Deal Protection Devices

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Abstract

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. This paper analyzes two commonly used devices: target termination fees and match rights. 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 allows the buyer to get compensated 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 the 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? The paper attempts to answer these question with the help of auction theory. The paper shows, foremost, that, contrary to the common understanding, these devices can actually increase the target and the buyer's joint return and possibly the target's stand-alone return. In particular, the paper shows that an unlimited match right—which puts no limit on how many times the buyer can "match" third parties' offers—will be more beneficial for the target than a limited match right. The paper 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 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. The paper also examines the devices through the lens of contract law and argues that a large termination fee, rather than an unlimited match right, is more likely to harm competition for the target and should be subject to stronger judicial scrutiny.

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Introduction

On April 12, 2018, two wholesale office supply companies, Genuine Parts Corporation ("GPC") and Essendant, Inc. ("Essendant") agreed to combine their office supply businesses in order to withstand the increasing competition from e-commerce sellers.[1] The agreement contained several deal protection measures for GPC.[2] The first was a non-solicitation ("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[3] is made ("fiduciary out").[4] The second was a match right: in case a third party makes 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.[5] The match right was "unlimited," in the sense that whenever a third party were to revise its offer, a new three day period were to start.[6] The third was a termination fee, which required Essendant to pay $12 million to GPC in case Essendant decided to merge with a third party.[7]

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.[8] Because Essendant had to issue a large number of stock, Essendant had to schedule a special meeting of its shareholders to receive their approval.[9] Before Essendant was able to get the approval, on April 29, 2018, a private equity firm Sycamore (which owned Staples, another office supply company) made a competing offer of $11.50 per share for all of Essendant's outstanding stock.[10] Deciding

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[1] See Genuine Parts Co. v. Essendant, Inc., 2019 Del. Ch. 991 (Del. Ch. 2019) ("Genuine Parts") and In re Essendant, Inc. Stockholder Litig., 2019 Del Ch. LEXIS 1404 (Del. Ch. 2019) ("Essendant").

[2] See 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. ("GPC-Essendant Merger Agreement"), available at: https://www.sec.gov/Archives/edgar/data/355999/000156459018009075/esnd-ex105_58.htm.

[3] 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." See GPC-Essendant Merger Agreement at A-12.

[4] See GPC-Essendant Merger Agreement Article 7.03(a).

[5] See GPC-Essendant Merger Agreement Article 7.03(d).

[6] Id.

[7] See GPC-Essendant Merger Agreement Article 9.01(g).

[8] The transaction was structured as a "spin-merger" (also known as the Revers Morris Trust transaction), where GPC were 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 sub will 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 Recitals and Section 2, The Merger. See also Essendant's 8-K filing on April 12, 2018 available at: https://www.sec.gov/Archives/edgar/data/355999/000119312518114844/d563637d8k.htm.

[9] See GPC-Essendant Merger Agreement Article 7(a). Under the New York Stock Exchange regulation 312, when a company were to issue 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, available at: https://nyse.wolterskluwer.cloud/listed-company-manual.

[10] See *Genuine Parts* at 9. While we are trying to use 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

that the 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 Staples was not "superior,"[11] GPC nonetheless decided to "match" the offer by increasing its consideration by about $4 per share.[12] When Sycamore came back with a sweetened offer, thereby triggering another three-day match period, GPC declined to match.[13] On September 10, 2018, after some further negotiations, Essendant accepted the Sycamore's final bid of $12.80, and upon the termination of the agreement with GPC, GPC collected $12 million in termination fee.[14]

While deal protection measures, such as no-shop clause, match right, and termination fee, as seen in the GPC-Essendant transaction, are fairly common,[15] corporate law's and the court's

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Essendant's board initially determined that the earlier offer would 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 non-public 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.

[11] While the cash offer from Sycamore was easy to value, valuing the consideration from GPC, GPC's wholly-owned subsidiary, was not as straightforward. Using 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.

[12] Id. The $4 increase was not in the form of cash but was in the form of "contingent valuation right," that Essendant shareholders would be able to receive once stipulated contingencies have been satisfied. 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. See *infra* Part III.B.1 for a more detailed analysis and comparison.

[13] See *Essendant* at 11.

[14] Id. at 11. Notwithstanding the acceptance of the $12 million termination fee, GPC has brought suit against Essendant arguing, among others, that Essendant breached its contractual obligations, especially the non-solicitation (no-shop) provisions. Because the argument is based on breach of non-solicitation provision, GPC is arguing that it is entitled to full expectation damages. According to the GPC-Essendant merger agreement section 9.03(e), "in the event 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." On September 9, 2019, the Delaware Chancery Court denied Essendant's motion to dismiss. See *Genuine Parts* at 25.

[15] The story of Dollar Thrifty Automotive Group, Inc. (a car rental company) is also quite instructive. On April 25, 2010, Dollar Thrifty and Hertz entered into an agreement, pursuant to which Dollar Thrifty shareholders were entitled to receive $41 per share (80% cash and 20% Hertz stock). The agreement contained, among others, a match right for Hertz. A few days later, however, Avis made a competing offer of $46.50 per share (part cash and part stock). Although the size of the consideration seemed more attractive than the offer from Hertz, Dollar Thrifty 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. See In re Dollar Thrifty S'holder Litig., 14 A.3d 573 (Del. Ch. 2010). More recently, Fox declined to entertain Comcast's offer due to antitrust and lack of reverse termination fee concerns, even though Comcast's offer was higher than Disney's. See Afra Afsharipour, *Transforming the Allocation of Deal Risk through Reverse Termination Fees*, 63 Vand. L. Rev. 1161 (2010) (examining the risk allocation role played by reverse termination fees); Albert Choi and George Triantis (2010), *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 Yale L.J. 848 (2010) (examining the role played by liquidated damages, such as reverse termination fees, in M&A transactions); Brian Quinn, *Optionality in Merger Agreements*, 35 Del. J. Corp. Law 789 (2010) (empirically comparing reverse termination fees with target termination fees and arguing that symmetric termination fees may be inefficient); and Albert H. Choi and Abraham Wickelgren, *Reverse Breakup Fees and Antitrust Approval* (2020) (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 and Peter Lattman, *After Long Pursuit, Hertz to Buy Dollar Thrifty for $2.3 Billion*, New York Times, August 26, 2012.

attitude towards them has gone through some significant changes over time. Judicial attitude toward deal protection devices can roughly be divided into three periods: initial hostility during the hostile 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.[16] Initially, courts were quite hostile to deal protection devices, as seen in the seminal cases, such as *Revlon*,[17] and *Paramount v. QVC*.[18] The courts were concerned about whether agreeing to certain deal protection devices would constitute breach of target directors' fiduciary duty and also undermine the target shareholders' return. In subsequent cases, however, such as *In re Toys R Us*,[19] *Lyondell Chemical*,[20] and *C&J Energy Services*,[21] the courts took a much more permissive approach toward deal protection devices.

Although the question about whether agreeing to certain deal protection devices can constitute a breach of fiduciary duty has not been fully resolved, the recent controversy over appraisal has breathed new life into the issue. In an appraisal litigation, target shareholders, who are dissenting to the merger, ask the court to determine the "fair value" of the shares.[22] One prominent issue was whether the court could use the deal price itself as an indicator of fair value.[23] In cases, such as *DFC Global*,[24] *Dell*,[25] and *Aruba*,[26] 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. In determining whether a transaction satisfies such a standard, the presence of deal protection devices have come back to the fore. For instance, in the case of *In re AOL*,[27] the Delaware Chancery Court declined to use the deal price to determine the fair value when, among others, the deal was subject to buyer-friendly deal protection measures, including an unlimited match right.

The line of cases, from *Revlon* and *Paramount v. QVC*, through *In re Toys R Us* and *C&J Energy Services*, and to the recent appraisal cases, such as *In re AOL*, raises interesting and important questions about deal protection devices. To the extent that the 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

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[16] See *infra* Part I for a more detailed review of the historical development over deal protection devices.
[17] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
[18] Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994).
[19] In re Toys R Us Inc. Shareholder Litigation, 877 A.2d 975 (Del. Ch. 2005).
[20] Ryan v. Lyondell Chem. Co., 2008 Del Ch. LEXIS 105 (Del. Ch. 2008) and Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009).
[21] C&J Energy Servs. v. City of Miami Gen. Employees' & Sanitation Employees' Ret. Trust, 107 A.3d 1049 (Del 2014).
[22] The controversy over appraisal stemmed, in large part, due to the emergence of "appraisal arbitrage," where institutional investors, such as hedge funds, would purchase 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 and Eric Talley, *Appraising the "Merger Price" Appraisal Rule*, 34 Journal of Law, Economics, and Organization 543 (2018).
[23] Id.
[24] DFC Global Corp. v Muirfield Value Partners, L.P., 2017 Del. LEXIS 324 (Del. 2017).
[25] Dell, Inc. v. Magnetar Global Event Driven Master Fund, 2017 Del. LEXIS 518 (Del. 2017).
[26] Verition Partners Master Fund, Ltd. V. Aruba Networks, Inc., 210 A.3d 128 (Del 2019).
[27] In re AOL Inc., 2018 Del. Ch. LEXIS 63 (Del. Ch. 2018).

they affect the 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)?[28] What if the target has an obligation to pay a large termination fee? What if we were to examine the issues from the target shareholders' perspective? Do the deal protection devices undercut their return?[29] 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 inadmissible as probative evidence?[30] What factors do we need to consider in answering these question?

The paper analyzes deal protection devices, focusing on match rights and termination fees, using auction theory.[31] The initial judicial hostility was against stock and asset lock-ups, but such deal protection devices are being used much less frequently, while termination fees and match rights have become quite prevalent.[32] The paper foremost argues that, while certain deal protection

[28] Professors Quinn and 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 Fernan Restrepo and Guhan Subramanian, *The New Look of Deal Protection*, 69 Stanford Law Review 1013, 1058—59 (2017). (stating that "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") and Brian Quinn, *Re-Evaluating the Emerging Standard of Review for Matching Rights in Control Transactions*, 36 Del. J. Corp. L. 1011 at 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." See Guhan Subramanian, *Appraisal after Dell*, in The Corporate Contract in Changing Times, at 226 (2019) and Guhan Subramanian and Annie Zhao, *Go-Shops Revisited*, 133 Harv. L. Rev. 1215 (2020). This paper argues that a competition between multiple buyers when the inside buyer has a match right should be thought of as replicating an English auction, and in that setting, 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. See *infra* Part II.A and note 132 for a more general discussion of winner's curse problem in auctions.

[29] 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 (it works 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 (Del. 1997) and In re Toys R Us Inc. Shareholder Litigation, 877 A.2d 975 (Del. Ch. 2005). See also, Yeon-Koo Che and Tracy Lewis, *The Role of Lockups in Takeover Contests*, 38 Rand Journal of Economics 648 (2007) (analytically examining the circumstances under which lockups can facilitate the emergence of a bidder) and Restrepo and Subramanian (2017). 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. By generously compensating the disappointed buyer with various expenses (including attorney 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.

[30] See, for instance, Subramanian, *Appraisal after Dell* (2019) (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").

[31] Auction theory has been used to analyze acquisitions and takeovers for quite some time. See Alan Schwartz and Peter Cramton, *Using Auction Theory to Inform Takeover Regulation*, 7 Journal of Law, Economics, and Organization 27 (1991) and Choi and Talley (2018).

