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Re-Evaluating the Emerging Standard of Review for Matching Rights in Control Transactions

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RE-EVALUATING THE EMERGING STANDARD OF REVIEW FOR MATCHING RIGHTS IN CONTROL TRANSACTIONS

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ABSTRACT

In recent years courts have taken a permissive approach to matching rights, viewing them as standard features in merger agreements. Matching rights are deal protection devices intended to give the rightholder assurance that the deal will be completed, consequently these measures can deter subsequent bidders and, in the event a subsequent bid appears, ensure that the initial bidder is advantageously positioned to succeed. This Article argues that courts should re-evaluate the emerging legal standard governing the use of "matching rights" in merger agreements.

Plaintiffs have brought challenges to the use of matching rights in various circumstances. Until now, however, courts have refused to acknowledge that there might be circumstances in which matching rights are preclusive deal protections and therefore unreasonable. Consequently, the emerging legal standard with respect to matching rights is one of permissiveness. In fact, there are circumstances in which one can expect matching rights to be potentially powerful deterrents to second bidders. In such circumstances, the use of matching rights may be unreasonable.

Courts should employ the same fact-intensive review to the use of matching rights that they employ with respect to other deal protection measures. Once sensitized to the specific deterrent effects of matching rights, courts should more closely scrutinize the use of matching rights, particularly when the right-holder is a financial buyer or the sales process demonstrates characteristics of a common value sale.

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I. INTRODUCTION

This Article argues that courts should re-evaluate the emerging legal standard governing the use of "matching rights" in merger agreements. Matching rights are a deal protection device intended to either deter second bidders or ensure that, a second bid having appeared, the initial bidder will be advantageously positioned to succeed in completing the acquisition.[1] In takeover jurisprudence, deal protection devices are subject to an intermediate standard of review.[2] Boards can remain faithful to their fiduciary obligations when they grant potential acquirers these protections, provided such protections are "proportionate and 'reasonable in relation to the threat posed.'"[3] While the courts have been explicit in their application of the intermediate standard to certain types of deal protection mechanisms, like

[1]*See* Brian JM Quinn, *Bulletproof: Mandatory Rules for Deal Protection*, 32 J. CORP. L. 865, 870-71 (2007).

[2]*See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1372 (Del. 1995) (quoting Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992)).

[3]*See id.* at 1379.

termination fees,[4] in recent years they appear to have adopted a more permissive posture with respect to matching rights.[5]

Although matching rights are subject to intermediate scrutiny in practice, courts appear to apply only a cursory review of the use of matching rights as deal protections.[6] This may be because the seemingly binary nature of matching rights often makes it difficult for courts to engage in the same kind of nuanced reasonableness analysis they regularly employ in the analysis of other deal protections, like termination fees. Or perhaps, indiscriminate pleading by plaintiffs' counsel has caused courts to become inured to the potential costs to shareholders, when a selling board grants initial bidders matching rights. In any event, the evidence from recent rulings is that courts view matching rights as no more than common or customary deal terms, mere boilerplate, and not a serious deterrent to subsequent bids.[7] While such terms are in fact commonly found in merger agreements, they nevertheless have potentially powerful disincentive effects that deserve close scrutiny. If not, transactional lawyers may misinterpret the court's current dismissiveness of plaintiffs' matching right arguments for the adoption of a new, bright-line rule favoring the use of matching rights in the sale of control context.

The economic literature on the incentive effects associated with matching rights suggests that intermediate scrutiny is an appropriate approach to evaluating the use of matching rights.[8] In certain circumstances, the presence of matching rights may deter some subsequent, higher-valuing, bidders and thereby be preclusive.[9] In such circumstances, matching rights can result in outcomes that are inefficient and undesirable. In other circumstances, matching rights will not necessarily prevent an efficient allocation of the seller to its highest and best use, but the presence of matching rights can have an impact on the distribution of the surplus generated in the transaction.[10] In such situations, matching rights can have the effect of shifting transaction surplus from the seller to the right-holder. In that case, such a result may place directors at odds with their fiduciary

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[4]Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 49 (Del. 1994) (discussing that termination fees and no-shop provisions are subject to enhanced scrutiny by the judiciary).

[5]*See In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1017 (Del. Ch. 2005) (noting that matching rights are a "common contractual feature").

[6]*Id.*

[7]*Id.*

[8]*See infra* Part III.

[9]*See infra* Part IV.

[10]David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 20-21 (Spring 1999) (discussing how a right of first refusal impacts multiple bidders in an auction).

duties in the context of a sale of control. In both cases, however, it is clear that matching rights are not altogether benign contract terms.

Nevertheless, there are reasonable and valid uses for matching rights. For example, matching rights can be a valuable tool for sellers to engage potential acquirers. Because the presence of a matching right may reduce the costs of uncertainty for an initial bidder and thus the right may prompt an initial bidder to make the transaction-specific investments required to prepare an initial bid.[11] Such rights can also be useful in ending a played-out process of shopping a company or a bidding contest. Sellers' boards, however, must remain attentive to the potential power of matching rights to deter subsequent bidders, as well as their potential negative distributive impacts on shareholder value at a point in the corporate life when the board is charged with securing the highest price reasonably available for selling shareholders.[12] For their part, courts should be attentive to the potential power of these common contractual provisions. Rather than take a dismissive approach to their use, courts should subject board decisions to grant matching rights the same highly contextualized analysis that courts bring to bear when analyzing other deal protection measures. Of course, while the general framework of analysis is the same for a matching right as it is for other deal protections, the economic incentives associated with matching rights suggest that courts need to focus on different attributes of the matching right and transaction structure to determine the reasonable bounds of their use.

In Part II, this Article places matching rights in context by describing them as they appear in merger agreements in their various forms. Part III provides a brief overview of the conclusions one can draw from the academic literature on the competitive effects of matching rights. In particular, it notes how the profile of the right-holder affects questions of allocative efficiency and distributional fairness. In Part IV, this Article describes the approach taken by courts in their evaluation of the use of matching rights in merger agreements. It then contrasts this permissive approach with the highly contextualized approach taken by courts when

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[11]Of course, sellers can use a properly priced termination fee to accomplish this same result and need not unnecessarily rely on a "belt-and-suspenders" approach to coaxing out an initial bid from a hesitant acquirer. *See, e.g.*, *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 502 (Del. Ch. 2010) ("[I]n an effort to entice an acquirer to make a strong offer, it is reasonable for a seller to provide a buyer some level of assurance that he will be given adequate opportunity to buy the seller, even if a higher bid later emerges.").

[12]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (in a sale of control context "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.").

evaluating the use of other deal protection measures, such as termination fees. Part V offers a series of considerations that courts might take into account when articulating a reasonableness standard for matching rights. It then attempts to provide both courts and transactional lawyers with a contextual framework for distinguishing circumstances where matching rights may be no more than standard boilerplate from circumstances where they may be preclusive and have potentially adverse effects on selling shareholders.

II. MATCHING RIGHTS IN MERGER AGREEMENTS

Matching rights are, by now, ubiquitous terms in merger agreements.[13] They come in multiple forms, but all share two common attributes: time and information. Matching rights work to create a cushion of time before a seller is permitted to terminate the merger agreement with the right-holder to pursue a superior offer.[14] Matching rights also provide right-holders with detailed information about the substance of any competing bid.[15] By providing the right-holder with information about competing bids and the time with which to determine whether or not to meet the second bid, matching rights place the right-holder in a superior position relative to second bidders. It is this superior position, with respect to both information and time, that is valuable to right-holders and potentially preclusive to second bidders.

Common matching rights include information rights, advance notice requirements prior to termination of the merger agreement, and notification of any adverse change in the selling board's recommendation or of its undertaking consideration of a subsequent offer.[16] All of these forms are implicit matching rights. Matching rights also include explicit rights to match subsequent offers and requirements that the seller engage in a good faith negotiation process with the right-holder.[17] In general, each of the different forms of matching rights work to generate a significant time delay

[13] *See In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1017 (Del. Ch. 2005) (noting that matching rights are a "common contractual feature").

[14] *See, e.g.*, Mentor Graphics Corp., General Statement of Acquisition of Beneficial Ownership (Form SC-13D) [hereinafter Mentor Graphics Agreement], at Exhibit 2, Section 7.1.6 (May 2, 2002).

[15] *Id.* at Exhibit 2, Section 5.4.2.

[16] *Id.* at Exhibit 2, Section 5.4.2 & 7.1.6; *see also* NovaMed, Inc., Current Report (Form 8-K) [hereinafter NovaMed Agreement], at Exhibit 2.1, Section 4.2(b) (Jan. 26, 2011).

[17] *See, e.g.*, Mentor Graphics Agreement, *supra* note 14, at Exhibit 2, Section 7.1.6; *see also* NovaMed Agreement, *supra* note 16, at Exhibit 2.1, Section 4.2(b).

between the point at which a subsequent bidder presents a potentially superior offer and the point in time when a seller may accept that offer. During that intervening period, the right-holder has the opportunity, either explicit or implicit, to match a subsequent bidder's offer and prevent the seller from accepting the subsequent bid.[18] In effect, a matching right makes every subsequent bidder a stalking horse.[19]

Information rights are the weakest form of matching rights. Information rights are best understood as implicit matching rights. Such rights provide that sellers will share information about subsequent bids with the initial bidder in the event a second bidder appears.[20] In essence, information rights permit the right-holder to sit at the table while the seller negotiates alternate offers with second bidders. The effect of information rights is to give initial bidders complete information about competing bids in near real time, thereby allowing the right-holder sufficient time to evaluate competing offers and prepare a counter-offer should she wish to pursue one. Information rights do not necessarily require the seller to engage the right-holder in additional negotiations. Rather, they rely on the seller's fiduciary duties to ensure that in the event the right-holder wishes to match or exceed a competing bid, the seller's board will consider the right-holder's amended offer before terminating the initial transaction.[21]

Merger agreements also include other implicit matching rights. As with information rights, these other implicit matching rights function as circuit-breakers and prevent a hasty termination of the merger agreement in

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[18]*See, e.g.*, *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 501-02 (Del. Ch. 2010) (noting that the matching rights in this case gave the initial bidder "five days to match or exceed any offer the Board deems to be a Superior Proposal").

[19]*See, e.g.*, *In re* Smurfit-Stone Container Corp. S'holder Litig., 2011 WL 2028076, at *21 (Del. Ch. May 20, 2011) (noting that a stalking horse is an initial bid that is designed "to draw others into a bidding war").

[20]*See, e.g.*, Mentor Graphics Agreement, *supra* note 14, at Exhibit 2, Section 5.4.2.

[21]The Mentor Graphics Agreement includes a typical information rights provision:

> The Company shall immediately advise Parent of any inquiry received by it relating to any potential Acquisition Proposal and of the terms of any proposal or inquiry, including the identity of the person and its affiliates making the same, that it may receive in respect of any such potential Acquisition Proposal, or of any information requested from it or of any negotiations or discussions being sought to be initiated with it, shall furnish to the [Parent] a copy of any such proposal or inquiry, if it is in writing, or a written summary of any such proposal or inquiry (as well as of any additional information received by the Company with respect to an Acquisition Proposal), if it is not in writing and shall keep Parent fully informed on a current basis with respect to the status of any such negotiations or discussions and any developments with respect to the foregoing.

