra* note 23, at 559–60.

<sup>168</sup> This concern is stronger with respect to termination fees than with match rights. As seen earlier, in order for the target shareholders to share in the additional surplus extracted through a large termination fee, the target directors must negotiate a higher initial deal price. For a match right, even if the target directors were to grant an unlimited match right, even without any price increase, the target shareholders can benefit.

agreement<sup>169</sup> or an agreement to exclude entry (such as a concerted refusal to deal). Under contract law, when a contract imposes an “unreasonable” restraint on trade, the contract will be unenforceable based on public policy.<sup>170</sup> Furthermore, especially with respect to termination fees, contract law prohibits the parties from agreeing to liquidated damages that are unreasonably large as against public policy.<sup>171</sup> An unreasonably large liquidated damages clause that allows a disappointed buyer to collect more than what the buyer was expecting to receive under the contract goes against the compensation objective of contract law remedies.<sup>172</sup> Given the difficulty of deciding whether a certain provision imposes an unreasonable restraint on trade or allows compensation that is unreasonably large, whether a certain deal protection device should be struck down under contract law should be determined on a case-by-case basis.

Regarding termination fees, several factors can come into play. For instance, while practitioners often argue that a termination fee is necessary to compensate a disappointed buyer for all

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<sup>169</sup> See *supra* note 39.

<sup>170</sup> See RESTATEMENT (SECOND) OF CONTRACTS §§ 186–187 (AM. L. INST. 2017). Section 186(1), for instance, states that “[a] promise is unenforceable on grounds of public policy if it is unreasonably in restraint of trade.” Courts have utilized this provision to strike down unreasonable noncompete agreements. According to the official commentary,

[e]very promise that relates to business dealings or to a professional or other gainful occupation operates as a restraint in the sense that it restricts the promisor’s future activity. Such a promise is not, however, unenforceable unless the restraint that it imposes is unreasonably detrimental to the smooth operation of a freely competitive private economy. . . . Whether a restraint is reasonable is determined in the light of the circumstances of the transaction, including not only the particular facts but general social and economic conditions as well.

RESTATEMENT (SECOND) OF CONTRACTS § 186(1), cmt. a (AM. L. INST. 2017).

<sup>171</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (AM. L. INST. 2017):

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

This is known as the “antipenalty” doctrine. See Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33, 48 (2003); Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428, 1456, 1481–82 (2004); see also *Brazen*, 695 A.2d at 49 (determining that the termination fee, as liquidated damages, was not in violation of the antipenalty rule); *supra* notes 109–10 and accompanying text.

<sup>172</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (AM. L. INST. 2017) (“The central objective behind the system of contract remedies is compensatory, not punitive.”); see also RESTATEMENT (SECOND) OF CONTRACTS § 355 cmt. a (AM. L. INST. 2017) (“The purpose[ ] of awarding contract damages is to compensate the injured party.”).

the expenses the buyer has incurred,<sup>173</sup> the presence of an expense reimbursement provision<sup>174</sup> along with the fact that the termination fee is much larger than the allowed expenses can strengthen the argument that the termination fee is unreasonable.<sup>175</sup> More generally, one of the concerns of allowing liquidated damages that are too large is that it can lead to allocative inefficiency.<sup>176</sup> While an evenhanded competition better promotes allocative efficiency, a termination fee that is substantially larger than the expenses incurred can impede that objective. Another factor may be the

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<sup>173</sup> See *Brazen*, 695 A.2d at 48–49:

[The termination fee took into account] (a) the lost opportunity costs associated with a contract to deal exclusively with each other; (b) the expenses incurred during the course of negotiating the transaction; (c) the likelihood of a higher bid emerging for the acquisition of either party; and (d) the size of termination fees in other merger transactions.

See also Nexstar-Tribune Merger Agreement, *supra* note 91, § 9.3(c), at 79; *supra* Part II.A (discussing the agreement).