[32] According to Lou Kling and Eileen Nugent, stock and asset lock-ups "have become vertically 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 Kling and Eileen Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions §4.04[6][b] at 4-90 to 92 (1992 & Supp. 2019). See also Restrepo and

devices can impede the target from being sold to the buyer with a higher valuation (i.e., they generate allocative inefficiency), they can also increase the joint profit of the target and the initial buyer. Termination fees and match rights function quite differently, however. Both a large termination fee and an unlimited match right can increase the joint return of the target and the initial buyer, but a large termination fee is likely to generate allocative inefficiency while an unlimited match right actually does the opposite. Finally, in order to boost the target's stand-alone return, a large termination fee requires a price concession from the buyer (i.e., a higher deal price) while an unlimited match right does not require such 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 (which increases the total size of the pie for the target and the initial buyer), but a large chunk of that additional payment flows to the initial buyer as the promised termination fee. Hence, in order for the target to share that additional return, the target needs to receive a concession from the initial buyer through a higher deal price. The story is different with a match right. When a match right is limited, i.e., the buyer has an option to match a third party's offers only a few times, because there is no corresponding limitation on third party buyers and the target is not obligated to accept the buyer's matched offer, this puts the 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 buyer and third parties. Furthermore, unlike a termination fee, the higher proceeds go directly to the target, thereby increasing the target's stand-alone return.

Based on these findings, the paper argues that answering the questions of (1) whether deal protection devices can maximize target shareholders' return and (2) whether their presence undermines the reliance of deal price as an indicator of "fair value" in appraisal proceedings, ultimately depends on the issue of 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 incentive 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."[33] At the opposite end of the spectrum, when the target directors (and managers) are pursuing their own private gains at the

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Subramanian (2017) (showing that the match rights 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) and Subramanian and Zhao (2020) at 1229 (showing 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 lock-ups, in general, would be unduly impeding third parties, particularly when compared to termination fees. For instance, with respect to an asset lock-up, unless the target is promising to sell its crown jewel or an important division (as in *Revlon*) at a price substantially below its fair market value to the buyer, a lock-up that consists of, say, 3% of the target's equity value would have a similar effect to 3% termination fee. An important difference, of course, is that the valuations of physical assets would differ among the buyer, the target, and a third party. Similarly, when there is a stock lock-up, presumably when the target gets sold to a third party, the buyer will exercise the option immediately before the sale and realize a gain. The effect can be quite similar, except for the fact that now the transfer comes more or less directly from the third party instead of the target (as in the case of a termination fee).

[33] This statement should not, however, be construed as a whole-sale 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 and Talley (2018).

expense of the interest of the target shareholders, such devices can be used to harm target shareholders and the court should no longer rely on the deal price to determine "fair value."

The paper also examines the deal protection devices from the perspective of contract law. Foremost, given that the devices can undermine competition between the initial buyer and a third party, under contract law, the court can inquire into whether they should be struck down as being against the public policy (for imposing "unreasonable" restraint on trade). This type of reasoning that has been used to cut down onerous non-compete clauses and unreasonably large liquidated damages. The paper argues that such a public policy concern is higher with a large termination fee than with an unlimited match right. A large termination fee, especially when the target also has an obligation to reimburse the expenses of the initial buyer in case the target gets sold to a third party buyer, raises the specter of unduly undermining the competition between the initial buyer and a third party. An unlimited match right, by contrast, the paper argues, actually promotes more competition. An unreasonably large termination fee, as liquidated damages, can also be deemed as a "penalty" and against the public policy.

The paper is organized as follows. Part I offers a brief overview of the case law, focusing primarily on corporate law cases that examined 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*, *Columbia Pipeline*, *Stillwater Mining*). Part II shows how deal protection devices, match rights and termination fees, are deployed in practice. To aid the discussion, the Part looks at actual acquisition agreements used in recent transactions, including Nexstar Media Group's acquisition of Tribune Media and Google's proposed acquisition of Fitbit. Part III presents an auction theory-based analysis to examine termination fees and match rights. The Part demonstrate how such deal protection devices can be used to maximize the target and the 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. Part IV, applying the analysis from Part III, discusses possible implications in both corporate and contract laws. The last Part concludes with some thoughts for future research.

I. A Brief Case Law History of Deal Protection Devices

This Part offers a brief overview of the cases that dealt with 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' fiduciary duty. 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 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 Delaware Supreme Court's decisions in *DFC Global*, *Dell*, and *Aruba*, and how the Delaware Chancery Court 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 duty by the target directors. As evidenced by cases, such as *Revlon v. MacAndrews and Forbes*,[34] and *Paramount v. QVC*,[35] the target and buyer corporations attempted to exclude possible third-party bidder using deal protection devices, sometimes along with a poison pill. The devices that attracted most attention were stock and asset lock-ups and termination (break-up) fees. In *Revlon*, for instance, in order to thwart the hostile takeover attempt by MacAndrews and Forbes, Revlon (the target) brought in Forstmann Little (a private equity shop) as a "white knight" defender while promising, among others, an asset lock-up that allowed Forstmann Little to acquire some of Revlon's most valuable businesses (Vision Care and National Health Laboratories) at a below market price in case Forstmann Little was unable to acquire Revlon (an asset lockup).[36] In *Paramount v. QVC*, favoring Viacom over QVC as the deal partner, Paramount (the target) promised Viacom a right to acquire Paramount stock at a below market price (a stock lockup) in case Viacom is unable to close the transaction. Viacom would also be able to collect a $100 million termination fee.[37] 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 an "even auction" among the buyers.

The height of judicial hostility against deal protection devices was represented by the case of *Omnicare, Inc. v. NCS Healthcare, Inc*.[38] In that case, the Delaware Supreme Court struck down a combination of deal protection devices of no-shop clause, termination fee, and force-the-vote provision (which did not have a fiduciary-out termination right) as breaching the fiduciary duty of NCS Healthcare's (target) directors.[39] Perhaps in response to the judicial hostility, stock

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[34] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
[35] Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994).
[36] Under the asset lockup provision of the agreement, when a third party were to acquire 40% or more of Revlon's stock, Forstmann Little were entitled to purchase Revlon's Vision Care and National Health laboratories divisions for $525 million, some $ 100-$ 175 million below the value ascribed to them by Lazard Freres (Revlon's financial advisor). See Revlon at 178.
[37] See *Paramount v. QVC* at 39. 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 was a competing transaction; (b) Paramount shareholders would reject the merger; or (c) Paramount board would recommend 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"). Give 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.
[38] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).
[39] The case is unique in the sense that there was a group of controlling shareholders (defendants Outcalt and Shaw, who were both directors and officers of NCS Healthcare 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 Genesis an irrevocable proxy. 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.

and asset lockups would gradually disappear over time (at least) in public company mergers.[40] Termination fees, however, would remain in the landscape.[41] In *Brazen v. Bell Atlantic*, the Delaware Supreme Court permitted a termination fee as a proper means of compensating a disappointed buyer.[42] Even though the termination fee (to be paid by the target Bell Atlantic) was $550 million, partly because the fee constituted only about 2% of Bell Atlantic's market capitalization, the court ruled that it did not violate the directors' fiduciary obligations nor contract law's anti-penalty principle. In subsequent cases, while being lenient towards the presence of a termination fee, the courts have been a bit more vigilant towards its size. For instance, in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, the Delaware Chancery Court criticized a 6.3% termination fee as "seem[ing] to stretch the definition of range of reasonableness…beyond its breaking point."[43] More recently, in *In re Comverge, Inc. Shareholders Litigation*, the Delaware Chancery Court characterized a 5.6% termination fee as "test[ing] the limits of what this Court has found to be within a reasonable range for termination fees."[44]

Deal makers 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 the case of *In re Toys R Us Inc. Shareholder Litigation*.[45] When Toys R Us (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.[46] Under the unlimited three-day match right, Toys R Us had an obligation to negotiate in good faith with KKR for three business days to allow KKR to revise its offer to make a third party's offer no longer attractive to the shareholders of Toys R Us, and there was no limit on how many times KKR could exercise the right.[47] When the shareholders of Toys R Us (the target) challenged the deal protection measures,

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[40] See *supra* note 32 and the surrounding discussion.
[41] Id.
[42] Brazen v. Bell Atl. Corp., 695 A.2d 43 (Del. 1997).
[43] Transcript of Afternoon Session, Phelps Dodge Corp. v. Cyprus Amax Minerals Co., No. Civ.A. 17398, 1999 WL 1054255, at 2 (Del. Ch. Sept. 27, 1999).
[44] In re Comverge, Inc. Shareholders Litigation, C.A. No. 7368-VCP, 2014 WL 6686570, at 14 (Del. Ch. Nov. 25, 2014). In the case, the merger agreement provided for a two-tier termination fee under which Comverge (the target corporation) would pay HIG (the buyer) $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).
[45] In re Toys R Us Inc. Shareholder Litigation, 877 A.2d 975 (Del. Ch. 2005).
[46] Id. 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 3 day match right. In the deal, the match right was given as part of the fiduciary out exception to the no shop covenant.
[47] See *infra* Part II for a more detailed discussion.

the Delaware Chancery Court upheld their validity, stating that "neither 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."[48] Resting upon the holdings of *Brazen* and *Toys R Us*, by now, two most frequently used deal protection 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.[49]

A couple of subsequent cases seems to put the courts in a more lenient posture regarding deal protection in answering whether the target directors might have breached their fiduciary duty. In *Lyondell Chemical*, the buyer, Basell, controlled by Mr. Blavatnik, made an offer to cash out all the shares of Lyondell Chemical at $48 per share, thereby putting the deal in the *Revlon* mode.[50] The merger agreement also included various deal protection measures, including $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. 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 Chancery Court denied the motion, stating that whether the directors breached their fiduciary duty under *Revlon* raised various questions of fact.[51] The Delaware Supreme Court reversed, however.[52] 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…[and] the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."[53]

Similarly, in *C&J Energy Services*,[54] which also involved a match right and a $65 million termination fee, the Delaware Supreme Court over-turned 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: "*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."[55] Finally, with respect to the question of whether deal protection devices can deter third parties from competing against the buyer, i.e., undermine 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,

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[48] Id. at 1017.
[49] See *supra* note 32 and the surrounding discussion. See also Fernan Restrepo and Guhan Subramanian, *The Effect of Prohibiting Deal Protection in Mergers and Acquisitions: Evidence from the United Kingdom*, 60 Journal of Law and Economics 75 (2017) (empirically examining the effect of UK's banning of deal protection devices on mergers and acquisitions activities); and John Coates and Guhan Subramanian, *A Buy-side Model of M&A Lockups: Theory and Evidence*, 53 Stanford Law Review 307 (2000) (an earlier study of buy-side lockups).
[50] See Ryan v. Lyondell Chem. Co., 2008 Del Ch. LEXIS 105 (Del. Ch. 2008) at 71—84.
[51] Id. At 84—88.
[52] Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009).
[53] Id. at 143—244.
[54] C&J Energy Servs. V. City of Miami Gen. Employees' & Sanitation Employees' Ret. Trust, 107 A.3d 1049 (Del 2014).
[55] Id. at 1053.

and the board has the flexibility to eschew the original transaction and accept the higher-value deal."[56]

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 duty (under *Revlon* or *Unocal*), overtime, the courts seem to have taken a more permissive approach towards deal protection measures. At the same time, *Omnicare* case (along with *Revlon* and *Paramount v. QVC*) tells us that it is possible for certain (combination of) deal protection measures to be "coercive and preclusive" or to constitute a breach of directors' fiduciary duty. Unfortunately, however, where that line is yet to be answered in a satisfactory manner.[57]

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.[58] Unlike the previous line of cases that dealt with the question of whether the target directors breached their fiduciary duty (including *Revlon* duty), appraisal cases raise a different set of questions: what is the "fair value" of the target's shares and how should court determine that fair value. The recent controversy on 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" for the dissenting shareholders (which, on occasion, substantially exceeded both the deal price[59] and the pre-announcement stock price), certain practitioners and scholars have advocated 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*[60] and *Dell*,[61] 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

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[56] Id. at 1068.