Id.

favor of a subsequent bidder.[22] Like information rights, advance notice provisions rely on the implicit force of the seller's fiduciary obligations to ensure that the right-holder has a final opportunity to match any subsequent bid, prior to a seller terminating the merger agreement. These advance notice provisions are typically found in one of three places: (1) the board recommendation, (2) the fiduciary termination right, or (3) the non-solicitation provision.[23] When tied to the board recommendation, such provisions may require that the seller inform the right-holder of its intention to change its recommendation and then wait *x* days before doing so. When tied to the fiduciary termination right, sellers are permitted to terminate the transaction to pursue superior offers, but only after having provided the seller with *x* days prior notice.[24] When found in the non-solicitation provision, sellers are permitted to negotiate with or respond to an unsolicited offer only after providing the right-holder with the specified number of days advance notice of their intent to engage in negotiations.[25] The effect of advance notice provisions, which may also be cumulative, is to create space and time for negotiation by preventing a seller from immediately terminating the transaction with the right-holder in order to pursue an alternative transaction. Neither advance notice provisions nor information rights create contractual rights for the right-holder to match any subsequent offer. However, when combined with a seller's fiduciary obligation in the sale of control context,[26] they do create a real opportunity for the right-holder to match any subsequent bid.

The final form of matching rights is the explicit contractual right or the good faith negotiation right. In their strongest form, these explicit matching rights provide the right-holder with a contractual right to match or exceed the terms of any subsequent bidder's offer.[27] Such provisions may also include requirements that the seller engage in good faith negotiations with the right-holder for a period of time such that the competing bid no

[22] *See, e.g.*, *id.* at Exhibit 2, Section 7.1.6.

[23] Mentor Graphics also includes an advance notice provision, allowing termination of the agreement "[b]y the Company if the Company Board determines to accept a Superior Proposal, but only after the Company (A) provides Parent with not less than five business days' notice of its determination to accept such Superior Proposal, including all terms thereof . . . ." Mentor Graphics Agreement, *supra* note 14, at Exhibit 2, Section 7.1.6.

[24] *See id.*

[25] *See, e.g.*, NovaMed Agreement, *supra* note 16, at Exhibit 2.1, Section 4.2.

[26] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (noting that in a change of control context a board's duty becomes "the maximization of the company's value at a sale for the stockholders' benefit").

[27] *See, e.g.*, *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 501-02 (Del. Ch. 2010).

longer constitutes a superior proposal.[28] By requiring sellers to engage with the right-holder, the explicit matching right ensures that the right-holder will always have the final opportunity to accept a subsequent bidder's offer.

A review of merger agreements for the period January 2002 to December 2006, available in the SDC Thomson Mergers and Acquisitions database, reveals just how common the various forms of matching rights are in acquisitions.[29] Some form of matching right was present in just over

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[28]Mentor Graphics included the following explicit match right in its acquisition agreement with Innoveda, allowing termination:

> By the Company, if the Company Board determines to accept a Superior Proposal, but only after the Company . . . (B) within the not less than five business day period referred, the Company has and has caused its financial and legal advisors to, negotiate with Parent to make such adjustments in the terms and conditions of this Agreement with the goal of enabling the Company to proceed with the transactions contemplated hereby . . . .

Mentor Graphics Agreement, *supra* note 14, at Exhibit 2, Section 7.1.6.

NovaMed included the following explicit matching right in its acquisition agreement with Surgery Center Holdings:

> No Adverse Recommendation Change or termination of this Agreement pursuant to this Section 4.2(b) may be made unless (A) the Board of Directors shall have first provided prior written notice to Parent that it is prepared to (I) effect an Adverse Recommendation Change (an "Adverse Recommendation Change Notice") or (II) terminate this Agreement pursuant to this Section 4.2(b) in response to a Superior Proposal (a "Superior Proposal Notice"), which notice shall contain a description of the material terms and conditions of such Superior Proposal (including the identity of the bidder and a copy of the definitive Acquisition Agreement for such Superior Proposal in the form to be entered into), together with any information required to be delivered to Parent concurrently therewith pursuant to Section 4.2(a) and (B) Parent does not make, within three Business Days after the receipt of such notice (the "Notice Period"), a proposal that would, in the reasonable good faith judgment of the Board of Directors of the Company (after consultation with its outside legal counsel and financial advisor), cause the offer previously constituting a Superior Proposal to no longer constitute a Superior Proposal. The Company agrees to negotiate in good faith with Parent during any Notice Period to allow Parent to match or better any Superior Proposal (as amended). Any changes to the financial terms or any change to other material terms of such Superior Proposal occurring prior to the Company's effecting an Adverse Recommendation Change or terminating this Agreement pursuant to this Section 4.2(b) shall require the Company to provide to Parent a new Adverse Recommendation Change Notice or Superior Proposal Notice and a new Notice Period and to comply with the requirements of this Section 4.2(b) with respect to each such new written notice.

NovaMed Agreement, *supra* note 16, at Exhibit 2.1, Section 4.2(b).

[29]A review of cash transactions greater than $75 million and excluding transactions in bankruptcy, transactions for less than 100% interests, all hostile or unsolicited offers, and transactions involving a controlling shareholder, provides a sample of 331 transactions. SDC Platinum, Thomson Reuters Financial Database, http://thomsonreuters.com/products_services/financial/financial_products/a-z/sdc/.

ninety-nine percent of all transactions in the sample.[30] Simple information rights, the weakest form of matching right, were present in approximately ninety-eight percent of all transactions in the sample.[31] Seventy-five percent of transactions in the sample had some form of notice requirement in advance of a change in the seller's board recommendation.[32] Less common, but still found widely, were provisions providing advance notice ahead of negotiations with third parties (twenty-one percent) as well as provisions providing advance notice ahead of termination (twenty-eight percent).[33] Forty-one percent of transactions in the sample provided the right-holder with an explicit right to match any superior offer, while fifty-four percent of transactions included a requirement that the seller negotiate in good faith with the right-holder in the event the seller received a superior offer.[34] Many transactions relied on multiple combinations of protection through a belt-and-suspenders approach to matching rights, examples include information rights and advance notice provisions as well as explicit matching rights.

The ubiquity of matching rights, in their various forms, begs the question: what purpose do they serve? On the one hand, such provisions may be no more than mere boilerplate provisions found in all merger agreements with no meaningful effect and not worthy of analysis.[35] This is the general approach that courts have adopted towards these rights—that they are surplus and not language with any real economic effect.[36] A board reading recent court rulings might not be faulted if, in good faith, it misinterprets the court's permissive approach to matching rights as admitting a per se validity of such provisions. On the other hand, it is precisely because these provisions are ubiquitous that they deserve closer scrutiny. It may well be that these rights find themselves in most agreements because they are *not* mere surplus. To that end, it may be that they have preclusive effects that need to be accounted for in the legal doctrine. Absent a more contextualized approach to analyzing matching rights in the context of a sale of control, it is possible that a board, acting in good faith, could mistakenly grant unreasonable defensive measures.

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[30] *See infra* Appendix.
[31] *See infra* Appendix.
[32] *See infra* Appendix.
[33] *See infra* Appendix.
[34] *See infra* Appendix.
[35] *See In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1017 (Del. Ch. 2005) (noting that matching rights are a "common contractual feature").
[36] *Id.*

III. THE ECONOMIC EFFECTS OF MATCHING RIGHTS AND DEAL PROTECTIONS

Deal protection measures, like termination fees, stock lockups, and matching rights among others, have been the subject of much study.[37] Such measures may be highly problematic. When granted to initial bidders, deal protections can have the effect of inducing a potential bidder to move from indifference to making a bid and in that way increase joint value.[38] On the other hand, when deal protections granted to initial bidders are excessive, potentially higher-valuing subsequent bidders may be deterred from entering into a bidding contest.[39] The ultimate outcome may be that the seller ends up in the hands of a lower-valuing bidder, resulting in an inefficient allocation of resources; or, excessive protections may result in a distribution of transaction surplus away from selling shareholders at a point in the corporate life when directors have a special obligation to be concerned with the distributional effects of a sale.[40] Legal standards play an important role in finding the proper balance between the level of deal protections sufficient to induce an initial bid and those that preclude the corporation from ending up in the hands of a higher-valuing subsequent bidder.

Termination fees, stock lockups, and topping fees, among others, fall into a general category of deal protections that are compensatory in nature.[41] These deal protections have dual functions: they compensate initial bidders for the opportunity costs of their bidding and, when large enough, they work

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[37] *See* Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 683 (1990); John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 310-13 (2000); Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1904-06 (2003); Micah S. Officer, *Termination Fees in Mergers and Acquisitions*, 69 J. FIN. ECON. 431, 432-33 (2003); Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 932-33 (2001).

[38] Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1547 (1996).

[39] *See, e.g.*, Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 49 (Del. 1994) (noting that the excessive deal protections in this case made the company "less attractive to other bidders").

[40] In the last period of play, the directors have an obligation not necessarily to seek the most economically efficient transaction, but rather seek the transaction that results in the highest possible percentage of the surplus generated in the transaction to the selling shareholders. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.").

[41] Quinn, *supra* note 1, at 871 (describing the various categories of compensatory deal protection devices).

to deter subsequent bidders.[42] The compensatory function is a common rationalization for the use of termination fees in merger agreements.[43] Unless the initial bidder has sufficient assurances that it will be able to consummate the proposed transaction, bidders may be dissuaded from undertaking the transaction-specific investments required to generate a bid and otherwise valuable transactions might not go forward. Compensatory devices are required to cover the initial bidder's transaction-specific search costs.[44]

Compensatory devices can play an important role in inducing an initial bidder to make the transaction-specific investments required to make a bid on a potential target.[45] When the size of the termination fee or stock lockup is set at reasonable levels, roughly equivalent to the opportunity costs of the initial bidders, initial bidders should be indifferent with respect to the prospect of a subsequent bidding contest.[46] Termination fees often play this role in the bankruptcy setting by compensating the bid costs of a stalking horse bidder in order to generate a competitive sale of the corporation.[47] When reasonably priced, termination fees and stock lockups can generate real value for shareholders.[48] Termination fees or stock lockups can be used by selling boards to induce second bidders to participate in an auction.[49] If used as incentives to bring second bids, compensatory devices can play an

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[42] *Id.*

[43] *See, e.g.*, Thomas A. Swett, *Merger Termination Fees After* Bell Atlantic*: Applying a Liquidated Damages Analysis to Termination Fee Provisions*, 70 U. COLO. L. REV. 341, 355 (1999).

[44] Such costs include those of identifying and evaluating potential targets and putting together a valuable bid. *Id.*

[45] *See* Ayres, *supra* note 37, at 698 (analyzing the incentive effects of stock lockups); Kahan & Klausner, *supra* note 38, at 1547 (arguing that lockups can increase a bidder's profit and hence induce a party to bid).

[46] *See* Kahan & Klausner, *supra* note 38, at 1548.

[47] *See, e.g.*, Paul B. Lackey, *An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 COLUM. L. REV. 720, 722 (1993) (discussing the use of termination fees as bidding incentives).

[48] *See* Timothy R. Burch, *Locking Out Rival Bidders: The Use of Lockup Options in Corporate Mergers*, 60 J. FIN. ECON. 103, 110 (2001); *see also* Thomas W. Bates & Michael L. Lemmon, *Breaking Up is Hard to Do? An Analysis of Termination Fee Provisions and Merger Outcomes*, 69 J. FIN. ECON. 469, 499-501 (2003) (noting that lockups and termination fees are associated with higher returns for selling shareholders).