<sup>174</sup> See ABA MODEL MERGER AGREEMENT, *supra* note 88, § 7.3, at 276. For instance, when the deal fails to close because the target consummates a deal with a different buyer or the target board changes its recommendation, the buyer is entitled to very generous expense reimbursement from the target. Section 7.3(a)(ii) states:

Company shall make a nonrefundable cash payment to Parent, in an amount equal to the aggregate amount of *all fees and expenses (including all attorneys' fees, accountants' fees, financial advisory fees and filing fees)* that have been paid or that may become payable by or on behalf of Parent in connection with the preparation and negotiation of this Agreement and otherwise in connection with the Merger (the "Expense Reimbursement") if this Agreement is terminated (A) by Parent or the Company pursuant to Section 7.1(b) and on or before the date of any such termination, an Acquisition Proposal shall have been publicly announced or disclosed or an Acquisition Proposal has otherwise been communicated to the Company Board, or (B) by Parent or the Company pursuant to Section 7.1(d) or (C) by Parent pursuant to either Section 7.1(e) or Section 7.1(f).

*Id.* § 7.3(a)(ii), at 276 (emphasis added).

<sup>175</sup> An important consideration here is that when the target is sold to a different buyer, the initial buyer no longer has an option to try to execute the deal again in the future. See *supra* note 113 and accompanying text.

<sup>176</sup> One of the economic justifications of expectation damages is that it facilitates allocative efficiency (the "efficient breach theory"): a contract will be breached when doing so will generate more surplus. See Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 558–59 (1977). But, the theory is usually based on the assumption that a contracting party gets to make a onetime breach decision and that there is no subsequent competition among the buyers, as in an auction. Once there is an auction, on the other hand, allocative efficiency is much more likely to be achieved and the goal of damages is to create a more even playing field among the interested buyers. This would be more feasible with reliance damages (such as expense reimbursement) than with expectation damages or any liquidated damages that are substantially larger than reliance damages.

market conditions or the target's bargaining power.<sup>177</sup> When the acquisition market is very seller friendly or when the target is in a strong bargaining position, so that the deal price is close to the inside buyer's reservation value, imposing even a moderate termination fee can generate allocative inefficiency.<sup>178</sup> At the opposite end of the spectrum, when the target is in a weak bargaining posture or the market is very buyer friendly, even a relatively large termination fee will not generate an inefficiency. In short, instead of concluding that a breakup fee of a certain percentage of the deal price (e.g., 3% or 5%) is reasonable across the board, that reasonableness determination should depend on a case-by-case analysis that looks at several different factors, such as whether a generous expense reimbursement provision is also present, and whether the target enjoyed a strong bargaining position against the buyer.

For a match right, since the right does not deal with the issue of compensation, the core concern, rather, is whether the right imposes an unreasonable restraint on trade. As we saw earlier, however, an unlimited match right, compared to a limited match right, is more likely to lower the outside buyer's expected return but, at the same time, to increase the chances that the target will be sold to the buyer with a higher valuation. From an efficiency perspective, it is the limited match right that is more likely to impose constraint and perhaps should be more subject to judicial scrutiny under contract law.<sup>179</sup> An unlimited match right, by contrast, does not, in general, unreasonably restrain trade (i.e., competition for the target among inside and outside buyers). In sum, while both termination fees and unlimited match rights are likely

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<sup>177</sup> More precisely, as shown earlier, allocative inefficiency will result when the size of the termination fee is larger than the expected surplus from the deal for the initial buyer. *See supra* Part III.A.

<sup>178</sup> One can think of termination fees as a "price" term in a contract—in this case, the price to walk away from the deal. When bargaining power shifts from one party to another, such a price term is most likely to be affected by that shift. *See* Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1678–79 (2012) (analyzing the impact of a shift in bargaining power on both price and non-price terms in a contract); *see also* Badawi & de Fontenay, *supra* note 54, at 1154 (examining the impact of being the first drafter on various deal provisions).