[57] According to Lou Kling and Eileen Nugent, a crucial aspect to this question is whether the deal protection devices can "unduly" deter third parties from making competing bids:

> …the 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….

1 Lou Kling and Eileen Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions §4.04[6][b] at 4-89 to 90 (1992 & Supp. 2019).

[58] In Delaware, target shareholders who dissent from (or not vote in favor of) certain types of merger 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 DGCL §262. See Choi and Talley (2018) for an overview and how using the deal price (merger price) can decrease target shareholders' expected return.

[59] See generally Choi and Talley (2018). For instance, in the case of Dell, the Delaware Chancery Court, 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, Inc. v. Magnetar Global Event Driven Master Fund, 2017 Del. LEXIS 518 at 2—3 (Del. 2017).

[60] DFC Global Corp. v Muirfield Value Partners, L.P., 2017 Del. LEXIS 324 (Del. 2017).

[61] Dell, Inc. v. Magnetar Global Event Driven Master Fund, 2017 Del. LEXIS 518 (Del. 2017).

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."

In short, *DFC Global* and *Dell* seem to dictate the court to 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 a (sufficient) competition for the target corporation (especially after the agreement has been signed) so as to require the court to use the deal price as an indicator of "fair value."[62] Presumably, when the deal is too tightly locked-up, so as to deter any interested third party buyer from competing against the existing buyer, there is, in some sense, no "market" for the target corporation and the deal price (agreed to between the 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, Inc.*[63] directly addresses this issue. The Delaware Chancery Court, in determining the "fair value" of AOL's stock, declined to use the deal price as an indicator of "fair value" due to, among others, the presence of deal protection devices. The acquisition agreement between Verizon (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. 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. The Court, citing the presence of deal protection devices and other problematic issues, such as Armstrong's (AOL's CEO) statement that he was "committed to doing the deal with Verizon,"[64] concluded that the sale process was not "*Dell* compliant,"[65] and the deal price could not be used as relevant evidence of fair value.[66] The

[62] 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 on 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 duty (including Revlon duty). Notwithstanding the difference, some have argued that the analysis should be similar. See Lawrence A. Hamermesh and 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 Charles Korsmo and 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").

[63] In re AOL Inc., 2018 Del. Ch. LEXIS 63 (Del. Ch. 2018).

[64] Id. at 22—23.

[65] 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 21.

[66] 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*." (italics 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. By contrast, in *AOL*, the termination fee was about 3.5% of the AOL's market capitalization and Verizon was given an unlimited matching right. According to the court, "cumulatively, these factors make for a considerable risk of informational and structural disadvantages dissuading any prospective buyer." Id. at 23—24.

Court, instead, applied the discounted cash flow analysis (as many courts have done in the past) to determine AOL's fair value.[67]

Three, more recent cases, *Aruba*,[68] *Columbia Pipeline*,[69] and *Stillwater Mining*,[70] all decided in 2019, put additional interpretive wrinkle on deal protection devices in appraisal actions. In all three cases, while there are some factual variations, the target corporation pursued a strategy of negotiating with one buyer (a "single-buyer strategy") and adopted deal protection measures that included both a termination fee and an unlimited match right.[71] In none of these cases, after the agreement was signed, a competing buyer emerged. Notwithstanding the presence of deal protection devices, in all three cases, the court determined that, after closely examining the respective negotiation history, the deal was done on an "arm's length" basis and the price was the reliable measure of "fair value." In the process of coming to that conclusion, *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 increased; and (5) "most importantly," no bidders emerged during the post-signing phase.[72] Particularly with respect to the fifth factor, according to the *Stillwater Mining* court, the non-emergence of a competing buyer was deemed to be "highly significant" in its conclusion that the deal price was a reliable indicator.[73]

Two salient patterns seem to emerge in the appraisal cases. First, the courts seem to have moved in the direction of relying more on the deal price as a reliable indicator of 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, more important for our purposes, the courts do not seem less inclined to use the deal price as an indicator of fair value even 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 Chancery Court in *Dell* appraisal litigation, an unlimited match right is a "powerful disincentive" against a third party bidder from making a topping bid.[74] According to Professor

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[67] Id. at 25—50.

[68] Verition Partners Master Fund, Ltd. V. Aruba Networks, Inc., 210 A.3d 128 (Del 2019).

[69] In re Appraisal of Columbia Pipeline Grp., Inc., 2019 Del. Ch. LEXIS 303 (Del. Ch. 2019).

[70] In re Stillwater Mining Co., 2019 Del. Ch. LEXIS 320 (Del. Ch. 2019). See also In re Panera Bread Co., 2020 Del. Ch. LEXIS 42 (Del. Ch. 2020) (applying similar analysis to match rights and termination fees in an appraisal proceeding).

[71] For instance, in Aruba, the target (Aruba Networks) agreed to an unlimited match right, which gave the buyer (HP) 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 *Aruba*, 2018 Del. Ch. LEXIS 52 at 21—22.

[72] See, e.g., *In re Stillwater Mining Co*., 2019 Del. Ch. LEXIS 320 at 66—69.

[73] Id. at 69. In emphasizing this factor, the court relied on the reasoning from *Aruba* and *Dell*. In *Aruba*, the Delaware Supreme Court stated: "[i]t 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." See *Aruba*, 210 A.3d at 136. Similarly, in *Dell*, the Court found that absence of (post-signing) 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." See *Dell*, 177 A.3d at 33.

[74] See In re Appraisal of Dell, 2016 Del. Ch. LEXIS 81 at 134 (Del Ch. 2016). See also Lender Processing, 2016 Del. Ch. LEXIS 189 at 25 (Del. Ch. 2016) (stating that "the 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

Subramanian, "the 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."[75] Furthermore, the courts seem to be inclined to rely more on the deal price when, after the merger agreement has been signed, no topping bid has emerged. At least in theory, this is puzzling since, the absence of a topping bid can be the result of one of two things: either that the deal price is already sufficiently high so that no other third party would be 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.[76]

II. Deal Protection Devices in Action

This Part discusses, in more detail, how deal protection devices, termination fees and match rights, 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) tries to compensate the disappointed buyer, while the second type (like a match right and a no-shop provision) tries to more directly control the target's behavior. The first type of devices 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 from acquiring the target corporation's stock or asset at a previously agreed-upon, favorable (and often, below-market) price.[77] A target termination (or break-up) fee would stipulate a dollar amount that the disappointed buyer can collect from the target in case the target gets sold to a different buyer.[78]

The second type of devices attempts to influence or control the target's pre-closing behavior. The most often-used mechanism is known as the "no-shop" (or no solicitation) clause,

realistic path to success, it made no sense to get involved"); Blueblade Capital Opportunities LLC v. Norcraft Cos. Inc. 2018 Del. Ch. LEXIS 255 at 43—44 (Del. Ch. 2018) (citing Subramanian "unlimited match rights are typically perceived as limiting any 'pathway to success…everybody agrees that match rights deter bids. It [is] not even a debated question"); and In re Panera Bread Co., 2020 Del. Ch. LEXIS 42 at 48 (citing investment banker's testimony "even 'customary' matching rights 'may discourage in a way and make it more challenging' for other bidders to come forward").

[75] See Subramanian and Zhao (2020) at 1234. See *supra* note 28 for more discussion on winner's curse problem associated with unlimited match right. See *infra* note 132 and the surrounding discussion for an analysis on how unlimited match right can be modeled as an English auction and 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.

[76] 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, *Appraisal after Dell*, in The Corporate Contract in Changing Times, at 226 (2019).

[77] In theory, poison pills can also function as a deal protection device that compensates a disappointed buyer since, when triggered, it allows the inside buyer to purchase the target's stock at an attractive price.

[78] Sometimes, the purchaser corporation is obligated to make a fee payment to the target and this is known as the reverse break-up (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 and Wickelgren (2020). Unlike target termination fees, 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 (to secure antitrust approval or line up necessary financing, for instance) device.

that prohibits the target from directly (or even indirectly) soliciting a competing bid from a third party.[79] Others include covenant provisions that requires the target corporation to hold a shareholder's meeting regardless of whether the target board changes its recommendation to the shareholders ("force the vote" covenant),[80] not to change its recommendation to the shareholders ("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 a 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 (or "superior"). Another often-used device is a "match right." Often combined with other covenants, such as no change in recommendation or a 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 ("superior") to the target shareholders.

Given the emergence of termination fees and match rights as the two most visible and frequently used deal protection mechanisms,[81] the Part focuses on the two, with the help with some recent mergers and acquisitions transactions: Nexstar Media's acquisition of Tribune Media[82] and Google's proposed acquisition of Fitbit.[83] On occasion, the Part also looks at the ABA Model Merger Agreement.[84] The transactions contemplate a reverse triangular merger structure, in which the purchaser (the "Parent") lets one of its wholly-owned subsidiary (the "Merger Sub") to merge with a publicly traded target corporation (the "Company") with the target corporation as the surviving entity. We will first closely examine the match rights used in the agreements and then turn to termination fees.

A. Match Right

When a buyer is given a match right, when there is an offer from a third party that is considered to be "superior" to the buyer's offer,[85] subject to certain conditions, it allows the buyer

[79] See, e.g., ABA Model Merger Agreement Section 4.4. 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 pre-specified duration. Go-shop period can kick in either before or after the agreement has been signed. See Dell, Inc. v. Magnetar Global Event Driven Master Fund, 2017 Del. LEXIS 518 (Del. 2017) for an example. Although there is an interesting debate as to how effect a go-shop provision is and whether they allow the target directors to satisfactorily discharge their fiduciary duties (in getting the maximum price possible), this paper is focused on deal protection devices. See Subramanian and Zhao (2020) at *supra* note 28 for a recent analysis of go-shop provisions.

[80] Under Delaware statute, a target company can agree to such a provision even if its board were to change its recommendation to the shareholders. See DGCL §146.

[81] See *supra* note 32.

[82] See Agreement and Plan of Merger among Tribune Media Company, Nexstar Media Group, Inc. and Titan Merger Sub, Inc. ("Nexstar-Tribune Merger Agreement"), available at: https://www.sec.gov/Archives/edgar/data/726513/000119312518342329/d642430dex21.htm.

[83] See Agreement and Plan of Merger by and among Fitbit, Inc., Google LLC and Magnoliophyta Inc. ("Google-Fitbit Merger Agreement"), available at: https://www.sec.gov/Archives/edgar/data/1447599/000162828019013022/exhibit21-8kmergeragre.htm.