[49] When used to induce a second bidder, the seller agrees to pay the bidding costs of a second bidder in the event a bidder enters a bidding contest and is unsuccessful. Although such strategies are common in other settings, in real-world mergers and acquisitions such strategies are rare. Kahan & Klausner, *supra* note 38, at 1552-53; *see also* Yeon-Koo Che & Tracy R. Lewis, *The Role of Lockups in Takeover Contests*, 38 RAND J. ECON. 648, 650 (2007) (noting that without a lockup "a second buyer may not compete against a better-informed first bidder").

important role in encouraging the efficient allocation of resources and increase value for selling shareholders.[50]

Though compensatory devices can have the salutary effects described above, when excessive, they can also have potentially adverse effects. When termination fees and stock lockups are sufficiently large, they may deter second bidders from participating in a bidding contest.[51] It is the potential deterrent power of these compensatory deal protections that gives them force as deal protection measures.[52] The deterrent potential of excessively large termination fees is well understood and serves as a primary motivation for the legal constraints on their use in the context of a corporate sale.[53] Where such fees become so large as to preclude second bidders, they may be unreasonable and invite intervention from the courts.[54]

While termination fees and stock lockups are compensatory in nature, matching rights are not intended to provide direct compensation for a jilted initial bidder. Rather, matching rights serve an exclusivity function.[55] The matching right's exclusivity function provides the right-holder with a degree of assurance that its transaction-specific investments will not be lost because the seller is constrained in its ability to use the initial bid to shop for a higher offer.[56] By assuring the initial bidder always has a last look, matching rights are a contractual means by which parties attempt to manage "foreseeable, but unpredictable, changes in business relationships," specifically the foreseeable, but unexpected, appearance of a second bidder.[57] By maintaining the exclusivity of the relationship between the right-holder and the seller, the matching rights raise the probability that the right-holder's bid will succeed.[58]

Because matching rights put the right-holder in a preferred informational position relative to subsequent bidders, such rights can place

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[50]Kahan & Klausner, *supra* note 38, at 1553.

[51]*Id*. at 1548 n.28.

[52]Quinn, *supra* note 1, at 870.

[53]*See, e.g.*, McMillan v. Intercargo Corp., 768 A.2d 492, 505-06 (Del. Ch. 2000); *see also* Coates & Subramanian, *supra* note 37, at 331 (discussing the increased usage and size of termination fees); Shmuel Leshem, *A Signaling Theory of Termination Fees in Mergers* 3 (Am. Law & Econ. Ass'n Annual Meetings, Working Paper No. 45, 2006) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=770388 (discussing the substantial effects termination fees have on the bidding process).

[54]*See In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 613 (Del. Ch. 2010).

[55]Quinn, *supra* note 1, at 870.

[56]*Id*.

[57]Walker, *supra* note 10, at 10.

[58]*See* Sushil Bikhchandani et al., *On the Right-of-First-Refusal*, 5 ADVANCES THEORETICAL ECON. 1, 10 (2005).

subsequent bidders at a significant disadvantage and thereby deter subsequent bids.[59] The work of theoretical economists with respect to the incentive effects of matching rights provides insights into situations where one can expect subsequent bidders to be the most disadvantaged.[60] More important from the perspective of sellers, economists point out situations where sellers should expect the presence of a matching right to work to their disadvantage with respect to the distribution of the joint gains from a transaction with the right-holder.[61] In particular, the nature of the sales process and the bidders has an effect on the potential deterrent impact of a matching right and the distribution of transactional surplus a seller can expect when granting one.[62]

First, however, there are circumstances in which one can expect a matching right to generate joint value for the right-holder and the seller.[63] To the extent a matching right induces a bidder to make an initial bid, the matching right can create joint value for both the right-holder and the seller.[64] The joint value created by the right is equal to the right-holder's private valuation of the seller, with those benefits distributed to the right-holder in the amount equal to the difference between the right-holder's private valuation and the price offered by the right-holder for the seller.[65] The right-holder will exercise her right only in the event a second bidder offers a higher price than the right-holder's initial bid, but lower than the right-

[59] Quinn, *supra* note 1, at 870.

[60] *See* Walker, *supra* note 10, at 17-18; Jeremy Bulow & Paul Klemperer, *Why Do Sellers (Usually) Prefer Auctions?*, 99 AM. ECON. REV. 1544, 1566 (2009).

[61] Although theoretical work with respect to the incentive effects of matching rights is still nascent, there is a growing interest in this question. *See* Marcel Kahan et al., *Rights of First Refusal* 11 (N.Y.U. Ctr. for Law, Econ. and Org., Working Paper No. 07-42, 2007) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1029313; Leandro Arozamena & Federico Weinschelbaum, *A Note on the Suboptimality of Right-of-First-Refusal clauses*, 4 ECON. BULL. 1, 4 (2006); Bikhchandani et al., *supra* note 58, at 2; Bulow & Klemperer, *supra* note 60, at 1566; Albert H. Choi, *A Rent Extraction Theory of Right of First Refusal*, 57 J. INDUS. ECON. 252, 263 (2009); Brit Grosskopf & Alvin E. Roth, *If You Are Offered the Right of First Refusal, Should You Accept? An Investigation of Contract Design*, 65 GAMES & ECON. BEHAV. 176, 178 (2009); Hayley H. Chouinard, *Auctions With and Without the Right of First Refusal and National Park Service Concession Contracts*, 87 AM. J. AGRIC. ECON. 1083, 1087 (2005); R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699, 714 (1987); Walker, *supra* note 10, at 26; Marcel Kahan, *An Economic Analysis of Rights of First Refusal* 8 (NYC Ctr. for Law and Bus., Working Paper No. CLB-99-009, 1999) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=11382.

[62] *See* Walker, *supra* note 10, at 20-21.

[63] Choi, *supra* note 61, at 263.

[64] *See* Bikhchandani et al., *supra* note 58, at 25.

[65] *See* Kahan et al., *supra* note 61, at 14-15.

holder's private valuation for the seller.[66] In the event a second bidder appears with a higher private valuation for the seller and bids in excess of the right-holder's valuation, then the right-holder will not exercise her right.[67] In that event, the joint value will increase to equal the second offer. The effect of the second bid in this case is to improve the distribution of joint profits in favor of the seller.[68] Note that the distributional improvement is a function of the seller being able to attract an additional bidder and not the presence of the matching right per se.[69]

A. *Private Value Setting—Potential for Inefficient Allocation*

In the private value setting the seller does not have an objective value; rather, it has different, or private, values for each of the potential acquirers.[70] For example, transactions involving strategic buyers often resemble private value deals.[71] Strategic buyers often envision combining the seller's assets as complements with their own to generate synergistic value for the buyer.[72] Consequently, each bidder knows only her valuation of the seller and that value differs with each bidder.[73]

Although matching rights in private value settings create joint value for the right-holder and the seller, in some circumstances it is possible that the presence of a matching right could result in a lower joint profit than might be optimal and represent an inefficient allocation of the seller to less than the highest valuing bidder.[74] An inefficient allocation is possible in two ways. First, an inefficient allocation can occur when the highest valuing bidder does not have a *materially* higher private valuation of the seller than

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[66] *See* Walker, *supra* note 10, at 19.

[67] *See id.*

[68] Choi, *supra* note 61, at 254. Joint value does not address distributional questions with respect to the distribution of the transaction surplus between the right-holder and the seller.

[69] This is consistent with Bulow and Klemperer's observation that an English auction with n+1 bidders will always return a better result for sellers than any other optimal auction structure. Jeremy Bulow & Paul Klemperer, *Auctions Versus Negotiations*, 86 AM. ECON. REV. 180, 181 (1996). Bikchandani et al. observe that the seller cannot adequately negotiate a fee for the matching right to compensate for this distributional result. Bikhchandani et al., *supra* note 58, at 4.

[70] *See* McAfee & McMillan, *supra* note 61, at 704-05.

[71] Quinn, *supra* note 1, at 871.

[72] *See* Coates & Subramanian, *supra* note 37, at 372.

[73] McAfee & McMillan, *supra* note 61, at 704-05 (describing the private value auction setting).

[74] Choi, *supra* note 61, at 255 (citing Bikhchandani et al., *supra* note 58, at 9). Arozamena and Weinschelbaum come to a more extreme conclusion. They show that under no circumstances where there are bidders with independent private values can we expect a matching right to maximize the joint surplus of the buyer and seller. Arozamena & Weinschelbaum, *supra* note 61, at 4.

the right-holder or other potential bidders.[75] Sushil Bikhchandani, Steven A. Lippman, and Reade Ryan show the presence of matching rights can deter incremental bidding and result in a right-holder—though not the highest valuing bidder—winning a sale.[76] Although a matching right can deter incremental bidding and thus at times lead to potentially inefficient allocation results, matching rights have not been shown to deter a risk neutral bidder with a materially higher private valuation.

Second, an inefficient allocation can occur if a risk-averse higher valuing bidder declines to bid in the face of a matching right.[77] Remember that private valuations are known only to the bidders and in the extreme case are not correlated among bidders.[78] At the same time, in an ascending price auction, initial bids are not necessarily correlated with private valuations. In the event the right-holder offers a low-ball initial bid, risk-averse second bidders with a materially higher valuation may decline to bid if the second bidder believes the right-holder's private valuation is higher.[79] The likelihood of such a deterrent is difficult to assess in the private value setting. It is likely affected by a number of factors, including the costs of preparing a bid, whether or not the risk-averse second bidder can be compensated for those costs, the amount and quality of publicly available information about the seller, as well as the reputation of the right-holder in bidding contests among many others.[80]

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[75] *See, e.g.*, Bikhchandani et al., *supra* note 58, at 3.

[76] *Id.* at 9. Bikchandani concludes that the presence of a matching right converts a second price auction into a third price auction, thus permitting the right-holder to acquire the seller even when it is not the highest valuing bidder. First, the matching right:

> [C]onverts the second price auction into something better than a third price auction for the [right-holder]. Upon winning the object, she pays the second highest among the others' bids; moreover, she may win the object even if her signal is less than the second highest signal of the other buyers. Second, from a regular buyer's standpoint, the presence of a [right-holder] converts a second price auction with n+1 buyers into something worse than a second price auction with n buyers. When a regular buyer, say buyer 1, wins the object, he pays the highest among the other (regular) buyers' bids; but he wins only if his signal is higher than the signals of [other buyers] *and* is sufficiently higher than the [right-holder's] signal. Third, the allocation of the object may be inefficient because, as already noted, the [right-holder] may purchase the object even when she does not have the highest signal . . . .

Id. Bikhchandani's conclusion is consistent with other work. *See* Walker, *supra* note 10, at 26; Kahan et al., *supra* note 61, at 10; Choi, *supra* note 61, at 262.

[77] *See id.* at 10.

[78] McAfee & McMillan, *supra* note 61, at 705.

[79] However, a higher valuing second bidder who is risk neutral can be expected to bid in the face of a lowball bid. Risk averse second bidders can be enticed into bidding through the allocation of expense reimbursements or second bidder termination fees. *See id.* at 719-20.

[80] *See* Kahan et al., *supra* note 61, at 19.

