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Bulletproof: Mandatory Rules for Deal Protection

Brian JM Quinn*

I. INTRODUCTION

This Article provides an economic analysis of mechanisms that protect negotiated acquisitions of companies and explains the need for a mandatory rule limiting the use of such mechanisms. The Delaware courts have in fact imposed restrictions on various forms of deal protection without recognizing a consistent underlying economic logic to their decisions and without establishing a consistent principle governing different forms of deal protection. At the same time, practitioners continue to push the edge of the envelope seeking ways to create stronger deal protection. I argue that when viewed together from an economic perspective, the courts' somewhat ad hoc decisions relating to deal protection are consistent with the efficiency objective underlying corporate law and should be bolstered rather than undermined. Specifically, I argue that sellers should be prohibited from providing buyers in non-*Revlon*[1] transactions with "bulletproof"

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1. *See infra* note 7 and accompanying text (discussing *Revlon*).

protection.[2] Instead, sellers should be permitted to provide limited protection only to the extent necessary to compensate bidders for the transaction and opportunity costs of making bids. A well-measured termination fee should be sufficient for this purpose.

In negotiating non-*Revlon* transactions, buyers of corporations commonly ask sellers to undertake certain commitments that prevent them from accepting an alternative offer from a third party.[3] Such commitments—including no-shops/no-talks, voting agreements, large stock or asset lockups, and large termination fees—when used alone or in combination can make the contemplated sale "bulletproof," or immune to a third party bid. The increased certainty that these commitments provide is valuable to the buyer, who must incur transaction-specific costs as well as opportunity costs to consummate the deal. By bulletproofing an acquisition, a seller may be able to extract some of this value by negotiating a higher sale price. Hence, buyers are frequently able to convince sellers to provide them with a bulletproof deal. The seller's cost of bulletproofing is the lost opportunity to expose the transaction to market competition, which would tend to increase the sale price—either through a price from the initial buyer that is high enough to pre-empt third party bids, or through a sale to a third party that outbids the initial buyer, or through a sale to the initial buyer after a bidding contest.

Through a series of cases during the 1990s, Delaware courts have taken up the question of bulletproofing on a number of occasions. Courts used a number of *ad hoc* approaches to place limits on the use of large termination fees, stock options, and no-talk provisions, among others. In *Omnicare, Inc. v. NCS Healthcare, Inc.*, the court held, broadly, that selling boards violate their fiduciary duties when they agree to merger agreements without effective fiduciary outs.[4] By requiring merger agreements to include effective fiduciary outs, the court has laid down a mandatory rule that significantly curtails the ability of sellers to bulletproof transactions and, more generally, that provides guidance regarding the limits of the uses of most, but not all, deal protection in stock-for-stock transactions. Reaction to the Delaware Supreme Court's majority decision in *Omnicare* was negative and has led to an expectation that the court will reverse its decision at the first opportunity.[5]

Commentators have argued that sellers should be permitted latitude in protecting a negotiated transaction and that a seller's decision to bulletproof such transactions should

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2. Deal lawyers use a variety of terms to describe transactions that employ combinations of deal protection to make them immune to a later topping bid, including: "tight"; "locked-up"; "locked"; and "bulletproof." In *Omnicare, Inc. v. NCS Healthcare, Inc.*, the buyer expressed his desire to make the transaction "bulletproof" so as to preclude a subsequent bid from Omnicare. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 923 (Del. 2003). Deal lawyers also use a number of terms, including "lock-ups," to describe deal protection measures. I have reserved the term "lock-up" to mean only stock options or asset options and not as a more general description of deal protection measures.

3. For example, research by Coates IV and Subramanian indicates that, in 1998, 80% of all negotiated transactions with public company targets employed a deal protection measure of some sort. John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M & A Lockups: Theory and Experience*, 53 STAN. L. REV. 307, 315 (2000).

4. *Omnicare*, 818 A.2d at 914.

5. Delaware Supreme Court Chief Justice Steele has been quoted saying, "So while I don't suggest that you rip the *Omnicare* pages out of your notebook . . . I do suggest that there's the possibility, one could argue, that the decision has the life expectancy of a fruit fly." *See* David Marcus, *Man of Steele*, D & O ADVISOR, Sept. 2004, at 16, 16. Vice Chancellor Strine called the *Omnicare* decision "aberrational." *In re* Toys "R" Us, Inc., 877 A.2d 975, 1016 n.68 (Del. Ch. 2005).

be subject to judicial review only under the business judgment rule. Decisions by the Delaware courts that subject bulletproofing to enhanced levels of scrutiny have been criticized as the wrong result, and the courts have been encouraged to reverse their position with regard to bulletproofing. The basis for these commentators' view is that limiting a seller's ability to bulletproof a sale will reduce the willingness of would-be acquirers to make bids, and to the extent that bids are made, bidders will offer lower prices than they would if a bulletproof deal was available.[6]

This Article presents an auction theory analysis of deal protection to demonstrate that, for reasons not necessarily related to the reasoning in the opinions themselves, the line of cases in the Delaware courts are correctly decided, that a mandatory rule against bulletproofing is sound as a matter of policy, and that it should be extended. While a seller may be able to negotiate a higher price from a particular buyer in exchange for bulletproofing a deal, auction theory models demonstrate that such a negotiated gain will, in expectation, be lower than the gains a seller can reap by exposing a deal to potential market competition. For reasons I will explain, without a mandatory rule sellers find it difficult to resist these demands. The line of cases limiting bulletproofing allows sellers to resist strong pressures from buyers to bulletproof transactions and thereby share in the joint gains generated by the transaction. At the same time, because acquisition bids are costly, in terms of direct expenses and opportunity costs, the expected return to making a bid must be sufficiently high to justify a bidder's up-front investment. Limited deal protection, and more importantly, termination fees covering bid costs, can accomplish this objective. Here, the courts are correct in permitting such limited protection for bidders. Limiting the ability of selling boards to grant bulletproofing will result in enhanced social welfare. Enhanced social welfare is the proper measure for legal rules. Consequently, the Delaware Supreme Court's mandatory rule regarding bulletproofing should be maintained and extended rather than reversed.[7]

This Article proceeds in the following manner: Part II describes the variety of bulletproofing measures and techniques that are commonly used in non-*Revlon* transactions. This Part also provides a brief overview of the legal restrictions on deal protection measures. Part III describes the arguments put forward to defend the use of

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6. *See Omnicare*, 818 A.2d at 946 (Veasey, C.J., dissenting) (arguing that bidders will offer sellers lower prices when deals are not bulletproof). Among others, see Meredith M. Brown & William D. Regner, *Delaware to Directors: Don't Do Done Deals*, M & A LAW., Apr. 2003, at 1 (arguing that bidders will offer sellers lower prices when deals are not bulletproof), Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of* Omnicare v. NCS Healthcare, 29 J. CORP. L. 569, 572 (2004) (same); Michael J. Kennedy, *The End of Time? Delaware's Search for the Fiduciary GUT*, M & A LAW., Oct. 2003, at 21 (same); Clifford E. Neimeth & Cathy L. Reese, *Locked and Loaded: Delaware Supreme Court Takes Aim at Deal Certainty*, M & A LAW., Oct. 2003, at 6-7 (same); Brian C. Smith, *Changing the Deal: How* Omnicare v. NCS Healthcare *Threatens to Fundamentally Alter the Merger Industry*, 73 MISS L.J. 983, 984 (2004) (same); and Justin W. Ovaretz, Comment, *Is a Merger Agreement Ever Certain? The Impact of the* Omnicare *Decision on Deal Protection Devices*, 29 DEL. J. CORP. L. 805, 812 (2004) (same).