[84] See American Bar Association, Model Merger Agreement for the Acquisition of a Public Company (2011) ("ABA Model Merger Agreement").

[85] 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

to (and obligates the target to) negotiate "in good faith" and revise the purchaser's offer so that the third party's offer is no longer superior to the buyer's revised offer. 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.[86] In section 7.3, titled "No Solicitation by the Company," a match right is given to 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 parts, states:

> Prior to making any Company Adverse Recommendation Change or entering into any Alternative Company 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 (to the extent Parent desires to negotiate)* regarding any revisions to the terms of the transactions contemplated hereby proposed by Parent in response to such Superior Company Proposal[87]…and (iii) at the end of the four (4) Business

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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" (italics added). 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 ABA Model Merger Agreement Definitions.

[86] On December 3, 2018, Nexstar Media Group and Tribune Media Company announced the merger, under which Nexstar will acquire all outstanding shares of Tribune for $46.50 per share (plus some extra in case there is a pre-closing dividend). The deal valued Tribune at about $4.1 billion and the consideration constituted about 15.5% premium above Tribune's closing price on November 30, 2018. See Tribune 8-K on December 4, 2018, exhibit 99-1, available at: https://www.sec.gov/Archives/edgar/data/726513/000119312518340361/d665385dex991.htm. The transaction is structured as a reverse triangular merger, where, a wholly-owned subsidiary ("Merger Sub") of the purchaser (Nexstar Media, the "Parent") merges into the target (Tribune Media, the "Company") with the target as the surviving corporation. The merger was subject to Federal Communication Commission's (FCC's) and Tribune shareholders' approval. Tribune shareholders approved the deal on March 12, 2019. See Tribune 8-K on March 12, 2019, available at: https://www.sec.gov/Archives/edgar/data/726513/000119312519071965/d715273d8k.htm. On September 16, 2019, the FCC approved the transaction. See Memorandum Opinion and Order, Federal Communications Commission, FCC 19-89 (September 16, 2019). The merger closed on September 19, 2019. See Tribune 8-K on September 20, 2019, available at: https://www.sec.gov/Archives/edgar/data/726513/000119312519250119/d807112d8k.htm. No competing bidder emerged between the signing and the closing of the merger.

[87] According to the merger agreement, "Superior Company Proposal" is defined as: a Company Acquisition proposal from any Person (other than Parent and its Subsidiaries) (with all references to "15% or more" in the definition of Company Acquisition Proposal being deemed to reference "50% or more" and all references to "less than 85%" in the definition of Company Acquisition Proposal being deemed to reference "less than 50%") which the Company Board determines in good faith, after consultation with the Company's outside financial advisors and outside legal counsel (a) to be more favorable, from a financial point of view, to the stockholders of the Company than the transactions

> Day period described in the foregoing clause (ii), the Company Board shall have concluded in good faith, after consultation with the Company's outside legal counsel and outside financial advisors…(A) the Company Acquisition Proposal continues to be a Superior Company Proposal…continues to warrant a Company Adverse Recommendation Change and, in each case, that failure to take such action would reasonably be expected to be inconsistent with the directors' fiduciary duties under applicable Laws. *After compliance with the foregoing sentence, the Company shall have no further obligations under the foregoing sentence, and the Company Board shall not be required to comply with such obligations with respect to any other Superior Company Proposal*…. (italics added)

In accordance with the provision, after an unsolicited, superior proposal ("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 (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 italicized 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 the Nexstar's revised offer. If the third party were to sweeten its offer in response to Nexstar's revised offer, Nexstar will no longer be entitled to an exclusive match period.

By comparison, here are the relevant sections from the merger agreement between Google LLC (the "Parent") and Fitbit (the "Company").[88] Under section 6.02, titled "Non-Solicitation: Acquisition 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 unless:

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contemplated by this Agreement after taking into account all factors that the Company Board deems relevant and (b) is reasonably expected to be consummated (if accepted) on the terms thereof. "Company Acquisition Proposal," in turn, is defined as a proposal to acquire either 15% or more of the company's assets or business (in terms of consolidated net revenue) or where the company's shareholders hold less than 85% of the equity interests or voting power of the surviving corporation.

[88] On November 1, 2019, Fitbit, Inc. and Google LLC (a subsidiary of Alphabet, Inc.) announced that Google will acquire all of the outstanding stock of Fitbit at $7.35 in cash per share. Similar to the Tribune-Nexstar transaction, 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, were to merge into Fitbit with Fitbit as the surviving corporation. See Fitbit 8-K on November 1, 2019, available at: https://www.sec.gov/Archives/edgar/data/1447599/000162828019013022/a8-kmergeragreement.htm. The merger consideration was about 19% above the latest Fitbit closing price. See Rob Copeland and Patrick Thomas, *Google to Buy Fitbit, Amping Up Wearables Race*, Wall Street Journal, November 1, 2019. On January 3, 2020, Fitbit shareholders held a virtual special shareholders meeting (via exclusive live webcast) and approved the merger. See Fitbit 8-K on January 6, 2020, available at: https://www.sec.gov/Archives/edgar/data/1447599/000162828020000158/fitbit8-k1320.htm. Between the signing of the agreement and the shareholder approval, no competing buyer emerged. As of the date of this draft, the merger is waiting for other closing conditions to be satisfied, including antitrust approval (from both US and other foreign jurisdictions, including EU).

> (i)…the 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 (the "Superior Proposal Notice") advising Parent that the Company intends to take such action…and (B) (1) during such four (4) Business Day period, if requested by Parent, 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[89]….(ii) The parties hereto acknowledge and agree that (A) if Parent, within four (4) Business Days…makes an irrevocable proposal that, *as determined in good faith* by the Company Board…results in the applicable Acquisition Proposal no longer being a Superior Proposal, then the Company shall have no right to terminate this Agreement…and (B) any (1) 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 Superior Proposal Notice and a new two (2) Business Day period* shall commence thereafter….

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, among other things, Fitbit board must negotiate "in good faith" with Google for four business days so as to make the third party's offer no longer superior. Unlike the match right in 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.[90]

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[89] 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…"

[90] The match right in the ABA Model Merger Agreement is also unlimited but more favorable for the acquirer. In section 4.6(b), the agreement states:

> 4.6 Company Shareholders Meeting….(c) Notwithstanding anything to the contrary contained in Section 4.6(b), at any time prior to the adoption of this Agreement by the Required Stockholder Vote, the *Company Board may effect...a Change in Recommendation*: (i) *if*: (A) after the date of this Agreement, an unsolicited, bona fide, written offer to effect a transaction of the type referred to in the definition of the term *Superior Proposal is made to the Company and is not withdrawn*….(D) the Company Board determines in good faith, after obtaining and taking into account the advice of an independent financial advisor of nationally recognized reputation and the advice of outside legal counsel, that such offer constitutes a Superior Proposal; (E) *the Company Board does not effect, or cause the Company to effect, a Change in Recommendation at any time within five Business Days* after Parent receives written notice from the Company confirming that the Company Board has determined that such offer is a Superior Proposal; (F) *during such five Business Day period, if requested by Parent, the Company engages in good faith negotiations with Parent to amend this Agreement in such a manner that the offer that was determined to constitute a Superior Proposal no longer constitutes a Superior Proposal*….and (H) the Company Board determines in good faith, after obtaining and taking into account the advice of outside legal counsel, that, in light of such Superior Proposal, a Change in Recommendation is required in order for the Company Board to comply with its fiduciary obligations to the Company's stockholders under applicable Legal

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 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 renegotiate or modify the agreement in response to a third party's superior offer. Second, with a limited match right, when the initial 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 initial 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 the 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."[91] If the target were to 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.[92] Under corporate law, such a behavior can also constitute a breach of the target

> Requirements (*it being understood that in the event of any revisions to the terms of a Superior Proposal, the provisions of this Section 4.6(c)(i) shall apply to such revised offer as if it were a new offer hereunder*) (italics added)

Similar to the Google-Fitbit match right, the buyer can exercise its match right whenever a superior proposal gets revised. More favorably, though, as seen in the last parenthetical phrase of the provision, the buyer still gets five business days of obligating the target to negotiate in good faith. On occasion, the parties will also stipulate that the target has an obligation to negotiate with the buyer on an exclusive basis. See Subramanian and Zhao (2020) at 1236.

[91] According to the Restatement (Second) of Contracts §205, "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." More specifically with respect to modification, Restatement (Second) of Contracts §89 states: "a promise modifying a duty under a contract not fully performed on either side is binding (a) if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract is made…." The Uniform Commercial Code is more explicit with the duty to modify in good faith. While UCC §2-209(1) states that "an 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." Although the contours of the good faith duty is not very clear, under the Uniform Commercial Code, 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). See Alan Schwartz and Robert Scott, *Precontractual Liability and Preliminary Agreements*, 120 Harvard Law Review 661 (2007), Cathy Hwang, *Deal Momentum*, 65 UCLA L. Rev. 376 (2018), and Albert H. Choi and George Triantis, *Designing and Enforcing Preliminary Agreements*, forthcoming in Texas Law Review (2020) (papers analyzing the good faith duty in the context of modifying non-binding preliminary agreements).

[92] Whether the contract law imposes an affirmative obligation to not refuse to renegotiate is not entirely clear. For instance, according to the official comment 2 of UCC §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." (italics 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 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." (italics original). Allan Farnsworth, Contracts (2004) at §4.22. But see Choi and Triantis (2020) (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 remedy,

directors' fiduciary duty.[93] 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 contract-law based obligation to negotiate with them (in good faith).[94] On the other hand, again, under corporate law, refusing to negotiate with a third party who makes a superior offer can constitute a breach of target directors' fiduciary duty.

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 Nexstar-Tribune and Google-Fitbit transactions, during which the buyer is granted with the right to 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 a behavior constitutes acting in bad faith under contract law or breach of fiduciary duty under corporate law. With a limited match right, as in 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 has "shall not be required to comply with [good faith negotiation obligations] with respect to any other Superior Company Proposal." If Tribune were to refuse to negotiate further with Nexstar after Nexstar's match right has run out, it will be difficult to argue that Tribune's behavior would constitute breach of implied duty to modify (or negotiate) in good faith under contract law.[95]

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 that the target can walk away once the obligation has been satisfied. While the default rules under the contract law impose somewhat uncertain and open-ended obligations ("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 more clear 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 and the target can switch sides once the specified opportunity has been satisfied with the initial buyer. Assuming that the target's legal obligations towards the third parties remain relatively stable through the competition and negotiation process, what a limited or unlimited match right does is to (at least) tilt the bargaining leverage towards or against the initial buyer.

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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 remedy and not just reliance damages.

[93] What is not entirely clear from either the Restatement or the Uniform Commercial Code is whether one party has an "obligation" to renegotiate with its counter-party when the counter-party makes a modification attempt. In some sense, perhaps it is in this context where a match right imposes an express obligation on the target to negotiate (in good faith) with the buyer.

[94] If, for instance, the target has entered into a confidentiality agreement ("Acceptable 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 create some contract-based duties on the target and the third party. See generally Schwartz and Scott (2007), Hwang (2018), and Choi and Triantis (2020) for more in-depth analyses on pre-contractual duty to negotiate in good faith.