The presence of a matching right, however, can in some circumstances lead to an inefficient allocation of the seller to the lower valuing right-holder, including where the second bidders do not have materially higher private valuations than the seller or when the second bidders are risk-averse.[81] For these reasons, economists caution "[matching rights] should be explained by reasons beyond the simple one-time interaction between the seller and a favored buyer, and should not be awarded lightly by sellers."[82] Because of their potential for adverse economic incentives in some situations, economic analysis suggests that matching rights are anything but standard terms.[83]

Of course, where a bidder with a private value for the seller is risk neutral, the presence of a matching right is not necessarily a deterrent to a subsequent bid.[84] This is true even if the second bidder's private valuation is lower than the right-holder's private valuation, provided the second bidder's valuation is higher than the right-holder's initial bid.[85] For risk neutral private value bidders, the optimal bidding strategy will always be to bid when the bid is less than their private valuation. The presence, or absence, of a matching right is not relevant to a risk neutral private value bidder.[86]

B. *Common Value Setting Adversely Affects Selling Shareholders*

Although pure common value auctions are rare, many transaction structures demonstrate important aspects of common value auctions. In the common value setting, the seller has a single objective value for all bidders.[87] Bidders, however, have different information about the seller, which affects their estimates of the seller's objective value.[88] Bidders with more, or more accurate, information are likely to have a better sense of the seller's objective value. Their bids are more likely to be closer to the true objective value of the seller than bidders with less or lower quality information.[89] Thus, in the common value setting one can expect a distribution of estimates around the mean with fifty percent of bidders overestimating the objective value of the seller.

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[81] *See* Bikhchandani et al., *supra* note 58, at 3, 10.
[82] Arozamena & Weinschelbaum, *supra* note 61, at 4.
[83] *See* Bikhchandani et al., *supra* note 58, at 1.
[84] Quinn, *supra* note 1, at 871.
[85] *See* Bikhchandani et al., *supra* note 58, at 15.
[86] *See* Quinn, *supra* note 1, at 870-71.
[87] McAfee & McMillan, *supra* note 61, at 705 (describing the common value auction setting).
[88] *Id.*
[89] *See id.*

When a firm is sold to private equity or other financial bidders such transactions exhibit many attributes of a common value sale.[90] The financing model that drives such transactions does not rely on the acquirer and the seller to generate synergies.[91] Rather, the financing model generates value from leverage and cash flow without respect to the idiosyncratic nature of the seller's business.[92] To the degree any target represents just a stream of cash flows that can be accessed to repay the debt required to finance the acquisition, such transactions exhibit characteristics of common value sales.

Because the value of a seller in the common value setting is objectively the same for all potential bidders, the presence of a matching right should have a number of important effects. First, the presence of a matching right will not prevent the seller from allocating it to its best and highest use.[93] Second, to the extent a subsequent bidder enters into a bidding contest for the seller, the second bidder risks falling victim to the winner's curse problem.[94] Assuming that the right-holder has the best quality information about the seller, non-right-holders will never succeed in buying without over-bidding.[95] Third, the presence of a matching right in the hands of an initial common value bidder will deter other common value bidders from making bids.[96] Financial buyers have a well-known aversion for engaging in bidding contests.[97] Consequently, it appears that the threat of the winner's curse is at least implicitly understood by market participants. Finally, the direct effect of the matching rights in the context of a common value auction is to appropriate transaction gains from the seller to the right-holder.[98] Because other market participants are hesitant to offer topping bids

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[90]Quinn, *supra* note 1, at 871.

[91]*See id.* at 883.

[92]*Id.*

[93]McAfee & McMillan, *supra* note 61, at 705.

[94]Paul Milgrom, *Auctions and Bidding: A Primer*, J. ECON. PERSP., Summer 1989, at 3, 4 (1989) (describing the "winner's curse" resulting from the winner underestimating the cost associated with completing the transaction); *see also* JOHN H. KAGEL & DAN LEVIN, COMMON VALUE AUCTIONS AND THE WINNER'S CURSE 2 (2002) ("[Y]ou only win when your estimate happens to be the highest . . . result[ing] in winning bids that produce below normal or even negative profits.").

[95]*See* Walker, *supra* note 10, at 18 (noting that an outside bidder with an informational disadvantage "faces serious obstacles to winning a contest . . . even if no right of first refusal exists").

[96]Quinn, *supra* note 1, at 870.

[97]*See, e.g.*, *infra* note 176.

[98]This phenomena is most commonly seen in the consumer contexts where retailers offer to "beat any price" for a consumer good. Rather than guarantee low prices, in the retail context the low-price guarantee strategy permits sellers to price discriminate between informed and uninformed consumers. Competitors have little incentive to compete on low prices because the low-price guarantee ensures that low prices will be met. Thus, the low-price guarantee strategy assures only

in the common value context, this permits the right-holder to offer low-ball bids and thereby extract transaction surplus at the expense of selling shareholders.[99] This expected result should have important implications for selling boards tasked with attempting to secure the highest price reasonably available upon a change in control.

As amongst common value bidders, society should be agnostic as to the ultimate identity of the winner of any bidding contest. Each of the bidders in a sale that has common value attributes will be an equally efficient user of the asset after sale. Consequently, the matching right plays only a distributive function. The common value bidder is able to create private value by offering a bid lower than its full valuation of the seller.[100] The matching right creates the space for a common value right-holder to create private value. By eliminating or reducing the likelihood of competition, the right-holder is able to appropriate the transaction surplus to itself.[101] Although matching rights in the common value setting can still improve joint value, as between the right-holder and the seller, the right-holder can be expected to appropriate much of the gains from the transaction at the expense of the selling shareholders.[102]

The distributive effects of matching rights when the sale process demonstrates common value attributes raises serious questions. In a sale of control, corporate boards are tasked with directing their efforts to achieve the highest price reasonably available to shareholders.[103] Granting a common value bidder a matching right has the affect of deterring subsequent common value bidders and shifts transaction surplus to the right-holder at the expense of selling shareholders. A court could find that granting matching rights in such a circumstance does not reasonably advance the cause of seeking the highest price reasonably available for selling shareholders.

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higher prices than in the equilibrium where sellers do not pursue a low-price guarantee strategy. Aaron S. Edlin, *Do Guaranteed-Low-Price Policies Guarantee High Prices, and Can Antitrust Rise to the Challenge?*, 111 HARV. L. REV. 528, 530-32 (1997); *see also* Subhasish Dugar, *Price-Matching Guarantees and Equilibrium Selection in a Homogenous Product Market: An Experimental Study*, 30 REV. INDUS. ORG. 107, 116 (2007) (finding that price matching guarantees facilitate collusion among sellers); Shakun Datta Mago & Jennifer G. Pate, *An Experimental Examination of Competitor-Based Price Matching Guarantees*, 70 J. ECON. BEHAV. & ORG. 342, 350 (2009) (concluding that when costs are symmetric, price matching guarantees significantly increase market prices).

[99]Quinn, *supra* note 1, at 876.

[100]*See* Kahan et al., *supra* note 61, at 14.

[101]*See id.*

[102]*See* Walker, *supra* note 10, at 20-21.

[103]McMillan v. Intercargo Corp., 768 A.2d 492, 502 (Del. Ch. 2000) ("Once a board of directors determines to sell the corporation . . . their responsibility is to endeavor to secure the highest value reasonably attainable for the stockholders.").

IV. THE EMERGING DE FACTO LEGAL STANDARD FOR MATCHING RIGHTS

Since at least 2001, when shareholders challenged Pennaco Energy's sale to Marathon Oil, courts have been asked regularly to rule on the question of whether, in the particular circumstances of a sale of control, matching rights in their various forms are unreasonable deal protections.[104] The courts' consistent answer has been no.[105] Notwithstanding the growing body of economic literature to the contrary,[106] courts appear to view matching rights as nothing more than "modest and reasonable"[107] deal protections that are "standard merger terms"[108] and "common contractual feature[s]"[109] in the context of a sale of control. Although the language of a heightened reasonableness review remains intact, courts may have become inured to the use of matching rights.[110] In fact, courts appear to have adopted a permissive approach to board decisions to grant matching rights in merger agreements.[111] This permissive approach is not entirely consistent with the highly contextualized analysis that courts bring to bear in evaluating other deal protection measures, such as termination fees.[112] When evaluating termination fees, courts appear quite concerned with the levels and methods of calculating the appropriate size of the termination fee granted by the selling board before passing judgment on a fee's reasonableness.[113] To the

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[104] *In re* Pennaco Energy, Inc. S'holders Litig., 787 A.2d 691, 707 (Del. Ch. 2001) (rejecting plaintiff's challenge that the combination of termination fees and matching rights were anything more than modest deal protection measures).

[105] *Id.* at 705.

[106] *See supra* note 61 and accompanying text.

[107] *Pennaco Energy*, 787 A.2d at 707.

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

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

[110] *Id.* at 1000-01.

[111] Even when courts have used their authority to enjoin the application of matching rights as deal protection measures, they have not done so because of a recognition of the potential unreasonableness of the matching rights themselves. For example, in *Del Monte*, the deal protection measures were invalidated by the court. *In re* Del Monte Foods Co. S'holders Litig., 2011 WL 532014, at *24 (Del. Ch. Feb. 14, 2011). The court was, however, less concerned about the preclusive effect of the matching right than it was the inadequacy of the sales process leading up to the granting of the deal protections including the match right: "These measures are not being enjoined because they coerce stockholders, preclude any alternative to the board's chosen transaction, or otherwise fall outside the range of reasonableness . . . . If included in an arms' length deal untainted by self-interest, the defensive measures would be quite reasonable." *Id.*

[112] *See, e.g.*, *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 613 (Del. Ch. 2010) (evaluating the termination fee by examining the value of the merger, bidder's intent, share price, stock dividends, and bidder competition).

[113] *See Toys "R" Us*, 877 A.2d at 1021-1022 (citing Chancellor Chandler in *Phelps Dodge* condemning unreasonably high termination fees as "a more than reasonably explicable barrier to a second bidder.").

extent transactional lawyers take their cues from court decisions, they may misinterpret the lack of a searching analysis of matching rights for license to increase reliance on them in deal-making, thereby increasing the amount and degree of exclusivity protection included when a seller is negotiating a sale of control.[114]

A. *Legal Standards with Respect to Deal Protections*

When courts evaluate board decisions to adopt deal protection measures, reasonableness is the touchstone. The reasonableness standard takes the form of the intermediate standard: deal protections must be "reasonable in relation to the threat posed" by a subsequent higher bid.[115] By now, the identification of a "threat" to corporate policy has devolved into merely a perfunctory exercise of recitation of common threats.[116] However, the court must also determine whether the deal protections adopted by the board are proportionate to the threat posed. Deal protections are not proportionate if they are "draconian, by being either preclusive or coercive."[117] If the challenged deal protections are not draconian, the court must still determine that the deal protections lie "within a range of reasonable responses to the threat" before they pass muster under intermediate scrutiny and the board's decision to grant them receives the presumption of business judgment.[118]

Board decisions to grant initial bidders deal protections in the sale of control context are measured against this highly contextualized intermediate standard.[119] In a sale of control boards "have the obligation of acting

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[114]Profs. Coates and Subramanian argue that transactional lawyers tend to read too much into Delaware decisions regarding deal protections and in that way push the envelope. Coates & Subramanian, *supra* note 37, at 336-37.