7. While this Article analyzes the question of deal protection as applied in non-*Revlon* transactions, the intuition of the Delaware Supreme Court in *Revlon* is consistent with my conclusions in this Article. In *Revlon*, the court approved deal protection measures to induce auctions, but not those deployed to preclude or end auction contests. Though the court was criticized for creating a difficult distinction between the two situations, from the perspective of auction theory the court was likely correct. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d. 173, 185 (Del. 1986) (invalidating defensive measures adopted in order to favor one bidder over another in an auction contest).

deal protection measures to bulletproof these negotiated transactions. These arguments focus on sellers' ability to negotiate higher prices by assuring buyers that a sale will be consummated. Part IV relies on auction theory to demonstrate that while such assurances may allow sellers to extract some of the buyers' gains, a seller would obtain a higher price in expectation by making itself available to third party bids. Part V argues that while the only valid justification for deal protection may be to encourage bids from a potential buyer, bulletproofing is not necessary for that purpose. A termination fee covering bid costs will be sufficient for that purpose. Sellers need not revert to bulletproofing in order to generate initial bids. Part VI argues that there are structural biases in the bargaining process that make it difficult for sellers to resist bulletproof transactions in a bilateral negotiation. These biases make it necessary to have a mandatory rule that prevent sellers from agreeing to bulletproof transactions. Part VII describes the welfare enhancing effects of taking bulletproofing off the table and leaving negotiated transactions open to competition. Without bulletproof transactions, sellers can expect higher sale prices for sellers—either from initial or third party bidders. Such a result is socially beneficial because it encourages sellers to invest ex ante in maximizing their value in a sale transaction and ensures that sellers end up in the hands of the highest-valuing buyer. Part VIII briefly summarizes and concludes.

II. COMMON DEAL PROTECTION AND BULLETPROOFING

Deal protection measures, to varying degrees, deter subsequent bids and in some cases compensate a would-be buyer if a third party ultimately acquires the seller. When used in combination, or in some circumstances alone, deal protection measures can render a transaction "bulletproof," or immune to a topping bid. This Article is concerned with using such measures to bulletproof transactions that have not been exposed to the market through either an auction or a pre-signing market check.[8] Common deal protection measures fall into one of three general categories: voting protections, exclusivity measures, and compensatory devices. This Part describes each of the measures that have been developed and tested in the courts and then describes the limitations that the courts have imposed on them.

A. Voting Protections

Voting protections enable a seller to "bank" a high percentage of the shareholders' votes in favor of the agreed upon transaction prior to an actual shareholder vote. A seller can ensure the success of its preferred transaction by securing voting agreements from stockholders holding a majority of the shares or voting power. Where ownership of the seller is closely-held, the transaction costs associated with assembling a majority bloc in support of the transaction can be reasonably low since many of the major stockholders

8. This Article does not analyze the implications of the recent rise in use of "go-shop" provisions. "Go-shop" provisions are, at least on their face, consistent with the general implication of this Article: latent exposure to market review can improve prices for sellers and does not necessarily deter potential buyers. "Go-shop" provisions are controversial because some believe that rather than promote an auction, they are intended to act as a deal protection. This proposition has not yet been tested, however. Andrew Ross Sorkin, *Dealbook: Looking for More Money, After Reaching a Deal*, N. Y. TIMES, Mar. 26, 2006, *available at* 2006 WLNR 4986455 (questioning whether "go-shops" are intended to actually promote auctions).

are often directly represented on the seller's board of directors and the universe of stockholders is limited in size.[9] Where voting agreements are used, the merger agreement is usually signed contingent upon or contemporaneous with their delivery.[10]

In public company transactions, where there is typically not a controlling bloc of shares that can be easily assembled in favor of the sale, sellers can offer lesser voting protections. The most attractive from the buyer's point of view is the commitment that the seller's board will continue to recommend the transaction regardless of whether a better offer arises before the time of the vote or, in the event of a better subsequent offer, that the seller's shareholders must be given an opportunity to vote on the initial transaction before being allowed to terminate the merger agreement. The "force-the-vote" provision, which requires boards to call such votes prior to terminating a merger agreement, can be an effective deterrent to a subsequent bid.[11] In particular, it can reduce the incentive of a seller's board to pursue alternative transactions or to re-open negotiations with buyers once an initial transaction is agreed to.[12]

There are a number of other voting provisions that provide incremental defensive security for buyers. These measures include provisions that require sellers to call stockholder meetings or set time limits on how long a selling board may delay its obligation to call a meeting. Other provisions include "best efforts" provisions relating to regulatory approvals that also provide incremental security for buyers. Though these provisions provide buyers with some additional deal security, voting agreements and the force-the-vote provisions are clearly the most valuable to buyers.

B. Exclusivity Measures

Exclusivity measures prevent selling boards from considering or negotiating with a potential rival acquirer. No-shop and no-talk provisions are the most common variants of exclusivity measures. No-shop, or no-solicitation, measures restrict selling boards from actively seeking an alternative buyer. No-shop provisions allow a seller to respond to an unsolicited bid but do not allow a seller to initiate discussions with a potential bidder or use a signed agreement to actively shop a target.[13] No-talk provisions go further by

9. Voting protections can also be extremely effective in public company transactions where a small number of stockholders hold a significant bloc of shares, as in *Omnicare*.

10. In the private company, an effective alternative to the voting agreement is the action by written consent. When the action by written consent is used, the consent of a majority bloc can be delivered simultaneously with the signing of the merger agreement, making a stockholder vote unnecessary, eliminating the period of time between signing and the shareholder vote.

11. The Delaware General Corporation Law was amended in 1998 to allow boards to submit mergers for a shareholder vote without a board's recommendation. In *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985), the Delaware Supreme Court read section 251(c) to require a board recommendation in order for shareholders to vote on a transaction. *See* R. Franklin Balotti & A. Gilchrest Sparks III, *Deal-Protection Measures and the Merger Recommendation*, 96 NW. U. L. REV. 467, 475-76 (2001) (discussing clauses in merger agreements that forbid a board to change a merger recommendation).

12. While a force-the-vote provision effectively ties the hands of the board before it has proposed the current deal to the shareholders, the provision does not prevent shareholders from voting down an inadequate deal or from tendering to another buyer.

13. This description includes only no-shops in the merger agreement and does not include "exclusivity agreements" signed as part of the negotiating process. It is not uncommon for parties to a negotiated acquisition to enter into a time-limited exclusivity agreement that limits the ability of the seller to shop the company while

prohibiting sellers from sharing proprietary and non-public information or engaging in any discussions with a potential subsequent bidder. In preventing sellers from sharing any non-public information or speaking with subsequent bidders, no-talk provisions can shut down a potential bid by starving a subsequent bidder of the information required to generate a competitive bid.[14] Common versions of the no-shop and no-talk provisions, also known as no-solicitation provisions, prohibit sellers from initiating any contact with a potential subsequent bidder, but do allow sellers to terminate the initial transaction in order to respond to unsolicited superior offers from subsequent bidders.[15]

Rights of first refusal, or matching rights, are another type of exclusivity measure. A right of first refusal provides that in the event that a subsequent bid is made, the buyer with a right of first refusal has the right to match the subsequent bid. The presence of rights of first refusal can be a strong deterrent against subsequent bids and is therefore a potentially potent protective measure in the non-*Revlon* context. A subsequent bidder faces a real risk of incurring the expense of evaluating a target and making a bid only to see the initial bidder exercise its right of first refusal and buy the company.[16] While a subsequent bidder is always free to make a topping bid, it may have only limited access to information regarding the seller. The subsequent bidder knows that it can win only in the event its bid (based on limited information regarding the seller) is larger than the bid of the incumbent (based on extensive information regarding the seller). Success under these circumstances may involve paying too much and suffering the "winner's curse."[17]

Of course, the deterrent value of rights of first refusal depends both on the nature of the company being sold as well as on the nature of the bidder. In a common value setting—where the value of the seller is the same to each bidder—the presence of a right of first refusal can be a strong deterrent to subsequent bids. Where the seller's value to a potential buyer is more idiosyncratic or dependent on synergies, potential buyers may

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engaging in negotiations with the potential buyer. Exclusivity provisions agreed to as part of the negotiating process are more troublesome than those in merger agreements because they actively prevent sellers from creating an auction or soliciting alternate offers before signing a merger agreement with a particular buyer. For that reason, exclusivity agreements are typically limited to relatively short periods. No-shops included as part of the merger agreement are not generally subject to similar time restrictions.