<sup>179</sup> This depends on our conception of "restraint of trade." Given that a limited match right hampers the inside buyer's competitive standing vis-à-vis outside buyers, one could conceptualize it as something akin to a noncompete agreement, although, of course, the analogy is not exact since a noncompete clause kicks in after the initial relationship has been terminated.

to reduce an outside buyer's expected return, unlimited match rights facilitate allocative efficiency while termination fees do not.

TABLE 4: CONTRACT LAW IMPLICATIONS OF DIFFERENT DEAL PROTECTION DEVICES

	Possible “Unreasonable” Restraint of Trade?	Possible Overcompensation of Disappointed Buyer?
Small Termination Fee	No	No
Large Termination Fee	Yes	Yes
Limited Match Right	Unlikely <sup>180</sup>	No
Unlimited Match Right	No	No

#### CONCLUSION

Deal protection devices provide more confidence to the buyer that the deal will close and have been in the mergers and acquisitions landscape for quite some time. Notwithstanding earlier judicial hostility against certain deal protection devices, particularly during the hostile takeover era of the 1980s and early 1990s, courts recently have been much more willing to validate deal protection measures, particularly termination fees and match rights. In an influential opinion, for instance, then-Delaware Vice Chancellor Leo Strine has called them “common contractual” features.<sup>181</sup> While most deal protection devices have been scrutinized within the frame of target directors' fiduciary duties, most recently, in the midst of heated controversy over whether courts should use the deal price as an indicator of fair value in an appraisal proceeding, the Delaware Court of Chancery has pointed to the presence of such devices as undermining the usefulness of the deal price as relevant evidence.

This Article has examined some of these issues, with a particular focus on whether deal protection devices will be detrimental to the target shareholders and whether the presence of such provisions should steer courts away from using deal price as

<sup>180</sup> See *supra* note 161.

<sup>181</sup> See *In re Toys “R” Us*, 877 A.2d at 1017; see also Part I.A.

evidence of fair value in appraisal proceedings. Applying simple auction theory, this Article has shown that deal protection devices can, under certain conditions, function as a contractual externality mechanism that allows the contracting parties to realize a higher joint return by extracting rent from a noncontracting party. While both match rights and termination fees can function as rent extraction mechanisms, their incidence and effect can differ. An unlimited match right, compared to a limited match right, will do better not only in enhancing the target's return but also in making sure that the target is sold to the buyer with the higher valuation. By comparison, a termination fee, without any price concession from the buyer, will reduce the target's return and also impede the target from being sold to the buyer with the higher valuation. While an unlimited match right may not require a corresponding price concession from the buyer to increase the target's return, a termination fee does. While the primary focus of this Article has been on termination fees and match rights, this Article also deployed auction theory to examine other deal protection devices, notably stock and asset lockups.

Properly utilized, deal protection devices can enhance the return for the target shareholders. Improperly used, they can (substantially) undercut target shareholders' interests. Therefore, whether they enhance the target shareholders' interests depends on the motives and the behavior of the target directors and managers who are agreeing to such mechanisms. This Article argues that when the incentives of target directors and managers are well aligned with those of the shareholders, not only can the deal protection devices increase the target shareholders' welfare, the deal price can also be a more reliable indicator (compared to a case that does not have any deal protection measures) of fair value. At the opposite end, not only can deal protection devices substantially destroy target shareholders' value, their presence can undercut the evidentiary value of the deal price as fair value. Finally, this Article argues that, even when the agents are properly discharging their duties, unreasonable deal protection measures can engender inefficiency and should be scrutinized under contract law for possibly being against public policy. Particularly when the target corporation has agreed to reimburse the buyer's (out-of-pocket) expenses in case the deal falls apart, or when the target enjoys a strong bargaining position, a generous termination fee should trigger stronger scrutiny by courts for its potentially harmful public policy implications.