[115]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1385-86 (Del. 1995) (setting out the intermediate standard); Capital City Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 796 (Del. Ch. 1988) (*overruled by* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989)) (calling Unocal "the most innovative and promising case in our recent corporate law").

[116]This was not always the case. In *Capital City*, Vice Chancellor Allen attempted to provide some substance to proportionality review, but this attempt was rebuffed by the Supreme Court. *See Time*, 571 A.2d at 1152; *see also* Ronald J. Gilson and Reinwer Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review*, 44 BUS. LAW. 247, 248 (1989) (arguing for a more nuanced approach to the intermediate standard).

[117]*Unitrin*, 651 A.2d at 1367.

[118]*Id.*

[119]This standard does not consist of a series of bright-line rules leading a maximization exercise. Rather, the court is tasked with answering the question: whether "directors made a

reasonably to seek the transaction offering the best value reasonably available to the stockholders."[120] This duty does not establish any bright-line rules or checklist for directors to prove that they fulfilled their duties.[121] Rather, courts "will apply enhanced scrutiny to ensure that the directors have acted reasonably."[122] Directors in the sale of control context bear the burden of proving: (1) they were informed and utilized a reasonable decision-making process; and (2) they acted reasonably in light of the circumstances at the time of their decision.[123]

Taken together, the intermediate standard in the change of control context is a highly contextualized analysis of the reasonableness of board decisions. The courts recognize that "in cases where the board failed to demonstrate that its defensive measures were reasonable and not draconian, it seems highly unlikely that the board could show that those measures were, nonetheless, 'fair'" under the more exacting *Revlon* standard.[124] In that sense, resolution of the question of the reasonableness of deal protection measures under the intermediate standard can be determinative of the outcome.

With respect to compensatory devices in a sale of control, the highly contextualized standard permits initial bidders to recoup the costs of their initial bid through a termination fee. The size of such fees is limited by a reasonableness analysis similar to that employed in reviewing the reasonableness of liquidated damages provisions in other contractual settings.[125] In *Louisiana Municipal Police Employees' Retirement System v. Crawford*, the court provided some additional context for its reasonableness analysis.[126] While not ruling on the question, the court dismissed attempts by defendant directors to have the court accept a three percent termination fee as a presumptively valid "customary" deal term.[127] The court noted the complexity of the task involved in passing judgment on such measures in the sale of control context.[128] The court also warned against adopting a "bright

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reasonable decision, not a perfect decision" when seeking the highest price reasonably available for shareholders. Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994).

[120] *Id.* at 43.

[121] Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989) ("[T]here is no single blueprint that a board must follow to fulfill its [fiduciary] duties.").

[122] *QVC*, 637 A.2d at 43.

[123] *Id.* at 45.

[124] William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1311 (2001).

[125] Brazen v. Bell Atl. Corp., 695 A.2d 43, 47-48 (Del. 1997) (treating termination fees like liquidated damages).

[126] 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007).

[127] *Id.*

[128] *Id.* (noting that the inquiry is "by its very nature fact intensive, [and] cannot be reduced to a mathematical equation"). Thus, the court could not establish a "blanket rule." *Id*.

line rule" based on some predetermined understanding of a "naturally occurring rate of deal protection" measures.[129] The reasonableness analysis that a court must engage in requires a close examination of the facts and circumstances faced by boards when they decide to grant termination fees to initial bidders.[130] For example, the court noted that any determination of reasonableness of a deal protection requires the court to:

> consider a number of factors, including without limitation: the overall size of the termination fee, as well as its percentage value; the benefit to shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole. The inquiry, by its very nature fact intensive, cannot be reduced to a mathematical equation. Though a "3% rule" for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule.[131]

In a later decision, reviewing the appropriateness of termination fees as deal protection measures, the court's analysis noted the importance of the potentially preclusive effects of such provisions by stating: "[t]he preclusive aspect of any termination fee is properly measured by the effect it would have on the desire of any potential bidder to make a topping bid."[132] A termination fee that is large enough to deter subsequent bids may be held to be preclusive and therefore unreasonable.[133] Unreasonable deal protection measures will fail to pass muster under Delaware's intermediate standard.[134]

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[129] *Crawford*, 918 A.2d at 1181 n.10 (citing *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1016 (Del. Ch. 2005)).

[130] *Id.*

[131] *Id.*

[132] *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 613 (Del. Ch. 2010).

[133] *See, e.g.*, McMillan v. Intercargo Corp., 768 A.2d 492, 506-07 n.65 (Del. Ch. 2000).

[134] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (requiring that a board's actions not be "draconian" and that they are "reasonable in relation to the threat posed" before getting the protection of the business judgment rule); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1385 (Del. 1995) (noting that a board's actions will pass enhanced scrutiny if it was "one of several reasonable alternatives").

Of course, the mere fact that a termination fee might deter a subsequent bid is not necessarily sufficient to justify a finding that a termination fee is preclusive. For example, courts have expressed their willingness to restrict the use of excessive fees when parties push the envelope, but not if the result is simply to encourage marginal bidding.[135] A policy of not seeking to squeeze every last drop of surplus from a transaction is consistent with Delaware's general deference to board discretion and decision making.[136] However, this deference is not without limits;[137] to the extent a deal protection measure deters materially higher bids or results in shifting transaction surplus away from selling shareholders, in a material way, a court should find such measures unreasonable.

B. *The Emerging Standard for Matching Rights*

In recent years, plaintiffs' counsel have increasingly challenged the use of matching rights in merger agreements arguing that matching rights are preclusive and therefore, unreasonable in the context of a sale of control.[138] While courts have accepted the argument that excessive compensatory devices—like termination fees and stock lockups—have the potential to be preclusive,[139] they have not yet accepted the argument that matching rights may have a similarly preclusive effect, alone or in combination with other deal protection measures. Indeed, courts' opinions do not appear to

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[135]The *Toys "R" Us* court explained:

> The central purpose of *Revlon* is to ensure the fidelity of fiduciaries. It is not a license for the judiciary to set arbitrary limits on the contract terms that fiduciaries acting loyally and carefully can shape in the pursuit of their stockholders' interest. Even less is it the purpose of *Revlon* to push the pricing of sales transactions to the outer margins (or beyond) of their social utility. If second bidders fear that any move beyond a small topping bid might leave them making an imprudent bid for a public company, it is not clear why our society benefits by encouraging bids of that type or how it would be harmed by their preclusion.

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

[136]*See Unocal*, 493 A.2d at 954.

[137]*Id.* (discussing that a board's power could be abused and therefore enhanced scrutiny is required in some settings).

[138]*See, e.g.*, Compl. at 26, Greater Pa. Carpenters' Pension Fund v. Bergen, C.A. No. 6220 (Del. Ch. Feb. 25, 2011) (alleging that directors breached their fiduciary duties to the corporation by granting a matching right in a merger agreement that was preclusive); *see also* Compl. at 11, Varipapa v. Warner Music Grp. Corp., C.A. No. 6478 (Del. Ch. May 12, 2011) (alleging that directors breached their fiduciary duties to the corporation by granting a matching right in a merger agreement that was preclusive).

[139]*See, e.g.*, *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 501 (Del. Ch. 2010) (noting that a court must review deal protection measures "to ensure that they are reasonable and do not preclude a higher bid from being successful").

recognize the prospect that matching rights might have any potentially preclusive effects.[140] Notwithstanding regular challenges to the use of matching rights in merger agreements, courts rarely grant matching rights the same degree of respect they accord to compensatory schemes and other exclusivity measures like no-shop provisions.

For example, in *Toys "R" Us*, the Delaware Court of Chancery heard expert testimony on the potentially preclusive effects of matching rights in merger agreements.[141] Relying on expert reports from Profs. Preston McAfee and Guhan Subramanian, the plaintiffs argued that explicit matching rights combined with a termination fee had the capability of deterring subsequent bids and therefore a board granting such protections might be acting in a manner inconsistent with its obligations under *Revlon*.[142] In particular, Subramanian argued, in accord with the economic literature, that one should expect matching rights to prove a more or less formidable deal protection measure depending on the characteristics exhibited by the sale process.[143] He noted that where there are matching rights in place one would expect financial buyers to be less likely to provide a topping bid or otherwise engage in an active auction process.[144] Data provided to the court by Subramanian supports that statement.[145] To the extent topping bids appeared in merger transactions with matching rights in place, the vast majority were bids offered by strategic bidders and not financial buyers.[146] These results were again consistent with the understanding in the literature that matching rights will be less likely to deter bidders with materially higher private valuations in the context of a sale that exhibits private value characteristics.

Notwithstanding the evidence presented in *Toys "R" Us*, the court was dismissive of the potentially preclusive power of matching rights in general. The court noted that matching rights and termination fees are a "common contractual feature" and not "per se invalid."[147] The court also held that the combination of a matching right and a termination fee did not present an unreasonable challenge to a second bidder who might wish to pay a

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[140] *See Toys "R" Us*, 877 A.2d at 1017 (noting that matching rights are "common contractual feature[s]").

[141] *Id.* at 1014.

[142] *Id.*; *see also* Aff. of R. Preston McAfee at 7-8, *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975 (Del. Ch. 2005) (C.A. No. 1212-N); Aff. of Guhan Subramanian at 13-17, *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975 (Del. Ch. 2005) (C.A. No. 1212-N).

[143] Aff. of Guhan Subramanian, *supra* note 142, at 7-8.

[144] *Id.*

[145] *Id.* at 9.

[146] *Id.* at 6-7.

[147] *Toys "R" Us*, 877 A.2d at 1017.

materially higher price.[148] Indeed, the *Toys "R" Us* court noted examples of real world deal situations in which the presence of a matching right was insufficient to deter a second bidder from paying a materially higher price.[149] The examples cited by the court all involved auction contests between strategic bidders in transactions that exhibited private value characteristics.[150] The court pointedly did not cite examples of financial bidders generating topping bids in the presence of matching rights, which was the precise situation in *Toys "R" Us*. In short, when dismissing the plaintiffs' claims that matching rights may have deterrent effects against potential financial bidders as second bidders, the court restated part of the plaintiff's argument: strategic bidders with private valuations are less likely to be deterred from making a topping bid than financial bidders with common valuations when matching rights are present.[151] Ironically, in dismissing the plaintiffs' case the court relied on the substance of the plaintiff experts' arguments while ignoring their most obvious conclusions—matching rights in a sale of corporate control demonstrating common value characteristics may have preclusive effects that should cause courts to pause.

Since *Toys "R" Us*, courts have repeatedly been asked to rule on limits to the deployment of matching rights in defense of a merger transaction.[152] Although courts have not abandoned the intermediate standard of review with respect to its application to matching rights, they do not consistently consider the potentially preclusive effect of those rights.[153] This may be because, unlike termination fees where the deterrent effect can be a function of its size, matching rights do not share the same linear-like function with respect to their potential preclusive effect. Because the potential preclusive effect of termination fees can be calculated as a function of their size,[154] courts may feel more comfortable asserting that large termination fees are

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[148] *Id.* at 1018.

[149] *Id.* at 1019 ("[T]here are actual examples that prove that a package of this kind would not deter a fervent bidder intent on paying a materially higher price for the Company.").

[150] The court cited the example of Qwest and Verizon battling for control of MCI as an example of how matching rights are weak deal protection devices. *Id.* The court also cited the active contest for control of Warner-Lambert by American Home Products and Pfizer (two strategic bidders). *Toys "R" Us*, 877 A.2d at 1019 n.75.