14. Confidentiality agreements signed during the negotiation process can also act as exclusivity measures. Such agreements work together with a no-shop or no-talk in the merger agreement. The standard no-shop or no-talk contains a requirement that any subsequent bidder sign a confidentiality agreement similar to that signed by the initial bidder. The initial bidder's confidentiality agreement will contain, often at the request of seller's management, a standstill provision that prevents the bidder from "going hostile." A subsequent bidder who signs a confidentiality agreement risks not being able to take any actions that might lead to an auction without the assent of the seller's board because of the standstill provision included in the confidentiality agreement. For a discussion of how the confidentiality agreement interacts with the standstill provision, see Dennis J. Block, *Public Company M & A: Recent Developments in Corporate Control, Protective Mechanisms and Other Deal Protection Techniques*, *in* CONTESTS FOR CORPORATE CONTROL 2005, at 9, 38 (PLI, Course Handbook Series No. 5836, 2005).

15. An example of such a provision can be found at *In re* MONY Group Inc. S'holder Litig., 852 A.2d 9, 24 n.31 (Del. Ch. 2004).

16. Initial bidders with rights of first refusal may have an incentive to under invest in transaction specific information gathering and to submit low-ball bids because the initial bidder may be able to free ride off of a subsequent bidder's investments in transaction specific information. Absent a subsequent bidder, the initial bidder can acquire the seller cheaply.

17. For an analysis of the deterrent effects of rights of first refusal in various contracting contexts, see David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 51-52 (1999).

have different valuations of the seller. In private value settings, rights of first refusal may have less deterrent effect. Strategic buyers are generally considered to be private value buyers and financial buyers are considered to have characteristics similar to common value bidders.[18]

C. Compensatory Devices

The final general category of deal protection devices are compensatory devices. Stock lockups, termination fees, and topping fees are all intended both to compensate bidders in the event of an unsuccessful bid and to deter third party bids. A stock lockup is an option granted to the initial buyer to purchase shares of the seller's stock upon the occurrence of a triggering event, such as the seller's termination of the initial merger agreement in order to pursue an alternative transaction. A termination fee is a cash payment to the initial buyer in the event the merger agreement with the seller is terminated due to a triggering event.[19] A topping fee is a cash payment made to the initial buyer by the seller in the event the seller terminates the initial buyer's transaction in order to accept a topping bid. The size of the fee is equal to a percentage of the difference between the price offered by the initial buyer and the topping bid. An asset lockup is an option issued to the initial bidder to purchase a division or other asset of the seller; such an asset may be the "crown jewel" of the seller or may involve assets that are of particular interest to the non-preferred bidder.[20]

From the point of view of a subsequent bidder, compensatory devices act as a tax on its bid. Depending on the size of the compensatory device, the third party's valuation of the seller and the price at which the third party can acquire the seller, these mechanisms can render a seller unattractive to a third party.[21] A topping fee can have a particularly perverse incentive effect. In its most extreme form, a topping fee pays the initial bidder the value of the difference between the initial bid and the subsequent sale price in the event the initial bidder is unsuccessful. This device not only deters subsequent bidders, but it also removes any incentive from a seller to pursue potential third party bids because the potential gains from a subsequent bid will accrue to the initial bidder and not the seller.

18. For a discussion of private and common value bidders in the context of corporate acquisitions, see JOHN MCMILLAN, GAMES, STRATEGIES & MANAGERS 134-35 (1992) and Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27, 33-45 (1991).

19. Triggering events can include termination of the merger to pursue an alternative transaction, a change in the board's recommendation to support the transaction, a no vote on the transaction by shareholders of the seller, or receipt of a superior competing transaction, among others.

20. Compensatory devices have been analyzed extensively elsewhere. *See* Ian Ayres, *Analyzing Stock Lock-ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions*, 90 COLUM. L. REV. 682, 710-15 (1990) (discussing the effect of treasury sales in takeover auctions); *see also* Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1543-70 (1996) (discussing lock-ups as a device to influence takeovers).

21. For example, if a seller agrees to a sale with buyer *A* for $1 million, including a $200,000 compensatory fee, then unless buyer *B* values the target at more than $1.2 million, it will be unlikely to make a subsequent bid and expect to have that bid accepted by the seller. *See* Ayres, *supra* note 20, at 699-700 (describing how compensatory devices could foreclose the possibility of a future bid in some circumstances).

D. Bulletproofing

The deal protection measures described above can be used alone or in combination with other measures to bulletproof transactions. In *Omnicare*, a combination of measures rendered the transaction immune to a subsequent bid.[22] During negotiations, Genesis, the buyer, threatened to walk if it was not granted a "bulletproof" transaction.[23] NCS, the seller, granted Genesis a force-the-vote provision, a no-shop provision without an effective fiduciary termination right, and voting agreements representing over 65% of the voting interest.[24] Combined with the force-the-vote provision *and* the absence of an effective fiduciary out, the voting agreements rendered the transaction a "mathematical certitude" at the time of signing.[25] Omnicare subsequently made a more attractive offer to acquire NCS. NCS's board and stockholders were unable to vote down or otherwise terminate the deal with Genesis.[26] Notwithstanding the fact that Omnicare offered a bid clearly superior to that of Genesis, the combination of voting agreements, a force-the-vote provision, and an ineffective fiduciary termination right rendered the agreement with Genesis bulletproof.[27] As discussed below, the Delaware Supreme Court later ruled that a

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22. One might argue that *Omnicare* is simply a sport on its facts, that its situation was too unique to inform any rule making. That is, perhaps, looking at the question too narrowly. There are, no doubt, a relatively small number of public companies that might be able to replicate the facts in *Omnicare* given the large bloc held by two shareholders. On the other hand, there are a large number of private companies where such a scenario is common. In addition, because of the lack of disclosure requirements and the difficulty in launching tender offers, bulletproofing measures can be extremely effective in protecting a transaction when the seller is private.

23. "[Investment banker Pollack] explained . . . [Genesis] wanted to have a pretty much bulletproof deal or they were not going to go forward." Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 923 (Del. 2003).

24. In *Omnicare*, Directors Oucalt and Shaw held Class B shares (ten votes each). These shares would convert to Class A (one vote each) upon a sale or transfer. This feature of the Class B shares made it possible for Genesis to acquire control of NCS *only in the event that the transaction was structured as a statutory merger*. A simple share purchase agreement between Oucalt, Shaw, and Genesis, or a tender offer, would have resulted in automatic conversion of the shares and would have required Genesis to acquire further shares from public stockholders in order to gain control. Through a statutory merger, Oucalt and Shaw could bind the majority of stockholders to the transaction in a manner that they could not otherwise do if the transaction were structured differently. *In re* NCS Healthcare, Inc., S'holder Litig., 825 A.2d 240, 244 (Del. Ch. 2002).

25. *Omnicare*, 818 A.2d at 936. The agreement also included a no-shop, a board recommendation in favor of the transaction, and a $6 million termination fee. Ultimately, these devices offered little protective value since the combination of the voting agreements with a force-the-vote provision and an ineffective fiduciary termination provision were sufficient to bulletproof the transaction. *Id.*

26. Had the merger agreement included an effective fiduciary termination provision, the board could have terminated the voting agreements. Since voting agreements are typically tied to the validity of a merger agreement, terminating the merger agreement would have the effect of terminating stockholder voting obligations under their respective voting agreements.