[95] 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 directors' fiduciary duty

B. 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, termination fee provision is intricately tied with the right to terminate the agreement.[96]

For instance, in the Nexstar-Tribune transaction, Nexstar is entitled to collect $135 million termination fee from Tribune when certain conditions are satisfied, the most important one of which is when Tribune enters into an alternative transaction with a third party.[97] For instance, Section 9.1 of the agreement, titled "Termination," lays out the circumstances under which the agreement can be terminated. The relevant portions state that:

> This Agreement may be terminated…(c) by Parent: (i) if a Triggering Company Event shall have occurred; or…(d) by the Company…(ii) if at any time prior to the receipt of the Company Stockholder Approval (A) the Company Board authorizes the Company to enter into an Alternative Company Acquisition Agreement with respect to a Superior Company Proposal to the extent permitted by, and subject to the terms and conditions of, Section 7.3, (B) substantially concurrent with the termination of this Agreement, the Company enters into an Alternative Company Acquisition Agreement providing for a Superior Company Proposal and (C) prior to or concurrently with such termination, the Company pays to Parent in immediately available funds the Company Termination Fee…

"Triggering Company Event" is defined to include either Tribune's board making a change in its recommendation to its shareholders ("Company Adverse Recommendation Change") or Tribune entering into a transaction with a third party ("Alternative Company Acquisition Agreement").

With respect to the payment of the $135 million termination fee, Section 9.3(a)(i) states, in relevant parts:

> In the event that this Agreement is terminated by Parent pursuant to Section 9.1(c)(i), or in the event that this Agreement is terminated by the Company pursuant to Section 9.1(d)(ii), then, in each case, 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….

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[96] Taking one step back, before one party has the right to terminate the contract, usually there is a non-satisfaction of condition. A change in the target board's recommendation, for instance, will first function as a non-satisfaction of condition, which will, in turn, give the purchaser the right to terminate the agreement and to collect a termination fee.
[97] 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 Section 8.03(a)(i).

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 $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 that, as of the date of the merger announcement, Tribune was valued at about $4.1 billion, $135 million termination fee constituted about 3.3% of the deal value.[98]

An important condition with respect to the payment of 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 get reimbursed for its expenses. For instance, in the Nexstar-Tribune agreement, Section 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],[99] 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 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)

As the section makes clear, in case the proposal goes to the shareholder vote and the Tribune shareholders do not approve the merger, Nexstar is entitled to get only its expenses (broadly construed) reimbursed and the total reimbursement is capped at $15 million, substantially below the termination fee of $135 million that Nexstar would have been entitled to receive in case Tribune enters into a competing transaction with a third party.[100] In other words, a large termination fee

[98] See Tribune 8-K on December 4, 2018, exhibit 99-1, available at: https://www.sec.gov/Archives/edgar/data/726513/000119312518340361/d665385dex991.htm.

[99] According to Section 9.1(b)(iii) of the agreement, the agreement can be terminated by either the Parent or the Company, "if the Company Stockholders' Meeting…shall have concluded following the taking of a vote to approve the Merger and the Company Stockholder Approval shall not have been obtained."

[100] 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 a naked no vote fee provision, the buyer will be entitled to collect a stipulated amount from the target. Unlike the Tribune-Nexstar deal, 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')." 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*, the Delaware Chancery Court had an opportunity to consider some of these, but relying, in part, on the factual findings that the target directors agreed to a naked no vote fee ("No-Vote Termination 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 duty and the naked no vote fee did not constitute a corporate waste. See *In re Lear Corp. Shareholder Litigation*, 967 A.2d 640 (Del. Ch. LEXIS 121).

that gets 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.[101]

Termination fees raise some difficult contract law issues, 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 anti-penalty doctrine should allow the court to strike down some of the fees.[102] According to the Restatement (Second) of Contracts, "damages for breach by either party may be liquidated in the agreement…."[103] 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 whether a "breach" has occurred.[104] A true breach happens presumably when one party does not abide by the terms of the

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[101] 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 is exemplary. For instance, Section 7.1(e) from the ABA Model Merger Agreement, allows the purchaser corporation ("Parent") to terminate the agreement when the target board has changed its recommendation to its shareholders.

> 7.1 Termination. This Agreement may be terminated prior to the Effective Time…(e) by Parent if (i) the Company Board shall have failed to recommend that the Company's stockholders vote to adopt this Agreement, (ii) *there shall have occurred a Change in Recommendation*, (iii) the Company Board shall have approved, endorsed, or recommended any Acquisition Proposal. (italics added)

And, when the agreement has been terminated in accordance with section 7.1(e), the following section, section 7.3(b)(i), allows the purchaser corporation (Parent) to collect a stipulated termination fee.

> 7.3 Expenses; Termination Fees…(a)(ii) 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…(C) by Parent pursuant to either Section 7.1(e)…(b) The Company agrees to pay Parent (or its designees) an amount equal to $_________ (the "Termination Fee") if this Agreement is terminated: (i) by Parent pursuant to Section 7.1(e)….

In short, if the Parent terminates the agreement in response to the Company board's change in its recommendation to the stockholders, the Parent is not only entitled to recover its expenses, but it is also entitled to receive a contractually stipulated termination fee. The quoted portion only shows the possible termination in response to an adverse recommendation change. In addition to a change in recommendation event, termination fee can also be triggered when the deal fails to close for other reasons, such as due to material inaccuracy in target corporation's representations and warranties or target's failure to satisfy other covenants, and the target corporation consummates a competing transaction within a specified period of time after the termination (known as the "tail period"). 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.

[102] Another issue is whether termination fee should be the exclusive remedy for the buyer. Acquisition agreements generally stipulate that, in case termination is triggered pursuant to the agreement, termination fee is the exclusive remedy for the buyer. See *infra* note 48.

[103] Restatement (Second) of Contracts §356(1). See also Uniform Commercial Code §§2-718 and 2-719.

[104] 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

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, termination fee could be thought of as setting up an alternative performance obligation for the target.

The distinction here is important because if termination fee were to be classified as liquidated damages, under the anti-penalty rule (doctrine) of contract law, it cannot be unreasonably large when compared to the actual or anticipated loss (by the purchaser).[105] If, on the other hand, a termination fee is not liquidated damages, presumably no such restriction would apply. Also, unless other problems, such as conflicts of interest by the directors and the managers, are present, a termination fee would only be subject to a deferential business judgment review under corporate law.

Notwithstanding this difficulty, the *Brazen* court treated a termination fee as liquidated damages and that holding still seems to control.[106] Perhaps in response to *Brazen* line of cases, often times, the transacting parties will expressly stipulate in their agreement that the termination fee should be (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….(italics added)

What is interesting in the Nexstar-Tribune example is that, not only do they expressly state that the termination fee and the expenses constitute liquidated damages, but also that they are not a penalty.[107] This raises an interesting question. Assuming that the *Brazen* line of cases is correct

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.

[105] Restatement (Second) of Contracts §356(1), which states that "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 cause by the breach and the difficulties of proof of loss."

[106] Brazen v. Bell Atl. Corp., 695 A.2d 43, 47 (Del. 1997). The court based its decision partly on the fact that the merger agreement itself (between NYNEX and Bell Atlantic) stated that the termination fee "constitute liquidated damages and not a penalty." Id. at 46. According to the court, "the express language in section 9.2(e) of the agreement unambiguously states that the termination fee provisions 'constitutes liquidated damages and not a penalty'….we 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"). But deferring to the parties' classification seems to invite possible opportunism.

[107] Foremost, note that this language is quite similar to those used in the *Brazen* case. Id. The agreement seems to treat these two concepts, liquidated damages and penalty, as being distinct, but this is likely incorrect. As mentioned

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" and therefore do not constitute a penalty.[108] Furthermore, section 9.3(c) also states that the termination fee is necessary to compensate Nexstar for the "efforts and resources expended and opportunities foregone" while they are negotiating the deal. 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. 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 (1/9) of the termination fee of $135 million.[109] 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.[110] 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 we examine in more detail in the next Part.

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earlier, the anti-penalty doctrine would apply when 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 anti-penalty doctrine. See Restatement (Second) of Contracts §356(1) (stating that "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 Uniform Commercial Code §§2-718 and 2-719 (stating that: "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 Farnsworth (2004) at §12.18 (stating that 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….").

[108] The relevant provision in the Google-Fitbit agreement is somewhat cleaner in this regard. Section 8.03(a)(iii), in relevant parts, states: "…the *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." 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 reasons, Google will reserve the right to pursue other remedy, including expectation damages or specific performance. See, e.g., Google-Fitbit agreement section 9.09 (stating that in case the provisions of the agreement "were not performed in accordance with their specific terms or were breached," the parties are entitled to seek specific performance). See also ABA Model Merger Agreement section 7.2(b) (stating that "the 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 where the parties are anticipating possible ex post dispute when they are drafting their contract. See Robert Scott and George Triantis, *Anticipating Litigation in Contract Design*, 115 Yale L. J. 814 (2006) and Choi and Triantis (2010).

[109] In the Google-Fitbit transaction, by comparison, the termination fee was $80 million while the "no vote fee", which gets triggered when Fitbit shareholders were to reject the deal, was $21 million. So, the termination fee was about 4 times larger than the "no vote" fee. See supra notes 97 and 100.

[110] One important implication of that difference is that when the target gets 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 the story of In re Dollar Thrifty Automotive Group discussed in *supra* note 15.

III. The Effect of Termination Fees and Match Rights

Having examined a brief history over deal protection devices and how they are used in practice, in this Part, with the help of auction theory, we examine the impact of deal protection devices. 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 were to make a superior offer to the target, within a pre-determined period of time, the initial buyer can simply "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 bid before deciding whether to match the third party's offer. However, as we will see shortly, whether a match right in fact creates an uneven auction setting and whether who will actually have an advantage depends importantly on whether the match right is limited versus unlimited.

The story with the target termination fee is, by comparison, somewhat more straightforward. When a target has an obligation to pay a termination fee, this could substantially decrease the target board's incentive of accepting a third party's offer. As a simple example, if the initial buyer's offer 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 no longer enter the competition, even though it may be 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.

What is somewhat counter-intuitive is the fact that such deal protection provisions can actually enhance both the existing purchaser's and the target's expected joint return.[111] 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") onto a third party. 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 the efficiency by allocating the target corporation's assets to a

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[111] 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.

buyer with lower valuation.[112] While a deal protection device harms the third party and reduces the inefficiency, it can increase the expected returns for the contracting parties.[113]

A. Target Termination Fee

This point can be most easily seen with a simple, numerical example of a 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 ($B1$), who values the target at \$120 million, for a possible sale. In this case, the target and the initial will execute an agreement at a price of P between \$100 and \$120 million. For simplicity, let's assume that 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 appear.[114] With the other 50%, no new buyer appears. More specifically, there is a 20% chance that $B2$, who is willing to pay up to \$125 million for the target, appears, and with the other 30% chance, $B3$, who is willing to pay up to \$150 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 buyers' reservation values is only known to that player.[115] For simplicity, though, we will assume that $B1$ knows that the outside buyer's

[112] 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.