[151] *Id.* at 1021-22.

[152] *See In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 501-02 (Del. Ch. 2010); *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 575 (Del. Ch. 2010); *In re* Lear Corp. S'holder Litig., 926 A.2d 94, 119 (Del. Ch. 2007).

[153] *See, e.g.*, *Toys "R" Us*, 877 A.2d at 1017 (noting that matching rights are "common contractual feature[s]").

[154] *See* La. Mun. Police Emps. Ret. Sys. v. Crawford, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007) (noting that a court must consider a number of factors in determining if a deal protection is preclusive including "the overall size of the termination fee").

unreasonable. Matching rights, on the other hand, must be assessed with a different contextual framework.[155] Consequently, without an appropriate contextual framework for assessing the potential preclusive nature of matching rights courts rely on a short-hand approach to matching rights that ignores their deterrent effect and defers to board decisions to grant them.[156]

For example, in *Cogent Shareholders Litigation*, the plaintiffs argued that the language of the no-solicitation provision of Cogent's merger agreement with 3M—which included a combination of a no-shop provision with a fiduciary out, information rights, plus an explicit matching right—was preclusive.[157] The matching rights in the agreement required the seller to negotiate in good faith with the acquirer for five days in the event the seller received a superior offer.[158] The court responded by ruling that "[a]fter reviewing the arguments and relevant case law . . . [the] Plaintiffs are not likely to succeed in showing that the no-shop and matching rights provisions are unreasonable either separately or in combination."[159] The court reasoned that the combination of the no-shop and the matching rights were reasonable provisions to provide the initial bidder with some assurance that he would have an "adequate opportunity to buy the seller, even if a higher bid later emerges."[160] While the court focused on the fact that the no-shop provision included a fiduciary termination right that did not preclude the seller from engaging in discussions with a second bidder with a higher offer, the court did not provide any contextualized analysis of the matching right or reasoning for why it believed a matching right in this circumstance was not preclusive.[161] The court might have observed that in the particular case of *Cogent*, where the acquirer was a strategic buyer, matching rights do not present as much of a concern with respect to the seller's fiduciary obligations, but it did not. Rather, the court rested its determination of reasonableness on the notion that the matching right provides initial bidders some level of assurance that their transaction-specific investments will not be lost in the event the initial bid is topped by a second bidder and thereby encourage initial bids.[162]

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[155] *See supra* notes 119-23 and accompanying text.

[156] *Cogent*, 7 A.3d at 502.

[157] *Id.* at 501-02; *see also* Cogent, Inc., Current Report (Form 8-K) [hereinafter Cogent Agreement], at Exhibit 2.1, Section 6.8 (Aug. 31, 2010).

[158] *Cogent*, 7 A.3d at 501-02.

[159] *Id.* at 502.

[160] *Id.* The court does not indicate why a reasonably priced termination fee is not sufficient to assuage an initial bidder of the fear that it might lose its transaction-specific investments due to a successful second bidder.

[161] *Id.*

[162] *Cogent*, 7 A.3d at 502.

In *3Com Shareholders Litigation*, the plaintiffs challenged 3Com's sale to Hewlett Packard; here, the court was equally dismissive of the plaintiffs' matching rights claim.[163] Plaintiffs alleged, among other things, that a four percent termination fee, combined with a no-solicitation provision and matching rights "effectively preclude any other bidders who might be interested in paying more than HP for the Company . . . ."[164] Without engaging in a searching analysis, the Chancery Court ruled that the matching rights were not preclusive and reiterated that the Chancery Court "has repeatedly held that . . . [matching rights] are standard merger terms, are not *per se* unreasonable, and do not alone constitute breaches of fiduciary duty."[165] It is of course true that such deal protection measures are not per se unreasonable. However, the court in *3Com* declined to engage in any of the contextualized analysis required to determine what effect—if any—matching rights might be expected to have in this circumstance.[166]

Similarly, in *Smurfit-Stone Container Corp. Shareholder Litigation*, the Delaware Court of Chancery found that the deal protection measures, including a termination fee and matching rights, were "relatively standard in form and have not been shown to be preclusive or coercive, whether they are considered separately or collectively."[167] Courts have begun to adopt this "standard merger terms" language in a manner that suggests courts have accepted these defensive measures as per se valid.[168] While this may not, in fact, be the case, what is lacking is a contextualized approach to the application of matching rights in merger agreements anywhere near the analysis offered by the court in *Toys "R" Us*.[169] Such an analysis would

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[163] *In re* 3Com S'holders Litig., 2009 WL 5173804, at *7 (Del. Ch. Dec. 18, 2009) ("The [matching right] provisions that plaintiffs attack have been repeatedly upheld by this Court.").

[164] Pls.' Mot. for Expedited Proceedings at 8, *In re* 3Com S'holders Litig., 2009 WL 5173804 (Del. Ch. Dec. 11, 2009) (C.A. No. 5067-CC).

[165] *3Com*, 2009 WL 5173804, at *7.

[166] *Id.*

[167] *In re* Smurfit-Stone Container Corp. S'holder Litig., 2011 WL 2028076, at *21 (Del. Ch. May 20, 2011).

[168] *See, e.g.*, *In re* Atheros Commc'ns, Inc., 2011 WL 864928, at *7 n.61 (Del. Ch. Mar. 4, 2011).

[169] The *Toys "R" Us* court explained the appropriate analysis for deal protections:

> [A] reasonableness inquiry does not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection . . . Instead, that inquiry examines whether the board granting the deal protections had a reasonable basis to accede to the other side's demand for them in negotiations. In that inquiry, the court must attempt, as far as possible, to view the question from the perspective of the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections.

In re Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1016 (Del. Ch. 2005) (citations omitted).

make it clear to transactional lawyers that matching rights, like other deal protection measures, are subject to intermediate scrutiny and not presumptively valid.[170]

V. A CONTEXTUALIZED APPROACH TO MATCHING RIGHTS

Since lawyers tend to read too much into court decisions—or lack thereof—there is a threat that the courts' permissive approach with respect to matching rights may be misinterpreted.[171] Transactional lawyers and litigators may misinterpret the courts' previous leniency with respect to the granting of matching rights for the adoption of a bright-line rule favoring the use of potentially preclusive matching rights in merger agreements. This tendency for transactional lawyers to sometimes oversimplify the courts' reasoning cautions courts to treat challenges to director decisions to grant initial bidders matching rights with the same seriousness and subtlety that they treat other deal protection claims.

Courts should apply the same highly-contextualized facts and circumstances analysis that is used when reviewing board decisions to adopt other deal protection measures.[172] Courts should also avoid the temptation of adopting a per se reasonableness approach to matching rights. There may well be circumstances where a matching right is preclusive, and courts should be prepared to strike down rights in such circumstances.[173] Of course, a reasonableness test for matching rights will, by necessity, be different in important respects than the contoured analysis offered by the court in *Crawford*.[174] A contextualized analysis of matching rights should focus on the currency of such rights, which include: (1) the nature of the initial bidder, (2) access to information, and (3) time. What follows are a series of considerations that courts should take into account when evaluating whether matching right provisions are more or less preclusive, or otherwise work to the detriment of selling shareholders.

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[170] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[171] Professors Coates and Subramanian argue that transactional lawyers tend to read too much into Delaware decisions regarding deal protections. They are, perhaps, looking for bright-line rules to help guide practice. *See* Coates & Subramanian, *supra* note 37, at 336-37.

[172] *See supra* note 165 and accompanying text.

[173] *See, e.g.*, Aff. of R. Preston McAfee, *supra* note 142, at 8.

[174] La. Mun. Police Emps. Ret. Sys. v. Crawford, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007).

A. *The Nature of the Initial Bidder*

The first component of a contextualized analysis of matching rights relates to the profile of the right-holder and whether the transaction exhibits attributes of a common value or private value sale. The economic incentives in the transaction differ with respect to the nature of the initial bidder. In current business practice, private equity bidders engaged in leveraged transactions most closely resemble common value bidders.[175] Transactions with matching rights that exhibit attributes of common value auctions may be more troublesome for courts for at least two reasons: (1) second bidders are less likely to attempt a topping bid in the common value setting when the initial bidder is holding a matching right; and (2) where a common value bidder holds a preemptive matching right, the initial bidders may be able to extract surplus out of the transaction by offering less than its full valuation for the seller because the threat of a topping bid is minimal.

Private equity and financial bidders are notoriously shy about engaging in bidding contests or generating topping bids.[176] This is consistent with our understanding of common value bidders. Leveraged acquisitions depend on the targets' ability to generate sufficient cash from cash flow to repay debt taken to finance the acquisition; therefore, such transactions are limited in their returns by the amount of leverage they can take on and the cost of capital.[177] Financial buyers are not normally able to generate private value from an acquisition through combination with other existing activities.[178] Leverage ratios and the cost of capital are common variables amongst almost all the players in the industries.[179] Private equity bidders bring few synergies to the bidding table.[180] Consequently, the challenge for the private equity bidder is not to overpay or fall victim to the winner's curse when completing an acquisition.[181]

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[175] Quinn, *supra* note 1, at 871.

[176] For example, Berkshire Hathaway—a financial buyer—has published its acquisition criteria in its annual report which includes among other conditions: a requirement that management remain in place for any sale and that Berkshire Hathaway not participate in any auctions. BERKSHIRE HATHAWAY, 2010 ANNUAL REPORT 28 (2011), *available at* http://www.berkshirehathaway.com/2010ar/2010ar.pdf.

[177] JOSHUA LERNER, FELDA HARDYMON & ANN LEAMON, VENTURE CAPITAL AND PRIVATE EQUITY: A CASEBOOK 1 (4th ed. 2009).

[178] *See id.*

[179] *See, e.g.*, Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J. L. Econ. & Org. 27, 47 (1991).

[180] *See supra* notes 90-92 and accompanying text.

[181] Milgrom, *supra* note 94, at 5.

The common value bidder with a matching right knows two things. First, there is an objective upper limit to what they are willing to bid. Second, they will have the right to revisit their bid and match second comers up until that limit. Consequently, initial bidders holding a matching right in the common value setting have an incentive to bid less than the full valuation. When a second bid does not appear, the initial common value bidder is able to extract surplus from the transaction. Potential second bidders in a common value setting are, or should be, uninfluenced by initial low-ball bids. These bidders understand the only way they will be successful in acquiring the target will be if their assessment of the objective value of the seller is incorrect. This is the winner's curse.[182]

While the transaction with the initial bidder still creates joint value for both buyer and seller through the presence of the matching rights, the acquirer has the ability to affect distribution of transaction gains in favor of the buyer. Although a structural bias against generating higher bids for selling shareholders is not necessarily preclusive, it seems inconsistent with the charge to directors of a seller to take actions reasonably intended to maximize the value for selling shareholders.[183] Indeed, if theory predicts that matching rights should deter second bids and distribute transactional gains in favor of buyers, a court could reasonably determine that granting matching rights to bidders who demonstrate common value characteristics is unreasonable in certain circumstances. This could be true even if the board mistakenly believes such rights are "boilerplate" and grants them in good faith.