27. Professors Gilson and Gordon argue that the Delaware Supreme Court would have been better off applying the holding of *In re* Digex, Inc., S'holders Litig., 789 A.2d 1176 (Del. Ch. 2000), to the facts of *Omnicare*. Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 816 n.115 (2003). Because NCS's directors Oucalt and Shaw held high vote shares that would convert to single vote shares upon a transfer, Oucalt and Shaw could not guarantee Genesis the requisite majority in any transaction structure other than a merger. A simple sale of the majority's bloc would have resulted in a dissipation of the majority's voting control of NCS. The same result would have occurred had the transaction been structured as a tender offer. Under a statutory merger structure, the high vote shares would approve the transaction before being converted to low vote shares. As a result, in order for the two controlling shareholders to sell control of the corporation, the board had to structure the transaction as a statutory merger. Because board

seller in a non-*Revlon* transaction cannot bulletproof a sale.

E. Restrictions on Use of Deal Protection

Delaware courts have been of two minds regarding the use of deal protection in non-*Revlon* transactions. At the one extreme, one court has treated them as normal contract terms subject only to business judgment review.[28] On the other hand, courts have indicated that any action that boards take to protect a corporate strategy, even in the non-*Revlon* context, is subject to *Unocal*[29] scrutiny.[30]

In between these extremes, Delaware courts have declared a number of restrictions on sellers' uses of deal protection measures to defend transactions. With respect to compensatory devices, the Delaware Supreme Court has held that they are acceptable only as liquidated damages provisions applying principles of contract law, and therefore must be a reasonable estimate of a buyer's bid costs, opportunity costs, and the likelihood of a topping bid emerging.[31] They may not be used to preclude third party bids. Termination fees up to 6% of an acquirer's market capitalization have been accepted by the Delaware courts as reasonable on these grounds.[32] Delaware courts have also approved of stock lockups as large as 30% of a firm's outstanding stock.[33] In *Paramount Communications, Inc. v. QVC Network, Inc*, the Delaware Supreme Court disallowed a

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members Oucalt and Shaw took action to benefit themselves by having the board structure the transaction as a statutory merger and not a simple stock purchase or tender offer, their actions should properly be subject to entire fairness review under the *Digex* holding.

28. *Omnicare*, 818 A.2d at 939 (Veasey, C.J., dissenting); IXC Commc'ns, Inc. v. Cincinnati Bell, Inc., Nos. C.A. 17324, C.A. 17334, 1999 WL 1009174, at *4-5 (Del. Ch. Oct. 27, 1999). An expansive reading of the holding in *Paramount Commc'ns, Inc. v. Time, Inc*., 571 A.2d 1140 (Del. 1989) has been taken to mean that boards in friendly settings may negotiate with preferred bidders, protect the resulting deal against a third party bid, and then receive the benefit of business judgment rule review. *See* Leo E. Strine, *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 929 (2001). Laster provides numerous examples of this view. *See* J. Travis Laster, *Exposing a False Dichotomy: The Implications of the No - Talk Cases for the Time/Revlon Double Standard*, 3 DEL. L. REV. 179, 189 (2000).

29. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

30. The Delaware Supreme Court noted that structural safety devices (deal protection measures) adopted in the context of a negotiated acquisition in anticipation of a potential competing bid "are properly subject to a *Unocal* analysis." *Time Inc.*, 571 A.2d at 1151; *see* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 106 (Del Ch. 1999) (applying a *Unocal* analysis to deal protection measures in a non-*Revlon* transaction); Phelps Dodge Corp. v. Cyprus Amax Minerals Co., Nos. CIV.A. 17398, CIV.A. 17383, CIV.A. 17427, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999) (same); *see also* Mark Lebovitch & Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger of Equals Transactions*, 2001 COLUM. BUS. L. REV. 1, 8-20 (arguing deal protection measures adopted in non-*Revlon* transactions should be properly subject to *Unocal* scrutiny).

31. Brazen v. Bell Atlantic Corp., 695 A.2d 43, 48 (Del. 1997). Professor Skeel argues that compensatory devices should be measured in the same way as reliance damages, rather than expectation damages, in contract law principles. Applying reliance damage principles to compensatory devices would compensate bidders for any direct bid costs and opportunity costs and place them in the position they were in before the transaction. *See* David A. Skeel, *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564, 595-96 (1996).

32. *Brazen*, 695 A.2d at 49 (permitting a 2% termination fee). The chancery court in *IXC* permitted a 6.3% termination fee. *See also IXC*, 1999 WL 1009174, at *4-5 (permitting a 6.3% termination fee).

33. *See, e.g.*, Rand v. Western Air Lines, Inc., Civ. A. No. 8632, 1994 WL 89006, at *6 (Del. Ch. Feb. 25, 1994), *aff'd* 659 A.2d 228 (Del. 1995).

19.9% option, stressing the large absolute size of the option.[34] Practitioners report topping fees equal to 50% of the difference between initial bid price and final price.[35] Unlike termination fees and stock lock-ups, courts have not yet stepped in to block unreasonable topping fees.[36]

Delaware courts take a different approach to determining the validity of exclusivity measures. The Delaware Chancery Court has held that strict exclusivity measures have a pernicious effect because they "involve[] an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely that time in the life of the company when the board's own judgment is most important."[37] Though the seller is "under no duty to negotiate [with subsequent bidders] . . . nevertheless, even the decision not to negotiate . . . must be an informed one."[38] The chancellor held that strict no-talk provisions are troubling because they "prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party."[39] In that respect, strict no-shop and no-talk provisions fail to meet even the relatively low duty of care standard. Similarly, the Delaware Supreme Court has held that covenants to continue to recommend a transaction in the face of a superior transaction do not comport with a board's fiduciary obligations.[40] With respect to exclusivity measures, boards may not simply close their eyes to potential subsequent transactions or changes in conditions without violating their duties as directors.[41]

34. Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 39 (Del. 1994). NASD and NYSE rules require separate shareholder votes to approve options greater than 20%, thus making it more difficult for sellers to offer options larger than 20%. *See* Coates IV & Subramanian, *supra* note 3, at 344 (discussing the effect of the NASD and NYSE rules).

35. *See* William D. Regner, *Looking at Lock-Ups:* Orman *and* Omnicare, M & A LAW., Dec. 2004, at 20 (referring to the acquisition of Lillian Vernon).

36. The size of stock lock-ups, topping fees, and asset lock-ups are not necessarily related to any measure of opportunity costs and are therefore not good approximations of the opportunity costs of generating a bid, particularly following an unsuccessful auction contest when asset values may have been bid up substantially over the initial bid. Ayres notes that in such situations initial buyers holding lock-ups may have an incentive to lose, rather than win, a bidding contest. *See* Ayres, *supra* note 20, at 90-91.

37. ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 106 (Del. Ch. 1999). In *ACE*, the merger agreement included a "no talk" provision that allowed the board to engage in discussions with a potential third party bidder if the board concluded "in good faith . . . based upon the written advice of its outside legal counsel, that participating in such negotiations or discussion or furnishing such information is required in order to prevent the Board of Directors of [the target] from breaching its fiduciary duties to its stockholders." Vice Chancellor Strine notes that Delaware courts have taken a "dim view" of actions by boards to disable themselves. *Id.* In *Quickturn Design Sys., Inc. v. Shapiro*, the court invalidated a delayed redemption provision. The court stated that the provision "would prevent a newly elected board of directors from completely discharging its fundamental management duties to the corporation . . . ." *Quickturn*, 721 A.2d 1281, 1291 (Del. 1998). On the other hand, in *IXC*, Vice Chancellor Jacobs expressed his opinion that no-talk provisions are not *per se* invalid when he subjected review of the provisions to a traditional business judgment review. *See IXC*, 1999 WL 1009174, at *6.

38. Phelps Dodge Corp. v. Cyprus Amax Minerals Co., Nos. CIV.A 17398, CIV.A 17383, CIV.A 17427, 1999 WL 1054255, at *1 (Del. Ch. 1999).