[113] In a seminal work, Aghion and Bolton showed how a supply contract with a termination fee can allow an existing seller and a buyer to erect barrier against entry and also to extract rent from a more efficient entrant. See Philippe Aghion and Patrick Bolton, *Contracts as a Barrier to Entry*, 77 American Economic Review 388 (1987). There are many other areas where a bilateral contract can be used to extract rent from a non-contracting third party. See, e.g., Albert Choi, *Golden Parachute as a Compensation-Shifting Mechanism*, 20 Journal of Law, Economics, and Organization 170 (2004).

[114] 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 mechanism can could 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 chances that a competing bidder emerges on the scene is higher. Especially if such a clause will tilt the probability of high-valuation buyer ($B3$) emerging, the contracting parties can have an even stronger incentive to adopt a large termination fee so as to increase their joint profit.

[115] Two points need to be made regarding the assumptions. First, given that the outside buyers get to observe the deal price of \$110, the outside buyers may be able to "reverse engineer" and find out (or at least get more information) that the inside buyer's reservation value is \$120. The substantive analysis on termination fees will remain the same, however. If the outside buyers observe that the inside buyer's valuation is \$120, the outside buyers (either with \$125 or \$150 valuations) will simply submit a competing bid of (slightly higher than) \$120 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, and their valuations may be correlated. This assumption sets up a private value auction. See Vijay Krishna, Auction Theory (2002) at 13—28. Alternatively, we could have assumed a more "interdependent" or "common-value" structure, where each buyer does not know its own valuation and only gets a signal about the valuation. Id. at 83—102. While the assumption of an interdependent valuation raises the possibility of what is known as the "winner's curse" problem, where the winner of the auction ends up paying more for the target than it values, as we will see shortly, when the parties engage in an ascending bid, English auction, the possibility of a winner's curse problem does not arise. The primary reason is that when the bidders observe whether the other, competing bidders are participating in the auction, they get to infer the

valuation is either \$125 or \$150 with respective probabilities: that is, the inside buyer knows the distribution of the outside buyer's valuation.[116]

1. The Case with No Termination Fee

Let's assume initially that there is no termination fee. With the initial price of \$110 million, for the new buyer (either $B2$ or $B3$) to successfully "jump" the deal, the new buyer will have to offer at 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 envision the bidding competition, probably the simplest and the most plausible way to think about this is to imagine that the buyers engage in an ascending-bid, English auction, where the initial bid starts at the initial price of \$110. That is, the initial (commonly observed) price starts at \$110 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 the reservation value of \$125) enters the fray, for instance, the bidding competition between $B1$ and $B2$ will result in $B2$ acquiring the target corporation at a price slightly higher than \$120 million.[117] To see this, as the commonly observed bid starts at \$110, each buyer would be 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 for the target while the new buyer ($B2$) is willing to pay up to \$125, when the bid reaches \$120, the initial buyer will drop out of the auction, the (commonly observed) bid stops, and $B2$ will be declared the winner of the competition. Similarly, when $B3$ (with reservation value of \$150 million) appears, again, $B3$ will be able to win the auction and acquire the target at \$120 million.

What is the implication of the auction? Foremost, from the target's perspective, there are three possible scenarios: (1) with a 50% chance, no new buyer appears, and it expects to sell to the initial buyer ($B1$) at \$110 million; (2) with a 20% chance, $B2$ appears on the scene, and the target gets to sold to $B2$ at \$120 million; and (3) with a 30% chance, $B3$ competes and wins against $B1$, and the target gets sold to $B3$ at \$120 million. When we combine these three possibilities, we can see that the target corporation's expected net profit is \$15 million ($= (0.5) \times (\$110\, million - \$100\, million) + (0.5 \times (\$120\, million - \$100\, million))$). Similarly, for the initial buyer ($B1$), given that it expects to acquire the target with 50% probability at the initially-agreed-upon price of \$110 million, its expected profit is \$5 million ($= (0.5) \times (\$120\, million - \$110\, million)$). For the new buyers ($B2$ and $B3$), conditional on their winning the competition, their profits are \$5 million ($= \$125\, million - \$120\, million$) and \$30 million ($= \$150\, million - \$120\, million$),

signals that the other bidders have gotten and the informational issues disappear or get mitigated. See *infra* note 132 for a more detailed analysis.

[116] 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 informational advantage against the outside buyer.

[117] We can think of an English auction where a commonly observed price keeps rising until only one bidder remains. The assumption that the new buyer is able to acquire the target at \$120 million is made to simplify the numerical analysis. To more complicate the analysis (and to make the example more realistic), once the new buyer appears the target will engage in a negotiation with the new buyer while using the existing contract as a bargaining point.

respectively. Finally, whenever a new buyer appears on the scene, the target gets sold to the buyer with the higher valuation (either $B2$ or $B3$): allocative efficiency is achieved. The results are summarized in the second column in Table 1.

2. The Case with Termination Fee

Now suppose the target and the initial buyer ($B1$) set the initial purchase price at \$110 million but with a termination fee of \$16 million: $(P, T) = (\$110, \$16)$. With these numbers, the termination fee is about 14.5% of the deal price. Based on the existing case law, this large a termination fee is unlikely to be upheld in court, but we will use these numbers to keep the numerical example as simple as possible. With the purchase price of \$110 and the termination fee of \$16, the minimum the new buyer will have to bid is, now, \$126 ($= \$110 + \$16$). Since the buyer ($B2$) values the target at \$125, it will no longer be able to compete for the target against $B1$. If $B2$ were to enter the auction, the starting bid will be \$126, which is higher than $B2$'s reservation value. Hence, $B2$ will simply decline to enter the competition.[118] When the buyer with \$150 ($B3$) appears, on the other hand, bidding competition still ensues, and $B3$ will be able to win the auction at (a price slightly above) \$136. The auction price will start at \$126 and rise until it hits \$136, at which point the initial buyer ($B1$) drops out, leaving $B3$ as the winner. With the winning bid by $B3$ of \$136 million, the target realizes a profit of \$10 million: after receiving the gross proceeds of \$136 million, the target pays \$16 million to $B1$ as the agreed-upon termination fee, and gives up the assets that are worth \$100 million.

Compared to the previous example, now, since $B2$ never enters the bidding competition against $B1$, we have only two possible scenarios: either the target gets sold to $B1$ at the initially agreed-upon price of \$110 or to $B3$ at \$136 after a bidding competition. When we combine these two possible scenarios, we can see that the target's expected profit becomes \$13 million ($= (0.7) \times (\$110 - \$100) + (0.3) \times (\$136 - \$16 - \$100)$). With a 70% chance, the target gets sold to the initial buyer, while with a 30% chance the target gets sold to $B3$. Similarly, the initial buyer's ($B1$'s) expected net profit is \$11.8 million ($= (0.7) \times (\$120 - \$110) + (0.3) \times (\$16)$): with a 70% possibility, the buyer acquires the target at \$110 million, while, with a 30% possibility, the buyer collects \$16 million of termination fee. Unlike the previous scenario with no termination fee, $B2$ has been completely shut out and will realize a profit of \$0; while for $B3$, conditional on winning the competition, it realizes a profit of \$14 million. The numbers are shown in the third column of Table 1.

3. Comparison

When we compare these two scenarios, a few salient observations bubble up. Foremost, when the initial price remains unchanged at \$110, with a \$16 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: the target is giving up an opportunity (20% chance) to be able to sell to

[118] The example shows that $B2$ is shut out from competition even though $B2$ values the target more than $B1$. We can make this point more general. When the initial agreement is given by (P, T), where P is equal to the deal price and T is the target termination fee, and $B1$'s reservation value is given by $R1$, allocative inefficiency inefficiency results whenever $P + T > R1$ or $P > R1 - T$. Hence, the allocative inefficiency becomes a bigger concern as the deal price (P) is closer to the initial buyer's reservation value ($R1$) and as the termination fee (T) gets larger.

a new buyer ($B2$) that values the target higher (at $125) than the existing buyer (at $120). At the same time, the existing buyer ($B1$) gains, not only because it shuts down some potential competition (from $B2$), but also because it gains an opportunity to collect $16 million of termination fee in case the target gets sold to $B3$. This implies that simply agreeing to pay a termination fee to the initial buyer is a costly enterprise from the target's (or, more precisely, its shareholders') perspective. More generally, holding the acquisition price the same, as the termination fee gets larger, the target's return gets smaller while the initial buyer's expected return gets larger.

	No Termination Fee $(P, T) = (\$110, \$0)$	With Termination Fee and Same Price $(P, T) = (\$110, \$16)$	With Termination Fee but Higher Price $(P, T) = (\$116, \$10)$
Target's (S) Expected Profit (Res. Value = $100)	$15 million	$13 million	$17.2 million
Initial Buyer's ($B1$) Expected Profit (Res. Value = $120)	$5 million	$11.8 million	$5.8 million
Target and Initial Buyer's Joint Profit	$20 million	$24.8 million	$23 million
New Buyer ($B2$)'s Profit (Res. Value = $125)	$5 million	$0	$0
New Buyer ($B3$)'s Profit (Res. Value = $150)	$30 million	$14 million	$20 million
Possible Inefficient Sale of Target?	No	Yes	Yes

Table 1: The Effect of a Termination Fee

More importantly, compared to the case with no termination fee, the joint (expected) profit for the target and the inside buyer is strictly higher: $24.8 million versus $20 million. While the target is giving up the opportunity to sell to a low-valuation outside buyer ($B2$) at $120 million, the target and the initial buyer, in concert, get to substantially increase in the price paid by the high-valuation buyer ($B3$): from $120 million to $136 million. In a sense, in return for foreclosing $B2$ from participating in the auction, they get to extract a higher surplus from $B3$. Given that there is a 30% chance that $B3$ appears on the scene, the expected increase in payment by $B3$ is equal to $4.8 million ($= (0.3) \times (\$16\ million)$). Note that this is exactly equal to the increase in joint profit for the target and the initial buyer.[119] In short, while a termination fee (holding the initial

[119] The reason why there is no decrease in the joint profits of the target and the inside buyer from shutting out the low-valuation buyer is that, regardless of whether $B2$ participates and wins, the gross return for the pair is equal to $120 million. When $B2$ wins, it pays $120 million to the target and nothing to $B1$, whereas when $B1$ wins the gross return is equal to $B1$'s valuation of $120 million.

price constant) decreases the target's expected return and creates an allocative inefficiency ($B2$ may no longer acquire the target even though it values the target more than $B1$), it allows the target and the inside buyer to reduce the high-valuation outside buyer's ($B3$'s) surplus and realize a higher profit.

As the example has shown, while the joint profit of the initial buyer and the target may increase from including a termination fee, simply agreeing to a termination fee without a corresponding increase in deal price will actually hurt the target shareholders. More generally, conditional on price, an increase in termination fee will decrease the return for the target shareholders. From the example, when the initial deal price stayed the same at $110, as we moved from no termination fee to $16 million termination fee, the target's expected profit went down from $15 million to $13 million while the initial buyer's expected profit increased from $5 million to $11.8 million. If the target directors were trying to maximize the return for their shareholders, they would demand an increase in the initial deal price in return for the termination fee. For instance, had they vigorously negotiated for an increase in the deal price to $116 million while reducing the termination fee to $10 million, the target will be able to increase its expected profit to $17.2 million.[120] The inside buyer is still better off with the termination fee than without: its expected profit, now, will be $5.8 million. When the deal price goes up in return for a termination fee, both the target and the inside buyer will be better off at the expense of the outside buyer and allocative inefficiency. These results are shown in the last column of Table 1.