Sales of control that exhibit characteristics of private value auctions are of less concern from the point of view of the reasonableness of the deal protections. Strategic bidders typically have private valuations for the seller.[184] While valuation differences in common value auctions arise due to differences in information, valuation differences in the private value context are traced to complementary business units controlled by the bidder that might generate synergies.[185] Thus, each bidder's valuation of the seller is independent of any other potential bidder's valuation. Consequently, strategic bidders are not generally deterred by the presence of a matching right.[186] The optimal strategy for a strategic buyer is to bid up to, but not

[182] *Id.*

[183] *See, e.g.*, Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("[D]irectors must decide which alternative is most likely to offer the best value reasonably available to the stockholders.").

[184] *See* Quinn, *supra* note 1, at 871.

[185] *See supra* Part III.B.

[186] Quinn, *supra* note 1, at 870-71.

beyond, its private valuation of the target without regard to what other bidders do. As a result, matching rights in a corporate sale that exhibit private value characteristics are not likely to be preclusive.[187]

The circumstances in which one might expect a strategic bidder to be deterred from making a topping bid are those in which the potential second bidder's valuation is close to the current bid price.[188] In the presence of a matching right, a second bidder can only reasonably expect to win when their bid is substantially higher than all other bidders and is substantially higher than the right-holder's private valuation.[189] Thus, a matching right can play a role in deterring or ending incremental bidding amongst strategic bidders, while not necessarily precluding a subsequent bid from a bidder with a significantly higher private valuation for the seller.[190]

Bidders' varied responses to matching rights are related to the profile of bidders and the nature of the sale process. This suggests a contextualized approach to evaluating the reasonableness of such terms. In that regard, courts should be more willing to closely scrutinize matching rights granted in connection with transactions that demonstrate common value characteristics (e.g. where the initial bidder is a financial buyer).

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[187]It is sometimes noted that in recent years financial buyers have consistently paid more for targets than strategic buyers. While that may be true, these recent valuations by financial bidders are a function of the relatively low cost of capital. "The result is that during periods of robust credit markets, such as occurred during 2004 to 2007, the highest bidders in takeover contests may often be those bidders, such as private equity firms, who are capable of using large amounts of debt financing." Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 1975 (2008). This imbalance cannot be expected to last forever. The key point here is that, although prior to the financial crisis financial bidders were able to outbid strategic buyers, the strength of financial buyers relative to strategic buyers in recent years was a function of the credit bubble and thus not generally representative.

[188]In auction literature, the presence of a matching right in a bidding contest with strategic buyers approximates a third price auction. Bikhchandani et al., *supra* note 58, at 9. In a second price, or Vickery, auction, the bidder with the highest valuation wins the auction, but pays the second highest revealed value. In a third price auction, the presence of a matching right converts a second price auction into a third price auction for the right-holder. The winning right-holder then pays the second highest among the others' bids. The right-holder may win even if her valuation is less than the second highest valuation of the other bidders. Bikhchandani et al., *supra* note 58, at 9; *see also* John H. Kagel & Dan Levin, *Independent Private Value Auctions: Bidder Behaviour in First-, Second- and Third-Price Auctions with Varying Numbers of Bidders*, 103 ECON. J. 868, 868-69 (1993).

[189]Bikhchandani et al., *supra* note 58, at 9.

[190]*Id.* at 10. Incremental bidding presents a challenge. Although incremental bidding can generate additional value for sellers, courts have adopted a policy of not encouraging this approach to bidding. While one might debate the value of deploying matching rights to avoid incremental bidding, such rights do not preclude a private value bidder, with a significantly higher private valuation, from topping an initial bid.

B. *Information*

Information is another key aspect of the deterrent power of matching rights. Information and information rights are particularly important in situations where the amount and type of information the potential bidder receives affects the valuation of the target.[191] Information plays an important role in sales processes, particularly those with common value characteristics where the extent to which initial bidders receive superior information, relative to subsequent bidders, will affect the incentives subsequent bidders have to make transaction-specific investments in putting together a competing bid. Specifically, information plays a key role in assuring parties do not overpay in the common value setting.[192]

In that regard, initial bidders have strict informational advantages over potential topping bidders.[193] With superior information, initial bidders are better able to generate an accurate estimate of the objective value of the target. With better estimates, initial bidders are in a better position to know when they are in danger of overpaying.[194] Compare that with potential second bidders who must generate an estimate with less information and in relatively rapid fashion. Successful second bidders are more likely to overbid and thus suffer from the winner's curse.[195] Consequently, for the second bidder in the common value setting, there are few incentives to engage in a bidding contest with an initial bidder with a matching right. Indeed, risk-averse private value bidders may find the prospect of sharing confidential information, which might relate to the second bidder's business with the seller and the right-holder, a deterrent from bidding at all. Where the proper measure of preclusion is the likelihood of a deal protection measure deterring a subsequent bid from appearing, a matching right may be preclusive.[196]

In situations where management is involved directly or indirectly with private equity bidders, the information advantage in favor of the initial bidder is exacerbated. The special access to information afforded to common value bidders, when they cooperate with incumbent management, improves the ability of the bidder to generate an accurate estimate of the seller's value.[197] More information for the initial bidder means that they will

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[191]*See supra* notes 87-89 and accompanying text.
[192]*See* Quinn, *supra* note 1, at 871.
[193]*Id.*
[194]*Id.*
[195]*See supra* note 94 and accompanying text.
[196]*See In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 613 (Del. Ch. 2010).
[197]*See* Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or*

be less likely to overpay for the seller. If management is involved with a private equity bidder, one of the few circumstances in which a second bidder can expect to win a bidding contest is when the second bidder overpays.[198] Thus, the granting of a matching right to an initial bidder participating with management may also deter second bids from appearing and thus be preclusive.

C. *Timing*

In addition to the nature of the right-holder and information, the extent to which the design and structure of matching rights included in the merger agreement creates a cushion of time for the right-holder may also influence the determination whether the rights are preclusive. Where matching rights create lengthy delays before a seller might accept or even consider a subsequent bid, such rights may be preclusive. For example, a seller might grant an initial bidder a series of advance notice provisions, including the following: a five day delay prior to consideration of a subsequent offer, a five day delay prior to changing a board recommendation, and a five day requirement to negotiate in good faith prior to accepting an alternative offer. The general effect of the combined advance notice provisions might be to unreasonably delay consideration of an alternative offer. A subsequent bidder, facing the prospect of lengthy delays imposed by the right-holder may be deterred from submitting a bid and therefore be preclusive. On the other hand, shorter advance notice provisions may provide a more modest deterrent to a subsequent bidder and therefore be reasonable. Because the timing involved in considering and accepting a subsequent offer is so critical to a topping bidder's decision to submit a bid, courts should consider the potential deterrent effect, if any, of delays posed by advance notice provisions as unreasonable.

D. *Other Considerations*

There are a number of other circumstances that courts should take into consideration when evaluating the reasonableness of granting matching rights; for example, whether matching rights are granted to an initial bidder before the seller has had an opportunity to shop the transaction.[199]

Appropriating Shareholder Wealth?, 41 VAND. L. REV. 207, 217-18 (1988) (discussing that management has access to inside information which affects their valuation for a company).

[198] *See supra* notes 94-95 and accompanying text.

[199] This is consistent with the reasoning with respect to the granting of termination fees or stock lockups to initial bidders. *See, e.g.*, Kahan & Klausner, *supra* note 38, at 1563-64 (discussing

Alternatively, matching rights may be granted at the tail end of a played out auction. With respect to the question of whether such rights might be preclusive, matching rights that are granted at the end of a played out auction are less troublesome than matching rights that are granted to an initial bidder. The former may represent an attempt by a board to reasonably provide some certainty and resolution to a process that has generated significant valuation information about the seller. On the other hand, granting matching rights to an initial bidder may raise concerns depending on the profile of the acquirer.

Courts should also take into consideration the potentially preclusive effect of matching rights combined with other deal protection measures. Combinations may result in a transaction being over-protected.[200] For example, a properly calculated termination fee should be sufficient to cover the opportunity costs of an acquirer in putting together a bid. With a properly calculated termination fee, an initial bidder should be indifferent to a topping bid. Having already been compensated for the costs of putting together a bid, the matching rights provide additional assurances in excess of what might be required to generate an initial bid. Matching rights in the private value setting, as noted above, have the effect of deterring marginal bids.[201] When a private value bidder with a materially larger valuation for the seller is less likely to place a subsequent bid due to the combination of a termination fee and matching rights, the combination may be preclusive. In any event, recent court opinions rationalizing the use of matching rights to provide initial bidders with sufficient deal certainty or to justify their transaction-specific investments are ignoring the compensatory effect of termination fees.[202] A reasonably priced termination fee should be large enough to compensate an initial bidder for the transaction-specific investments involved in generating an initial bid. Encouraging initial bids through both a termination fee as well as additional certainty may prove too much.

Other combinations of deal protections are less likely to be preclusive and therefore may be reasonable. For example, when a seller grants a non-solicitation provision with a fiduciary termination right as well as a matching

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the impacts of granting lock-ups to initial bidders).

[200] *See, e.g.*, *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 508-09 (Del. Ch. 2010) (after reviewing each deal protection measure independently, the court reviewed the "cumulative effect" to determine if, when combined, the protection measures were preclusive).

[201] *See supra* notes 74-80 and accompanying text.

[202] *See, e.g.*, *Cogent*, 7 A.3d at 502 ("[I]n an effort to entice an acquirer to make a strong offer, it is reasonable for a seller to provide a buyer some level of assurance that he will be given adequate opportunity to buy the seller, even if a higher bid later emerges.").

right, that combination will not likely present any more of a deterrent to a subsequent private value bidder than a matching right on its own.

E. *Examples of a Contextualized Approach*

What follows are two examples of how a court might apply this contextualized analysis to the question of whether matching rights are reasonable. The first example involves H.P.'s recent acquisition of 3Par after a bidding contest with Dell.[203] In that transaction, Dell signed a merger agreement with 3Par that included information rights, three day advance notice provisions, as well as a good faith negotiation provision and a termination fee.[204] Although these protections appear substantial, they were not preclusive. This transaction exhibited attributes of a private value sale. Dell is a strategic buyer that sought out 3Par for the synergies associated with the company.[205] Dell's private value for 3Par was known only to Dell and was independent of the valuation of any other potential bidder. One expects that in the private value setting, matching rights should not prove an insurmountable barrier to a bidder with a higher private value for the seller.

As it turned out, there was at least one other potential bidder: H.P.[206] Like Dell, H.P. was a private value bidder. Its own valuation of 3Par was independent of Dell's valuation of 3Par. Not long after the transaction was announced, H.P. made a topping bid for 3Par.[207] After a number of rounds, Dell, the initial bidder, dropped out in favor of H.P.[208] In that setting, the presence of a combination of deal protections, including significant matching rights, was not preclusive. The seller ended up in the hands of the private value acquirer with a private valuation that was materially higher than the initial bid for 3Par.[209]

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[203] 3Par Inc., Current Report (Form 8-K) [hereinafter 3Par Agreement], at Exhibit 2.1 (Aug. 16, 2010).

[204] *Id.* at Exhibit 2.1, Article 10.

[205] James Rogers, *Dell's 3Par Buy is a Shrewd Move*, THE STREET (Aug. 16, 2010, 9:13 AM), http://www.thestreet.com/story/10836514/1/dells-3Par-buy-is-a-shrewd-move.html.

[206] DEALBOOK, *H.P. Wins 3Par as Bidding War Ends*, N.Y. TIMES DEALBOOK (Sept. 2, 2010, 10:51 AM), http://dealbook.nytimes.com/2010/09/02/h-p-wins-3Par-as-bidding-war-ends/.