39. *Id.*

40. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d. 1140, 1142-43 (Del. 1989) (citing Smith v. Van Gorkom, 488 A.2d 858, 873-74 (Del. 1985)).

41. The amendment of title 8, section 251 of the Delaware General Corporation Law in 1998 has reduced the impact of the board recommendation as an exclusivity measure. *See* Balotti & Sparks III, *supra* note 11 at 470. At the same time, it led to the development of a new deal protection measure—the "force the vote" provision, which requires that boards send the transaction to shareholders for a vote with or without a

In reviewing the validity of voting protections to defend a transaction, the Delaware Supreme Court took yet another doctrinal approach. The court took into account the "operative effect" of voting agreements that were "inextricably intertwined with the defensive aspects of the . . . merger agreement."[42] In the court's analysis the stockholders who signed voting agreements in favor of a merger became a "cohesive group acting together."[43] The presence of a majority bloc "impose[s] upon the [selling] board an affirmative responsibility to protect . . . minority shareholders' interests."[44] Consequently, a selling board violates its fiduciary duties to minority shareholders by granting voting protections that assure buyers of the required vote.[45] The court also held that the use of voting protections such that "any stockholder vote would have been robbed of its effectiveness" was coercive and could be invalidated on those grounds as well.[46]

The rationales for courts' ad hoc responses to each of the categories of deal protection are not entirely satisfying when taken as a whole since they appear to lack a consistent motivation. Exclusivity measures are limited by a board's duties under section 141(a).[47] There is, however, ample evidence that boards can commit to strict exclusivity measures when entering into material agreements. For example, a board may include a strict no-talk provision in an agreement to sell a material division and thereby tie its own hands. Courts deal with compensatory devices differently. Courts limit compensatory devices under liquidated damages rationales, though there is little to suggest that the value of some compensatory devices, particularly stock and asset options, should bear any relationship to actual liquidated damages. In extreme cases, bidders could have incentives to lose a bidding contest and profit from the presence of compensatory devices. Finally, with regard to the category of voting protections, courts have adopted yet another approach. Courts limit the ability of shareholders to commit to a particular transaction via a voting agreement, based in part on a duty of the board to minority shareholders not to impede the effectiveness of the voting process. In the case of voting agreements, the courts' worry is stimulated by the presence of a statutory requirement for a shareholder vote to approve a merger under section 251(c) and preference that the statutory shareholder vote not be reduced to a mere formality.[48] However, in other circumstances, the Delaware courts readily recognize shareholders' right to sell or otherwise commit their shares in any manner they wish.[49]

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recommendation from the board.

42. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 934 (Del. 2003).

43. *Id.* at 937.

44. *Id.*

45. *Id.* at 936-37.

46. *Id.* at 936.

47. DEL. CODE ANN. tit. 8, § 141(a).

48. *Omnicare*, 818 A.2d at 936-37.

49. Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) (recognizing the right of shareholders to dispose of their shares in any manner they wish). Of course, in other contexts, the Delaware courts have permitted boards to control how and under what circumstances shareholders may tender their own shares to a buyer. Professor Ron Gilson notes that Delaware has expressed an inexplicable preference for election procedures over tendering in the takeover context. *See* Ronald J. Gilson, Unocal*: Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001). Delaware's view on alienability, it seems, is somewhat malleable. In the takeover arena, at least, management applauds such malleability. *See id.* at 510.

Notwithstanding the courts' seemingly ad hoc approaches to the issue of deal protection, there is an economic logic that links the approaches. This more consistent economic logic can provide boards and courts a clearer understanding of the limits to the use of deal protections. I explain that logic in Part V below. Before doing so, however, I review the near universal condemnation that commentators have leveled against the Delaware Supreme Court's prohibition on bulletproofing transactions.

III. COMMENTATORS' ARGUMENTS IN FAVOR OF BULLETPROOFING: CERTAINTY INCREASES SALE PRICE

Proponents of bulletproofing transactions argue that improved certainty will increase the value and numbers of bids and thereby improve seller shareholder welfare. Without the ability to offer buyers certainty, a seller's transactional commitments lose credibility "and thus hardly amount to commitments at all."[50] Consequently, proponents argue that sellers should be permitted to bulletproof their transactions. They argue that, if a deal is not bulletproof, uncertainty regarding closing will lead would-be bidders to decline to bid, resulting in a loss of shareholder welfare.[51] The source of the uncertainty stems from an inherent problem with the "credibility" of seller commitments.[52] For example, subsequent to signing, but prior to a shareholder vote, a seller might receive a topping bid or enjoy a change in circumstances that improves its prospects as an independent company. If either of these events occurs, the seller's board might, in the absence of an obligation, decline to close the transaction. Proponents argue that, because of the uncertainty stemming from the lack of credible commitments by sellers, some potential bidders may not be willing to make the transaction specific investments required to generate a bid. Without certainty some (lower-valuing) bidders will refuse to bid and other (higher-valuing) bidders will submit lowball bids.[53] Consequently, the absence of bulletproofing will lead to lower deal prices and some transactions not occurring at all.[54]

The certainty offered by bulletproofing transactions, proponents argue, can change this dynamic. By allowing sellers to offer certainty to lower-valuing bidders, those bidders will make bids that they might not otherwise make, and sellers will enjoy higher prices because by taking control of the sale process, sellers can avoid low-ball bids from

50. Griffith, *supra* note 6, at 596.

51. *Id.* at 605.

52. For arguments related to a seller's "credibility" problem, see Griffith, *supra* note 6, at 612. *See also* Wayne O. Hanewicz, *When Silence Is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Mergers*, 28 J. CORP. L. 205, 231-32 (2003) (describing credibility problems in relation to defensive measures and no-shops in mergers); Michael A. Stanchfield, *Fiduciary Duties in Negotiated Acquisitions: Questioning the Legal Requirements for "Outs"*, 27 WM. MITCHELL L. REV. 2261, 2263-64 (2000) (describing concerns of an acquiring corporation in a merger); *see generally* Stephen Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 21-25 (2003) (describing various corporate strategies for addressing credibility problems).

53. Griffith, *supra* note 6, at 610 (describing the decision making process of bidders); Hanewicz, *supra* note 52, at 208 (same).

54. "If the inability of targets to commit to a particular transaction does not keep potential bidders entirely away, it will almost certainly cause them to bid less [because of an uncertainty discount] . . . ." Griffith, *supra* note 6, at 614. *See also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (Del. 2003) (Veasey, C.J., dissenting) (making an argument similar to the one made by Professor Griffith); Neimeth & Reese, *supra* note 6, at 6 (noting that uncertainty may lead bidders to put something other than their best bid on the table).

higher-valuing bidders.[55] In addition, proponents argue that since transactional certainty is a commodity, it can be traded for value to the benefit of selling shareholders.[56] Because managers of sellers are actively looking to sell, commentators argue that shareholders need not fear agency problems.[57] As a result, proponents argue that courts should defer to selling boards who agree to protect transactions.[58]

IV. DOES BULLETPROOFING RESULT IN HIGHER SALE PRICES?

If it could be shown that bulletproofing leads to sellers receiving a higher share of the transaction surplus, then one could mount a reasonable defense of the practice. Absent such a showing, however, bulletproofing is problematic. Sellers' managers face issues related to agency costs and diversification that could systematically shift transaction surplus in favor of buyers at the expense of sellers. It is possible that bulletproofing will lead to sellers receiving a *lower share* of joint value created by the transaction, or the transaction surplus, than they might otherwise expect to receive. Because bulletproofing limits potential competition, buyers have an incentive to submit lower bids than they would in the event that their bids were not bulletproof. Consequently, contrary to the commentators' argument that bulletproofing resolves a "credibility" problem thereby leading to higher seller prices, a more likely result is that bulletproofing does not lead to sellers receiving a higher share of the transaction surplus than they might otherwise expect and in some situations could result in lower expected prices for sellers.