B. Match Rights

While the focus of the discussion so far has been on termination fees, comparable analysis can be applied to match rights, but with an important twist and variation. 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 (e.g., negotiate in good faith) the inside buyer to "match" that outside buyer's offer 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, known as the right of first refusal.[121] 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.[122]

[120] With the price of $116 and termination fee of $10, $B2$ will still not be able to compete against $B1$. When $B3$ appears, on the other hand, $B3$ will be able to win the auction at (slightly above) $130. The target's expected profit is given by: $(0.7) \times (\$116 - \$100) + (0.3) \times (\$130 - \$10 - \$100) = \$17.2$. The inside buyer's expected profit is $(0.7) \times (\$120 - \$116) + (0.3) \times (\$10) = \$5.8$. The joint profit, therefore, is $23 million. $B2$'s and $B3$'s profits remain unchanged from the previous example.

[121] For a more detailed, auction theory based analysis, see Albert H. Choi, *A Rent Extraction Theory of Right of First Refusal*, 57 Journal of Industrial Economics 252 (2009). See also Restrepo and Subramanian (2017) and Quinn (2011) (both papers comparing a match right to a right of first refusal).

[122] When a right of first refusal is in place, the right holder can basically engage in "cream-skimming": declining to not exercise the right (not match 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

1. Right of First Refusal: Comparison

A right of first refusal functions as what's known 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.[123] The reason why 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 even-handed 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 will 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.[124] In short, a right of first refusal, a lot 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 story. The outside buyer, after observing the inside buyer's matching bid, is free to come back with another, more attractive, offer for the target.[125] In fact, while the inside buyer may be contractually limited in how many times it may be able to exercise the right, there is no formal constraint on the outside buyer on how many times it may be able to come back with a more attractive offer for the target. Furthermore, even when 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.[126] A limited match right, in particular, constrains the inside buyer's behavior for the benefit of the outside buyer.

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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 (2009).

[123] 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.

[124] If an English (or the 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.

[125] 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 relationship. See *supra* note **Error! Bookmark not defined.** and the surrounding discussion. 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.

[126] There are also a few other differences between a conventional right of first refusal and a match in an M&A context. First, in an M&A 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

2. Limited Match Right

To be able to more concretely examine the impact of a match right, just like the case with termination fees, 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. Unlike the previous example, however, we will assume slightly different reservation values for the new buyer. Just as before, we will assume that there is a 50% chance that a new buyer does not appear, with 20% chance that a new buyer with valuation of $115 million ($B2$) will appear, and with remaining 30% chance that the new buyer's ($B3$) valuation is $150 million. The main difference from the previous example is that, now, there is a 20% chance that the new buyer's ($B2$'s) valuation is lower than the initial buyer's valuation ($115 million versus $120 million). As before, we continue to assume that the buyers do not observe the others' valuations,[127] but $B1$ knows that the outside buyer's valuation is either $115 or $150 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. We will allow for the possibility of including both later. The match right can be of two types: limited ($M < \infty$) or unlimited ($M = \infty$). If the match right is unlimited ($M = \infty$), 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 ($M = 1$).[128] In sum, when the match right is unlimited, the initial buyer (the right holder) can exercise the right as many time as it desires; whereas if it 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

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property owner and the right holder. Second, in a conventional right of first refusal setting, though not always, there often is a pre-existing relationship between the property owner and the right holder. The most common case is that between an owner-landlord and tenant. See Choi (2009).

[127] We are assuming that the inside buyer knows that the outside buyer's reservation values will be either $115 or $150; whereas 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, that the outside buyers can infer the inside buyer's valuation of $120, while the substantive analysis will remain the same, in the case with unlimited match right, the inside buyer will benefit while the target will suffer. In that case, if the outside buyer has a valuation of $115, rather than triggering an auction, it will simply decline to participate. This will allow the inside buyer to acquire the target at $110 (rather than at $115).

[128] As we saw in Part II, allowing the buyer to match a third party's offer only once seems to be the most common type of limited match right. We have not been able to find a real-life example where a limited match right allowed the buyer to match more than once.

out of luck and the target will be sold to the new buyer.[129] 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 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 \$150 (which, as assumed, happens with 30% probability). The outside buyer ($B3$) will start the competition by making an offer that is slightly higher than the initial price of \$110 (say \$111). 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 \$150 buyer ($B3$) will be able to acquire the target. Given that the initial buyer ($B1$) values the target at \$120, the initial buyer's "matching" offer will be below its reservation value of \$120 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 and $B1$ makes a "matching" bid of \$117. $B3$ will be able to now purchase the target by offering \$118. The bottom line is that when the outside buyer's reservation value is \$150, (1) the target will always be sold to the outside buyer; and (2) the final sale price will be (at least weakly) lower than the initial buyer's reservation value (\$120 million).

What if the outside buyer's reservation value is, instead, \$115? Just like the outside buyer with \$150 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. From the initial buyer's perspective, it does not know whether the topping bid is coming from the buyer with \$150 valuation or \$115 valuation. But, it does know that if it were coming from the buyer ($B3$) with \$150 valuation, it will lose the bidding for certain, whereas if it were coming from the buyer ($B2$) with \$115 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. By doing so, the initial buyer ($B1$) retains the chance of winning the auction in at least 20% of the time. When the initial buyer bids at slightly above \$115 (say, \$116), the \$150 valuation buyer ($B3$) will top that bid (with, say, \$117) while the \$115 buyer ($B2$) will decline to increase its bid above \$115.[130]

[129] We are, of course, taking a simplified and stylized view of how match rights work for the purposes of presenting a simple numerical example. See *supra* Part II.A for a more detailed legal analysis.

[130] 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 and \$150, 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 if the outside bid is anywhere between \$110 and \$115 and (2) bid slightly above any outside bid above \$115 so long as the outside bid is below \$120. Third, turning to the initial stage, the optimal strategy for $B2$ and $B3$ is to submit the initial bid between \$110 and \$115. So, in a pooling equilibrium, both $B2$ and $B3$ submit the initial bid that is between \$110 and \$115; $B1$ submits a matching bid slightly above \$115; $B3$ comes back with a bid slightly above $B1$'s matching bid; and $B2$ drops out after observing $B1$'s matching bid.

3. Unlimited Match Right

Now, suppose the initial buyer is given an unlimited match right ($M = \infty$). That is, whenever an outside buyer were to revise its initial offer, the initial buyer will be able to come back and "match" the revised offer. Unlike the case with a limited match right, with an unlimited match right, the initial buyer and the outside buyer will be on an 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, knowing that both parties will be able to continue matching the other's bid, the topping bid will start at a little above \$110[131] and will continue rising until one bidder decides to drop out.[132] For instance, if the outside buyer's ($B2$'s) valuation for the target is

[131] If the third party buyer knew (1) how much the initial buyer valued the target; and (2) the initial buyer's valuation is larger than the third party's valuation, the third party will not trigger the bidding competition. See Subramanian and Zhao (2020) at 1234 (stating that "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), 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.

[132] Given that we can replicate an unlimited match right using an English auction, the "winner's curse" problem will likely disappear. As a matter of background, a winner's curse problem can occur when the bidders' valuations are "interdependent" and the bidders are competing in a sealed-bid first price auction. By "interdependence," we mean that each bidder does not know the true value of the asset (the target) and gets only a signal about its value. When the bidders are competing in a sealed-bid first price auction, the fact that one has won the auction (without knowing others' signals) implies 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). In an English auction, by contrast, as the bid gradually rises, bidders get to observe other bidders' behavior, from which each bidder can infer what type of signal the others have gotten. See Krishna (2002) at 84—85. Now, of course, even in a sealed-bid first price auction, if the bidders are rational, they would shade their bids so as to avoid the winner's curse problem. This, in turn, leads to a lower revenue for the seller. Id. By contrast, because this informational issues are mitigated in an English auction, the seller will be able to get a larger revenue. Id. at 90—92 and 96—100.

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 75 and the surrounding discussion. 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 one-time 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, per se, does not 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 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 realize 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.

\$115, the initial buyer ($B1$), with a higher valuation of \$120, 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. The inside buyer wins the auction process at a price equal to (or slightly higher than) the outside buyer's ($B2$'s) reservation value of \$115. Similarly, when the outside buyer's ($B3$'s) valuation is \$150, 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.

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 outside buyer ($B2$), the target gets sold to the existing buyer at \$115; and with \$150 outside buyer ($B3$), the target gets sold to the outside buyer at \$120. Since the target is being sold to the buyer with the higher valuation, unlike in the case with a limited match right, there would be 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 \$150, because the initial buyer ($B1$) was matching the bid at (slightly above) \$115, the target was being sold to the outside buyer at a price strictly below the initial buyer's valuation of \$120. By contrast, with an unlimited match right, the target gets sold to the outside buyer ($B3$) at the inside buyer's valuation of \$120. 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 is either \$150 or \$115. 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 outside buyer's ($B2$'s) stand-alone profit will be higher when the inside buyer has a limited, rather than unlimited, match right.

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

The third point is with respect to information rights. According to Kling and Nugent, 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 (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 purchase may have." 1 Lou Kling and Eileen Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions §4.04[6][b] at 4-93 (1992 & Supp. 2019). The presence of such information right will also likely eliminate (or substantially reduce) the initial buyer's informational advantage. See also Quinn (2011) (discussing various information rights given to the third party bidder so as to reduce the problem of information asymmetry).

Foremost, suppose the outside buyer's valuation can range anywhere between $110 and $150, the inside buyer has a limited match right ($M = 1$), and the outside buyer starts the bidding process at slightly above $110. Suppose also that the initial buyer ($B1$), 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, say, at $116. Unlike the case with two-point distribution (of either $115 or $150), now, any time the outside buyer's valuation falls between the initial buyer's ($B1$'s) matching bid (of $116) and the buyer's valuation (of $120), 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, after observing the initial buyer's matching bid of $116, the outside buyer will be able to come back with a more attractive bid of, say, $117, 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.

	Limited Match Right[133] ($P = \$110;\ M = 1$)	Unlimited Match Right ($P = \$110;\ M = \infty$)
Target's (S) Expected Profit (Res. Value = $100)	$12.5 million	$14 million
Initial Buyer's ($B1$) Expected Profit (Res. Value = $120)	$6 million (Likely lower with more general distribution)	$6 million
Target and Initial Buyer's Joint Profit	$18.5 million	$20 million
New Buyer ($B2$)'s Profit (Res. Value = $115)	$0 (Higher with more general distribution)	$0
New Buyer ($B3$)'s Profit (Res. Value = $150)	$35 million	$30 million
Possible Inefficient Sale of Target?	Yes	No

Table 2: Effect of a Match Right

Second, while the result will depend on the assumption on 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 can only be either $115 and $150, and with a limited match right, the inside buyer was matching the outside buyer's bid at (slightly above) $115, the expected profit of the inside buyer stayed the same at $6 million: with 50% chance, it acquires the target at $110 million (for a profit of $10 million) and

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

with 20% chance, it acquires the target at (slightly above) \$115 million (for a profit of \$5 million). But this is because the inside buyer knew exactly what $B2$'s valuation of the target is and managed to shut out $B2$ from winning the auction. If, for instance, the outside buyer's valuation were on a continuum between \$110 million and \$150 million, not only will the inside buyer's matching bid may 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 and \$120, the inside buyer is no longer guaranteed to win the bidding competition, it will likely reduce the inside buyer's stand-alone profit.[134]

Finally, under the current setup, where $B2$'s valuation is fixed at \$115, $B2$ is always shut out from being able to purchase the target (because of $B1$'s strategy of submitting the "matching" bid of \$115), but when $B2$'s valuation isn't fixed at \$115 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 million and \$120 million. Now, in response to $B2$'s starting the bidding process at \$110, $B1$ will submit a "matching" bid that is between \$110 and \$120 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 we compare these two deal protection devices, some interesting similarities and differences emerge. As we move from no termination fee to a positive 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 from 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, 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 its participation cost.