[207] *Id.*

[208] *Id.*

[209] H.P.'s winning bid for 3Par was eighty-three percent higher than Dell's original bid. For contemporaneous descriptions of the 3Par bidding contest for 3Par, see DEALBOOK, *supra* note 206; Steven M. Davidoff, *Dell and Its Deadline*, N.Y. TIMES DEALBOOK (Sept. 1, 2010, 8:25 PM), http://dealbook.nytimes.com/2010/09/01/dell-and-its-deadline/.

In the example above, the presence of a matching right clearly did not preclude a subsequent determined bidder from beginning an auction contest for the seller. That result is not totally unexpected. The 3Par sale involved strategic bidders, each with their own private valuation of the seller. Economic theory suggests that in such situations matching rights will not necessarily deter second bidders who are risk-averse and have materially higher valuations. A court reviewing a challenge to matching rights in the initial merger agreement with Dell would be correct to hold that matching rights in that circumstance were not preclusive. However, it does not require 20/20 hindsight to reach this conclusion. The private value characteristics of the sale suggest that a matching right would not necessarily deter a higher valuing strategic bidder. A court could conclude that, with respect to the matching rights available in the 3Par transaction, they were reasonable when granted to the right-holder.

A second example of a seller granting a matching right—but this time in a manner that might raise concerns of unreasonableness—is the case of J. Crew Group's transaction with private equity investor TPG to take the company private for $43.50 per share in cash.[210] This transaction was controversial because of a variety of procedural shortcomings.[211] One of those included the fact that the CEO of J. Crew Group expressed a preference to do this sale of control transaction with only the initial bidder.[212] Managers, including the CEO, participated in the ownership group of the post-transaction corporation.[213] The transaction included a number of deal protections, including a termination fee and matching rights; these rights included information rights, advance notice provisions, and a good faith negotiation right.[214] The seller also received a go-shop provision as part of the transaction.[215]

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[210]J.Crew Grp. Inc., Current Report (Form 8-K) (Mar. 1, 2011); *see also* Michael J. de la Merced, *J. Crew Shareholders Approve $3 Billion Buyout*, N.Y. TIMES DEALBOOK (Mar. 1, 2011, 10:15 AM), http://dealbook.nytimes.com/2011/03/01/j-crew-shareholders-approve-buyout/ (providing detail of the $43.50 per share offer).

[211]Steven M. Davidoff, *J. Crew Buyout Raises Questions*, N.Y. TIMES DEALBOOK (Dec. 10, 2010, 4:14 PM), http://dealbook.nytimes.com/2010/12/10/j-crew-buyout-raises-questions/ (discussing the various flaws that occurred in the buyout process).

[212]*Id.*

[213]J.Crew Grp. Inc., Current Report (Form 8-K) [hereinafter the J.Crew Agreement], at Exhibit 2.1, Section 1.6 (Nov. 26, 2010).

[214]J.Crew Group granted the following matching rights to the acquiring group:

> Notwithstanding anything to the contrary set forth in this Agreement, prior to the time the Company Stockholder Approval is obtained, but not after, the Board of Directors of the Company may make a Company Adverse Recommendation . . . provided, however, that (1) the Company has given Parent at least three calendar days' prior written notice of its intention to take such action (which notice shall

Given the profile of the transaction, which included an acquirer with common value attributes and the participation of management with the initial bidder, two things are expected. First, one would not expect a subsequent common value bidder to make a topping bid. Second, to the extent there was transaction surplus to be divided between the acquirer and the shareholders of the seller, the acquirer should capture most of that surplus. No matter how good the sellers are as negotiators one should not expect them to be able to capture a significant amount of transaction surplus without the competitive threat of a viable third party bid.[216] In this circumstance, a court could examine the use of matching rights and determine that the structural, informational, and time advantages such rights afforded the initial bidder effectively precluded second bidders from making competitive bids. In fact, the go-shop provision generated no additional competitive offers to compete with the offer of the financial buyer cooperating with the management group.[217]

> include an unredacted copy of the Superior Proposal, an unredacted copy of the relevant proposed transaction agreements and a copy of any financing commitments (including Redacted Fee Letters) relating thereto and a written summary of the material terms of any Superior Proposal not made in writing, including any financing commitments relating thereto), (2) the Company has negotiated, and has caused its Representatives to negotiate, in good faith with Parent during such notice period, to the extent Parent wishes to negotiate, to enable Parent to propose revisions to the terms of this Agreement, the Financing Letters and the Guaranty such that it would cause such Superior Proposal to no longer constitute a Superior Proposal, (3) following the end of such notice period, the Board of Directors of the Company (acting upon recommendation of the Special Committee) shall have considered in good faith any proposed revisions to this Agreement, the Financing Letters, the Rollover Letter and the Guaranty proposed in writing by Parent in a manner that would form a binding contract if accepted by the Company, and shall have determined that the Superior Proposal would continue to constitute a Superior Proposal if such revisions were to be given effect and (4) in the event of any material change to the material terms of such Superior Proposal, the Company shall, in each case, have delivered to Parent an additional notice consistent with that described in clause (1) above and the notice period shall have recommenced, except that the notice period shall be at least one calendar day (rather than the three calendar days otherwise contemplated by clause (1) above); and provided, further that the Company has complied in all material respects with its obligations under this Section 5.2 and provided, further, that any purported termination of this Agreement pursuant to this sentence shall be void and of no force and effect, unless the Company termination is in accordance with Section 7.1 and, to the extent required under the terms of this Agreement, the Company pays Parent the applicable Termination Fee in accordance with Section 7.3 prior to or concurrently with such termination.

Id. at Exhibit 2.1, Section 5.2(e).

[215]*Id.* at Exhibit 2.1, Section 5.2(a).

[216]*See* Bulow & Klemperer, *supra* note 60, at 1568.

[217]Michael J. de la Merced, *J. Crew 'Go-Shop' Ends with No New Bids*, N.Y. TIMES DEALBOOK (Jan. 17, 2011, 11:49 AM), http://dealbook.nytimes.com/2011/01/17/j-crew-fetches-no-

Of course, the object of these two examples is not to engage in ex post evaluations in which hindsight is 20/20. Instead, these examples demonstrate that the bidder profile, as well as the informational and timing advantages engendered by various matching rights, can affect subsequent bidders' incentives to generate competing bids and the distribution of transaction surplus, making these measures unreasonable.

Although findings of unreasonableness typically involve some "evidence of self-interest, undue favoritism or disdain towards a particular bidder, or a similar non-stockholder-motivated influence that calls into question the integrity of the process," it is nevertheless possible for a board, acting in good faith, to make unreasonable decisions.[218] Where a board, in good faith, grants an initial bidder with common value attributes matching rights and other deal protections, such decisions may be unreasonable and therefore require the attention of the courts. It is possible that a board, relying on recent case law,[219] may mistakenly determine in good faith that matching rights are no more than standard terms and grants such rights to a buyer in circumstances that are preclusive of subsequent bids or have negative distributional effects. Rather than permit that to happen, courts should signal that they remain open to the possibility that there are potentially preclusive uses of matching rights, instead of simply accepting such rights as standard terms or mere boilerplate.

VI. CONCLUSION

Professors Coates and Subramanian have argued that "courts should not rubber-stamp" deal protections.[220] And, in most cases courts do not. In the special case of matching rights, in recent years courts have refused to accept plaintiffs' arguments that in some circumstances matching rights may "overprotect" a deal by providing more compensation than is necessary to induce an initial bid. Notwithstanding pronouncements by the courts that such rights are no more than standard or common deal terms, they can create economically powerful structural incentives against subsequent bidders. Because the presence of matching rights may have the power to deter subsequent bids, there are circumstances when granting such rights to initial bidders may be unreasonable. In those cases, courts should not be afraid to

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new-takeover-bids/.

[218] *In re* Del Monte Foods Co. S'holders Litig., 2011 WL 532014, at *15 (Del. Ch. Feb. 14, 2011) (noting boards can act in good faith, but nevertheless make inequitable decisions).

[219] *See, e.g.*, *In re* 3Com S'holders Litig., 2009 WL 5173804, at *6 (Del. Ch. Dec. 18, 2009).

[220] Coates & Subramanian, *supra* note 37, at 389-90.

find that the use of matching rights is either preclusive, or lies outside the range of reasonable responses to the perceived threat.

Of course, this is not to say, as the courts correctly acknowledge, that there are no circumstances under which a board acting reasonably in conformity with its fiduciary obligations might agree to grant matching rights to an initial bidder. Indeed, there are circumstances in which such an action would be perfectly reasonable and entirely consistent with their fiduciary obligations. For instance, when a fully-informed board, acting in good faith, negotiates a sale to an unaffiliated third party, decisions to grant the initial bidder matching rights may well be reasonable.

However, economic theory suggests that courts should employ a more nuanced and serious approach to reviewing the use of matching rights. At the very least, courts should subject matching rights to the same level of scrutiny as that applied to termination fees. There are circumstances—for example, in transactions with controlling shareholders—where courts should be more circumspect of the use of such rights. In such circumstances, the presence of matching rights may well be preclusive of a second bid, or may result in an inequitable distribution of the transaction surplus away from selling shareholders and therefore be unreasonable. In any event, courts should refrain from treating matching rights as a standard contract term that requires little by way of substantive analysis.

APPENDIX: MATCHING RIGHTS IN MERGER AGREEMENTS

Transactions with some form of match right:	
Yes	328 (99.09%)
No	3 (0.91%)
Total	331 (100.00%)

Transactions with simple information rights:	
Yes	326 (98.49%)
No	5 (1.51%)
Total	331 (100.00%)

Transactions requiring advance notice prior to negotiating with third party (no-shop provision):	
Yes	71 (21.45%)
No	260 (78.55%)
Total	331 (100.00%)

Average number of days of advance notice prior to engaging in negotiations with a third party regarding a potential superior offer: 2.16.

Days	Count
Not Required	260
Not Specified	3
1	16
2	34
3	14
4	0
5	3
6	1

Transactions requiring advance notice prior to change in board recommendation:	
Yes	251 (75.83%)
No	80 (24.17%)
Total	331 (100.00%)

Average number of days of advance notice prior to change in board recommendation: 3.63.

Days	Count
Not Required	80
Not Specified	5
1	4
2	22
3	116
4	29
5	74
6	0
7	0
8	0
9	0
10	1

Transactions requiring advance notice prior to termination of agreement:	
Yes	93 (28.10%)
No	238 (71.90%)
Total	331 (100.00%)

Average number of days of advance notice prior to terminating merger agreement: 3.74.

Days	Count
Not Required	238
1	0
2	10
3	41
4	10
5	31
6	0
7	0
8	0
9	0
10	0
11	1

Transactions providing buyer with explicit right to match:	
Yes	135 (40.79%)
No	196 (59.21%)
Total	331 (100.00%)

Transactions requiring seller to negotiate in good faith following third party offer:	
Yes	178 (53.78%)
No	153 (46.22%)
Total	331 (100.00%)

Average number of days of delay built into merger agreement (implicit match period [sum of all advance notice provisions]): 4.5.

Days	Count
0	22
1	3
2	20
3	101
4	37
5	87
6	24
7	13
8	12
9	0
10	9
11	1
12	2