A buyer's expected value of making a bid can be stated as follows: $EV = P^*(Profit) + (1-P)^*(Bid\ Costs)$, where P is the probability of closing the transaction, and is a function of the bid price; *Profit* is the present value of the acquisition, and is inversely related to the amount the buyer pays; and *Bid Costs* is the present value of bid costs, including any termination fee that might be paid in the event the transaction is terminated. Bidders will submit bids according to a decision rule that will permit bids to be made as long as the expected value (EV) of making a bid remains positive. A buyer can increase its *Profit* by submitting a low bid to the seller. The effect of a low bid, however, is to reduce the probability that the initial transaction will successfully close. Increasing *Profit* directly, then, is not a viable strategy for a buyer seeking to increase its EV of making a bid. Alternatively, a buyer can attempt to negotiate a bulletproof transaction with a seller, thereby increasing P to 1 and setting the EV equal to the *Profit* associated with a successful transaction.[59]

Though it is possible that increased bid certainty may lead to sellers receiving a higher share of the transaction surplus, this outcome is not necessary. Holding other factors constant, increased certainty attributable to bulletproofing will lead to an increase in the buyer's EV of making a bid. In exchange, a buyer may increase its bid price. But a seller has no way of knowing that a buyer is actually paying for bulletproofing. A solitary

55. *See, e.g.*, Griffith, *supra* note 6, at 611; Stanchfield, *supra* note 52, at 2285-86 (greater certainty may lead to higher initial bids).

56. Griffith, *supra* note 6, at 614-15.

57. *Id.* at 584; Hanewicz, *supra* note 52, at 241.

58. *Omnicare*, 818 A.2d at 943; Hanewicz, *supra* note 52, at 255.

59. R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699, 719 (1987).

bidder with a bulletproof deal could simply offer the seller a nominal bid increase in exchange for the additional certainty offered by bulletproofing, or simply insist on deal protection for whatever bid is then on the table. Without having received other bids or otherwise attained a sense of the market valuation, the seller has no way of knowing what it is giving up when it provides a bulletproof transaction to a buyer.

Negotiated acquisitions are, in principle, bargaining problems. Bargaining over price represents a division of the economic surplus between the buyer and the seller.[60] The economics literature shows that, in expectation, a seller in a bilateral negotiation will not do better than a 50-50 split of the surplus unless it can find a way to force the buyer to reveal private information about its valuation of the seller.[61] However, parties to a negotiation have a difficult time credibly setting limits or signaling their private valuations to the other side. Commitment devices can help parties in a bilateral negotiation set negotiating limits or reveal information about their own valuations in such a way as to shift surplus to one side or the other during a negotiation.[62] If a seller is able to commit to real negotiating limits that are visible to the other side, such limits can facilitate revelation of private information by the buyer and thereby shift the distribution of surpluses in favor of the seller.[63]

Bulletproofing does not help sellers capture more of the surplus than they might otherwise expect to receive.[64] Irrevocably committing to a particular buyer raises P to 1, but it does not cause that buyer to credibly reveal information about its private valuation of the seller. The seller has no way to adequately value the buyer's increased certainty

60. Since the economic surplus is the difference between a seller's minimum reservation price and a buyer's maximum reservation price, both parties will be better off doing the transaction, regardless of the ultimate distribution of the surplus.

61. Paul Milgrom, *Auctions and Bidding: A Primer*, J. ECON. PERSP., Summer 1989, at 3, 19.

62. "If a buyer can accept an irrevocable commitment, in a way that is unambiguously visible to the seller, he can squeeze the range of indeterminacy down to the point most favorable to him." THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 24 (1960).

63. Such limits generally relate to a series of credible commitments regarding process, rules, or limits to negotiations, including rules surrounding the sales process—sale to the highest bidder or lack of bulletproofing. An irrevocable commitment to enter into a transaction with a particular party is not a credible commitment in the sense envisioned by Schelling and the auction literature. An example of a credible commitment device in the government context might include a legislative limit to negotiations. A negotiating team provided with well-known, legal limits as to what it is permitted to negotiate might be able to resist intense international pressure to accede certain points outside of its brief. In the business context, a board might convene and adopt a resolution to approve an acquisition at not more than $50 per share and a second resolution not to meet again for six months and then adjourn. With no prospect that the board will return to improve a $50 bid, the seller knows that the buyer's statement that he can go no higher than $50 is credible. *Id.* at 25-30. Commentators appear to confuse the concept of credibly committing to an information revealing mechanism with irrevocably committing to a particular buyer. The former can improve a seller's negotiating position, the latter cannot. Serial buyers understand the power of credible commitments. When negotiating it is not uncommon for a buyer to respond to a request from a seller by saying, "We never give that," or "All of our deals have this." When the truthfulness of such statements can be demonstrated, such protestations gain credibility and improve the bargaining position of the buyer.

64. In a bargaining setting, if the buyer knows that the seller has "precommitted" to sell a property to the buyer in a bulletproof transaction, the seller's statement that she will not accept less than $200,000 lacks credibility since the buyer understands that the seller will not pursue potential alternatives to the buyer's offer. *Id.* at 24. In that situation, the buyer then has an incentive to extract more surplus from the seller, confident that no later bid will force him to raise his offer price. *Id.*

and so does not know how much, if any, additional value should be attributed to an increase in buyer certainty.[65] Indeed, it may even have the opposite effect since buyers can insulate themselves from the competitive forces that might otherwise elicit a higher price for the seller. When the buyer has an ex ante expectation of receiving a bulletproof transaction, the buyer has an incentive to submit a low-ball bid relative to a buyer's reservation price. Consequently, sellers should have no reason to expect that bulletproofing transactions will help them increase their expected share of the surplus when negotiating with buyers. To the extent that negotiations are opened with low-ball bids that are ultimately protected by bulletproofing, sellers are likely to receive an unfavorable split of the transaction surplus.

Negotiations that are open to topping bids are better for sellers than bulletproof transactions. If a seller can leave a transaction open to a subsequent bid, the seller will create a credible negotiating limit that can establish an advantage in bargaining.[66] The credible threat that the seller will accept a higher bid from a competitor is a mechanism that can shift transaction surplus from the buyer to the seller.[67] Bulow and Klemper show that, subject to certain assumptions, a standard English auction with $N + 1$ bidders will always yield higher expected revenue than a negotiation with only N bidders.[68] Bulow and Klemperer also show that an auction with $N + 1$ bidders is superior to *any* mechanism involving only N bidders.[69] McMillan and McAfee point out that under certain conditions the expected selling price in an auction is strictly higher when the bidders do not know how many other bidders there are compared to when they do know.[70] The two key insights are that competition, or the threat of competition, will lead to a price closer to the buyer's reservation price and that the price effect of one additional

65. *See, e.g.*, McAfee & McMillan, *supra* note 59, at 713 (stating that a bilateral negotiation is troublesome because sellers have no way of eliciting credible valuation information from buyers). If a seller commits to a bulletproof transaction in order to generate an initial bid, the initial bidder, knowing that the seller has already committed to deal exclusively, is under little pressure to offer its best bid. Sellers can signal their intent to offer bulletproof terms early in the negotiation process. A bidder may offer a low bid relative to his reservation price once he has a commitment for a bulletproof deal in hand. The stronger the seller's ex ante commitment to a bulletproof transaction, the stronger the incentive for the buyer to offer up a low bid relative to its reservation price.

66. The limit in this case is that sellers will be free, but not obligated, to consider superior offers. They will not be constrained by coercive or preclusive deal protection measures.

67. Because the seller does not know the buyer's private valuation of the seller, the seller's ability to bargain is limited. The seller can, however, exploit competition among bidders, or potential bidders, to drive up the price closer to the buyer's reservation price. *See* McAfee & McMillan, *supra* note 59, at 704.