At the same time, there are some important differences between the two devices. Foremost, as we move from no termination fee to a positive termination fee, allocative efficiency suffers: the buyer ($B2$) with a valuation of \$125 was unable to participate in the auction even though it had a

[134] For instance, if $B2$'s valuation is uniformly distributed between \$110 and \$120 (while $B3$'s valuation is anywhere above \$120), it is fairly easy to show that the optimal strategy for the inside buyer is to submit a "match" bid of \$115. 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.

higher valuation than the initial buyer. By contrast, when we move from limited match right to an unlimited match right, allocative efficiency actually improves: by creating a more even playing field among the inside buyer and the outside buyer, an unlimited match right was creating an English auction like environment. The final 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 from a limited match right to an unlimited match right, the target's stand-alone expected profit actually increased.

Finally, we can also think about 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 implications. 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 be the case especially 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, the deal price is $110, and the termination fee is at $10, for instance, a third party buyer will enter the competition only when it values the target at more than $120, 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.[135]

IV. Corporate and Contract Law Implications for the Deal Protection Devices

The analysis in the previous Part has shown that, when properly structured, deal protection devices, such as a termination fee and a match right can enhance the joint expected return of the target and the inside buyer. But the issue of whether a deal protection device can enhance the target shareholders' return is more subtle. As we saw earlier, holding the initial deal price fixed, when the target agreed to a larger termination fee, the target's stand-alone profit would suffer while the inside buyer's expected return will benefit. By contrast, when the target to an unlimited match right, the target's stand-alone profit can increase while the effect on the inside buyer is more ambiguous. In both cases, the joint profit of the target and the inside buyer went up as deal protection devices became 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 managers) of the target corporation would have to negotiate with the buyer to increase the deal price. As we saw earlier, by agreeing to a termination fee of $10 million while receiving a corresponding increase in the deal price from $110 million to $116 million, the target was able to realize a higher profit of $17.2 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,

[135] 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.

the issue is whether the target directors can receive further concession from the inside buyer. Nonetheless, the issue of extracting a bigger deal premium isn't as strong as the case with a large termination fee.

Ultimately, then, whether deal protection devices can benefit or harm the target shareholders depends on the target directors' and the officers' incentives. Properly incentivized directors and managers will utilize deal protection devices to increase the return for the target shareholders, while un-incentivized 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 benefit from promoting one buyer over another. There are a number of possible scenarios. For instance, the target directors and the officers may have been guaranteed of post-merger employment by the initial buyer.[136] 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 a financing agreement. Still other possibility is that the target directors and the officers, as investors or employees of the initial buyer, could receive direct pecuniary benefit from consummating the merger with the initial buyer. 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 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 at the detriment of reduced competition.[137]

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

Another dimension in which the directors' and the officers' incentive matters is with respect to the question of whether the court can use the deal price as 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 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 device. 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 even higher when a deal protection device is in place. With agents that are 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 also 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 price forced the outside buyer to pay the inside buyer's valuation to acquire the target, thereby producing a higher ex post deal price. In

[136] 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.

[137] 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.

short, when there is a topping bid and subsequent competition among the buyers, using the winning bid as evidence of fair value will substantially enhance the target shareholders' returns.[138] When the directors' and the 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 or unreliable in determining fair value of the target shares. In such a setting, it would be better for the court to require there being an actual competition among buyers before using the final deal price in assessing fair value. Table 3 presents the arguments in a tabular form.

	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

Table 3: Target Directors' Behavior and Its Implications

C. Contract Law Considerations

While the discussion so far has been focused on the issues under corporate law, deal protection devices also raise some interesting contract law problems. Given that the devices can discourage (or even prohibit) a new bidder from competing with the initial buyer and, when a new bidder does emerge, can reduce the new bidder's return, they can create an anti-competitive effect and impose a negative externality onto the new bidder (a non-contracting party). In that sense, a deal protection device, especially a large termination fee, functions like a non-compete agreement (between an employer and an employee) or an agreement to collude on price or exclude entry (such as 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.[139] Furthermore, especially with respect to termination fees, contract law prohibits the parties from liquidating damages that are unreasonably large based on public policy.[140] An unreasonably large liquidated

[138] See Choi and Talley (2018) 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).

[139] See Restatement (Second) of Contracts §§186 and 187. 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 non-compete agreements. According to the official commentary, "every 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."

[140] See Restatement (Second) of Contracts §356(1). According to the Restatement, "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 that allows the 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.[141] Given the difficulty of deciding whether a certain provision imposes an "unreasonable" restraint on trade or allows compensation that is unreasonably large, whether or not a certain deal protection device should be struck down under contract law should be determined on a case-by-case basis and based on facts and circumstances.

Regarding the termination fee, several factors can come into play. For instance, while practitioners often argue that the termination fee is necessary to compensate the disappointed buyer for all the expenses the buyer has incurred,[142] when an acquisition agreement also contains an expense reimbursement provision,[143] the presence of such a provision and the fact that the termination fee is much larger than the allowed expenses can make the argument that the termination fee is unreasonable stronger.[144] More generally, one of the concerns of allowing liquidated damages that are too large is that it can lead to allocative inefficiency.[145] To the extent that there is an even-handed auction, the concern over allocative inefficiency can be largely addressed. In that sense, a termination fee that is substantially larger than the expenses incurred can impede that objective. Another factor may be the market conditions or the target's bargaining

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damages is unenforceable on grounds of public policy as a penalty." This is known as the "anti-penalty" doctrine. See Alan Schwartz and Aaron Edlin, *Optimal Penalties in Contracts*, 78 Chicago Kent Law Review 101 (2003) and Robert Scott and George Triantis, *Embedded Options and the Case against Compensation in Contract Law*, 104 Columbia Law Review 1428 (2004). See also Brazen v. Bell Atl. Corp., 695 A.2d 43 (Del. 1997) (determining that the termination fee, as liquidated damages, was not in violation of the anti-penalty rule) and *supra* notes 107, 108, and the surrounding discussion.

[141] See Restatement (Second) of Contracts §356 Comment a (stating that "the central objective behind the system of contract remedies is compensatory, not punitive"). See also Restatement (Second) of Contracts §355 Comment a (stating that "the purpose of awarding contract damages is to compensate the injured party").

[142] See *Brazen* 695 A.2d at 48—49 (stating that, according to the defendants, 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 agreement, discussed in *supra* Part II.B.

[143] See ABA Model Merger Agreement section 7.3. For instance, when the deal fails to close because the target consummates a deal with a different buyer or the target board changes it 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)" (italics added).

[144] An important consideration here is that when the target gets 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 110 and the surrounding discussion.

[145] One of the economic justification of expectation damages is that it facilitates allocative efficiency (the "efficient breach theory"): contract will be breached when doing so will generate more surplus. 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 we allow for 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.

power.[146] When the acquisition market is very seller friendly or when the target has a strong bargaining power, so that the deal price is close to the initial buyer's reservation value (and the initial buyer's expected profit is small), imposing even a moderate amount of termination fee (that is larger than the size of the expense reimbursement) can generate inefficiency. At the opposite end of the spectrum, when the target has weak bargaining power or the market is buyer friendly, even a relatively large termination fee will not generate an inefficiency.

	Possible "Unreasonable" Restraint of Trade?	Possible Over-Compensation of Disappointed Buyer?
A Small Termination Fee	No	No
A Large Termination Fee	Yes	Yes
Limited Match Right	Unlikely[147]	No
Unlimited Match Right	No	No

Table 4: Contract Law Implications of Different Deal Protection Devices

For a match right, since the right does not deal with the issue of compensation, the core concern, rather, is whether the right can impose 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 outside buyer's expected return but, at the same time, to increase the chances that the target will be bought by the buyer that places a higher valuation. From the 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.[148] An unlimited match right, by contrast, does not, in general, unreasonably restrain trade (or competition for the target between the inside buyer and third parties). In sum, while both termination fees and unlimited match rights are likely to reduce a third-party buyer's expected return, unlimited match rights facilitate allocative efficiency while termination fees do not.

Concluding Remarks

Deal protection devices, such as termination fees and match rights, provide more confidence to the buyer to be able to close the deal and have been in the mergers and acquisitions

[146] 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* note 118. When the acquisition market is very seller friendly or when the target has a strong bargaining power, so that the deal price is close to the initial buyer's reservation value and the initial buyer's expected profit is small, imposing even a moderate amount of termination fee (that is larger than the size of the expense reimbursement) can generate inefficiency. At the opposite end of the spectrum, when the target has weak bargaining power or the market is buyer friendly, even a relatively large termination fee will not generate an inefficiency.

[147] See *supra* note 148.

[148] 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 third party buyers, one could conceptualize it as something akin to a non-compete agreement, although, of course, the analogy is not exact since a non-compete clause kicks in after the initial relationship has been terminated.

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 the termination fees and the match rights. In an influential opinion, for instance, the Delaware Chancellor has called them "common contractual" features.[149] While most deal protection devices have been scrutinized within the frame of target directors' fiduciary duty, most recently, in the midst of heated controversy over whether the court should use the deal price as an indicator of fair value in an appraising proceeding, the Delaware Chancery Court has pointed to the presence of such devices as undermining the usefulness of the deal price as relevant evidence.

This paper has attempted to examine (or re-examine) 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 the court away from using the deal price as evidence of fair value in an appraisal proceeding. Applying a simple auction theory, the paper has shown that deal protection devices can function as a contractual externality mechanism that allows the contracting parties to realize a higher joint return by extracting rent from a non-contracting party. While both match rights and termination fees can function as a rent extraction mechanism, their incidence and effect can differ. An unlimited match right, compared to a limited match right, will do better not only in enhancing target's return but also in making sure that the target gets sold to the buyer with a 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 a 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.

Properly utilized, deal protection devices can enhance the return for the target shareholders. Improperly used, on the other hand, they can (substantially) undercut target shareholders' interest. Therefore, whether they do or do not enhance the target shareholders' interest depends on the motives and the behavior of the target directors and managers who are agreeing to such mechanisms. The paper 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, the presence of them can undercut the evidentiary value of the deal price as fair value. Finally, the paper has argued 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 the public policy. Particularly when the target corporation has agreed to reimburse the buyer's (out-of-pocket) expenses in case the deal falls part, the deal protection measures (especially a generous termination fee) should trigger a stronger scrutiny by court for their harmful public policy (negative externality) implications.

[149] See *In re Toys R Us*, discussed in *supra* Part I.A.