68. This assumes symmetric bidders, and on the one side a seller with no bargaining power running an English auction with no reserve price, and on the other side a seller with all the bargaining power, including the ability to make binding commitments, conducting a negotiation or an auction with N bidders, culminating with a final take-it-or-leave-it offer. *See* Jeremy Bulow & Paul Klemperer, *Auctions vs. Negotiations*, 86 AM. ECON. REV. 180, 187-88 (1996). Analytically, a bilateral negotiation is the same as an English auction but with only one bidder.

69. *Id.* at 185. Bulow and Klemperer also show that where the negotiations are followed by a market check, sellers would be better off to simply proceed to an auction process without negotiating because a bidder in the negotiation round has an incentive to withhold his best bid in hopes that there will be no bidders in the subsequent market check round. *Id.* at 189.

70. This holds in a first price sealed bid auction with bidders who have independent private valuations and are risk averse. R. Preston McAfee & John McMillan, *Auctions with a Stochastic Number of Bidders*, 43 J. ECON. THEORY 1, 18 (1987).

competitor is greater than the price effects attributable to bargaining.[71]

The uncertainty created by leaving a transaction open to potential competition generates an incentive on the part of a bidder to bid as if it were in competition against an aggressive bidder because the only way a bidder can improve its odds of winning the target is by raising its bid.[72] When given the choice between losing a potential transaction or giving up some of the expected surplus, rational bidders are not indifferent. A rational bidder will exchange surplus for certainty up until the point where the bidder has no additional surplus from pursuing a transaction. Deal makers seem to have an instinctive understanding of the value of uncertainty in negotiated transactions. It is not unknown for sellers to create phantom bidders or for a private seller to raise the prospect of a competing IPO in order to raise the level of uncertainty and force bidders to increase their offering prices closer to their valuations. Consequently, the existence of potential post-bid competition should lead to a higher negotiated price, in expectation.[73] When a seller leaves a transaction open to potential topping bids, the result will be an increase in the price that the seller will be able to negotiate relative to the price it might negotiate in the absence of potential competition.

The reason buyers often insist on bulletproofing a transaction may be because they understand that by limiting competition they can accomplish the transaction for less than their private valuation, thereby retaining more surplus. Bulletproofing may sometimes be defended as innocuous when the buyer is the "only game in town."[74] However, if the probability of a subsequent bid were zero, or close to it, then rational buyers would not be willing to offer any increase in price in exchange for bulletproofing. It is because buyers understand that bulletproofing excludes potential competition and allows buyers to take the seller for less than their private valuations that buyers are willing to offer some value in exchange for bulletproofing measures.[75] On the other hand, leaving a transaction open to topping bids creates an incentive for buyers to shift surplus to sellers in order to secure the transaction. Because bulletproofing does not increase a seller's share of transaction surplus, it is difficult to argue that bulletproofing generates positive shareholder value.

Commentators who argue in favor of offering transaction certainty through bulletproofing do, however, make one important point. To the extent that there are costs

71. *See* Bulow & Klemperer, *supra* note 68, at 185-86 (noting an auction with $N + 1$ bidders and no reserve price is more profitable than any standard mechanism with only N bidders).

72. In this sense an "open" negotiation is like a sealed bid auction as bidders have lots of information about the target but do not know who else or how many other potential bidders may be vying for the seller. The "murkiness" can create additional perceived risk and thereby induce buyers to make bids closer to their reservation prices. *See* Guhan Subramanian & Richard Zeckhauser, *"Negotiauctions": Taking a Hybrid Approach to the Sale of High-Value Assets*, NEGOTIATION, Feb. 2005, at 4 (arguing that creating murkiness, rather than credibility, can generate an advantage in a negotiated sale).

73. This should be true even in cases where there are no obvious second bidders on the horizon, because in a transaction left open to potential subsequent bidders, the number of bidders is equal to $N+T$, where T is the probability of a topping bid.

74. Omnicare, Inc., v. NCS Healthcare, Inc., 818 A.2d 914, 943 (Del. 2003).

75. Professor Klemperer provides an example of how the lack of competition in European 3G auctions resulted in low prices. In the Netherlands, where four licenses were auctioned off, the fact that there were four incumbent telecoms in the market decreased competition because all entrants and possible entrants believed that the incumbent telecoms would receive licenses. As a result, revenue from the Dutch 3G auction of licenses was approximately 30% of that of a similar auction in the UK where there was actual competition (four incumbents and five licenses). PAUL KLEMPERER, AUCTIONS: THEORY AND PRACTICE 155 (2004).

associated with making a bid, a potential bidder may decline to make a bid if the expected value of doing so is negative. This possibility arises as a result of bid costs such as investigation and diligence costs, negotiation and drafting costs, opportunity costs, and possibly reputation costs associated with losing a transaction. As discussed in Part V, however, a seller can address these problems without bulletproofing.

V. COMPENSATORY DEVICES CAN GENERATE INITIAL BIDS

Sellers can generate initial bids without bulletproofing. All sellers must do is provide a buyer with a deal that increases the expected value of a bid above zero. This can be done with compensatory devices. Since a buyer's decision criteria rests on the *EV* of making a bid, the key issue for buyers is not establishing certainty so much as to ensure the *EV* of making a bid that is positive.[76] Compensatory devices can be set to cover the costs of transaction specific investments in order to attract initial bids.[77]

Compensatory devices can spur competition for a seller. The auction theory literature supports the concept of subsidizing lower-valuing bidders in order to generate competition.[78] The presence of a compensatory device, such as a termination fee, can ensure the *EV* of making a bid that is positive and thus spur an initial bid. When granted to subsequent, even lower valuing bidders, compensatory devices can have the same effect, thus leading to prices nearer to buyers' reservation values.

Because compensatory devices leave a transaction open to the prospect of a topping bid, compensatory devices are better for sellers and society. When the transaction is open to potential competition, the seller can negotiate a higher price, closer to the buyer's reservation value, and the seller's business can end up in the hands of the highest-valuing party. Bulletproofing, by closing off the possibility of subsequent bids, results in a shift of transaction surplus in favor of the buyer and does not assure that the highest-valuing bidder acquires the seller. As a result, diversified investors (buyers and sellers) should favor the use of compensatory devices over bulletproofing.

VI. WHY DO SELLERS AGREE TO BULLETPROOFING?

Deal protection is common in both private and public companies. If bulletproofing is so obviously detrimental to the interests of sellers, why would a seller's management agree to bulletproof a transaction for a buyer? Private companies face diversification problems that create incentives for sellers to place value on certainty. In the public company context, managers of sellers face diversification and agency issues. In both cases, there are also important practical business concerns that may raise the cost to sellers of a failed negotiation, thus making it more likely that a seller will accept bulletproofing demands. Finally, buyers' threats to walk away from a transaction over bulletproofing are credible.

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76. Williamson notes that termination fees and other contractual safeguards can promote transaction specific investments. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 32-35 (1985).

77. For a discussion of using compensatory devices to cover transaction specific costs of initial bidders, see Kahan & Klausner, *supra* note 20, at 1552.

78. McAfee & McMillan, *supra* note 59, at 719; *See, e.g.*, Milgrom, *supra* note 61, at 3.

The typical negotiated acquisition involves the sale of a private company.[79] These sales are exits for entrepreneurs who may hold large blocs of seller stock and are typically not diversified. When exit is the objective, the perceived threat of losing the "bird in the hand" can make it difficult for undiversified sellers to resist buyer demands to bulletproof transactions.[80] Because the seller is not diversified, the seller's threat not to sell the company over issues of deal protection is not credible unless there is a third party visibly waiting in the wings. In such a transaction it is clear to both parties that the seller's strategy is to exit through a sale and that the seller will be harmed by the buyer walking away. As a result, both parties expect that the seller will agree to adverse terms.[81]

With regard to public companies, there is an agency problem. Managers of sellers may be willing to accept a lower premium in exchange for private benefits, such as employment contracts, golden parachute payments, or board representation in the surviving entity.[82] These exchanges are not symmetrical. Empirical data indicates that managers appear to give up shareholder value in exchange for private benefits worth only a fraction of the transaction surplus left on the table.[83] Also, a manager with something to gain will value certainty more than diversified shareholders. This is also an agency cost.

In addition, there are other reasons why a seller's manager, public or private, might want to grant a potential buyer a bulletproof transaction. Practitioners often argue that sellers want to ensure that a signed deal gets completed because sellers may be viewed by the market as "damaged goods" should a buyer walk away before a merger agreement is closed.[84] Sellers may fear that the market penalty for failing to come to agreement will be

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79. Eighty-nine percent (3714 of 4177) of transactions disclosed in 2003 involved a private company seller. MERGERSTAT REVIEW 6 tbl. 1-3 (2004).

80. The threat of losing the "bird in the hand" is a good example of what is known as a "status quo bias." Korobkin defines this bias as a preference for "the present state of the world to alternative states, all things being equal." *See* Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227, 1228-29 (2003). Sellers with a present offer on the table will tend to prefer that offer, even if low, to the prospect of a potential future higher offer. The "bird in the hand" is also consistent with the concept of loss aversion in behavioral economics where individuals tend to value losses more heavily than gains of the same magnitude. *See* Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV. 1115, 1119 (2003). While sellers may be subject to certain cognitive biases that limit their ability to make rational and economically efficient decisions, there is no reason why legal rules should reinforce these tendencies.

81. *See* MCMILLAN, *supra* note 18, at 54.

82. *See, e.g.*, Jay C. Hartzell et al., *What's in It for Me? CEOs Whose Firms Are Acquired*, 17 REV. FIN. STUD. 37, 51-56 (2004) (finding that target managers exchange lower premiums for generous compensation); Julie Wulf, *Do CEOs in Mergers Trade Power for Premium? Evidence from Mergers of Equals*, 20 J.L. ECON. & ORG. 60, 94 (2004) (finding that target managers in merger of equals transactions exchange lower premiums for post-merger employment with surviving entity). While these studies focus on publicly traded companies, it is likely that managers of private companies with few shareholders face similar incentives.

83. Hartzell et al., *supra* note 82, at 59 (concluding that generous compensation packages are only worth a fraction of the premia that are foregone).

84. Practitioners often raise the concern that a seller will not complete a deal, leaving it "damaged goods" in the view of the market. The reference to the "market" is broad and includes the capital market, the product market, and the market for human resources. When a buyer walks away, the markets might interpret that as a signal of an underlying problem with the seller or its product. This arrangement suggests agreements that make it difficult for buyers to walk away, not sellers. Alternatively, in businesses where human resources are critical, instability at the top and the ensuing threat of transaction-related layoffs may instigate key employees to search for other employment thereby damaging the seller.

larger than the loss in surplus which might accompany acceding to demands for bulletproofing. Alternatively, sellers might have some proprietary corporate information, the release of which to the market might be damaging to their businesses.[85] Sellers consequently grant certainty, which they are unable to adequately value, rather than allow prospective buyers to walk. For these reasons, a seller's resistance to bulletproofing demands is often not credible.[86]

On the other hand, a buyer's threat to walk away without transaction certainty may be credible. If a seller will not provide a bulletproof deal, another seller of a similar company may provide such a deal. Sellers seeking to liquidate their positions and exit suffer from a collective action problem that makes it difficult for them to resist bulletproofing demands and makes buyer demands for bulletproofing credible. The source of this collective action problem comes from the fact that buyers tend to have greater bargaining power because there are more potential sellers than buyers.[87] For example, financial buyers, such as private equity funds, treat all companies as cash flow streams. As a result, all companies are potential targets for financial buyers. In a consolidating industry, by definition, strategic buyers have multiple possible targets within the industry as companies self-identify as sellers and the number of players in the sector decreases. Where buyers have other potential targets and where the seller knows this, a buyer's threat to walk away from a proposed transaction, unless the seller agrees to bulletproofing, will be credible.

The structural problems faced by both private and public sellers give rise to a distribution of bargaining power in favor of buyers. Buyers can expect sellers in such negotiations to accept bulletproofing demands rather than lose a potential deal even though sellers might be able to achieve a more favorable distribution of surplus by

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85. Hansen calls this the "competitive information effect." *See* Robert G. Hansen, *Auctions of Companies*, 39 ECON. INQUIRY 30, 33 (2001).

86. In *In re* Toys "R" Us, Inc., S'holder Litig., 877 A.2d 975, 1017 (Del. Ch. 2005), Vice Chancellor Strine engaged in an illustrative bit of conjecture about how difficult it might be for a seller to push back against certain deal protection measures in a negotiation with a buyer:

> Let's plausibly imagine how that exceedingly awkward negotiating session that the plaintiffs desire might have gone:
>
> First Boston/Simpson Thacher: The board wants 3.0% on the termination fee and to get rid of the matching right.
>
> KKR: Fine, you can have $25.75 per share and 3.0% or the $26.75 with 3.75% protection for our trouble. And we want the match in either case.
>
> First Boston/Simpson Thacher: No, no. We demand 3.0% and the $26.75; take it or leave it.
>
> KKR: What did Cerebus and Apollo bid?
>
> First Boston/Simpson Thacher: We can't comment.
>
> KKR: I think we're done.
>
> First Boston/Simpson Thacher: (with panicky overtones) Please don't go . . .
>
> KKR: Click.
>
> First Boston/Simpson Thacher: Expletive deleted.

Id.

87. McMillan notes that increased competition improves bargaining power for sellers. *See* MCMILLAN, *supra* note 18, at 49.

resisting bulletproofing.[88] With bulletproofing in place, buyers have little, if any incentive to share deal surpluses with sellers.

VII. THE VIRTUES OF A MANDATORY RULE AGAINST BULLETPROOFING

Because sellers and their agents face incentives that make it difficult to credibly resist a buyer's demand to bulletproof a transaction, a mandatory rule against bulletproofing is necessary. A simple announcement by a seller in a negotiation that it will not accept terms that include bulletproofing is not credible. Unless the seller can demonstrate that its commitment to resist bulletproofing demands is credible, buyers will not believe the seller's claim. The result is a structural bias in favor of bulletproofing.[89] A mandatory rule will allow sellers to credibly resist buyers' demands to bulletproof transactions and addresses the structural bias.[90]

A mandatory rule against bulletproofing will result in higher prices for sellers in negotiated transactions and ensure that such sales are welfare enhancing. Competition, or the threat of competition, is a strong incentive for buyers to make higher bids for sellers.[91] Sellers will have an opportunity to capture more of the surplus by negotiating in the shadow of an open transaction structure than they would have with a bulletproof structure.

While investors' diversified shareholders may be uninterested in the distributional effects of bulletproofing, there are important allocative issues at play.[92] There is no guarantee that when a seller decides to engage in an exclusive negotiation with a particular buyer, it has selected to negotiate with the highest-valuing bidder. Limiting the ability of a buyer to bulletproof a transaction increases the odds of the seller ending up with the highest-valuing bidder.[93]

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88. In the spirit of Easterbrook and Fischel, one might argue that rational managers should expect this structural difference and, consequently, should build provisions into their charters against bulletproofing. Precommitment to keep transactions open to subsequent bidders through the charter would create more credibility for sellers when attempting to resist buyer demands for bulletproofing. However, empirical work in this area confirms that managers do not make such efficiency enhancing precommitments at the IPO stage. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J.L. ECON. & ORG. 83, 85 (2001) (finding that at IPO firms uniformly avoid adopting efficiency enhancing precommitments in their charters).

89. There is no reason, ex ante, to expect that a seller will have more negotiating or bargaining skill than any particular buyer or that such skills will be evenly distributed. On the other hand, to the degree there is a disparity in the distribution of such bargaining skills it should flow in favor of the buyer. Sellers, by definition, only sell their businesses once, while buyers (and their counsel) can accumulate knowledge, information, and expertise through serial acquisitions. To the degree there is any uneven distribution of bargaining power in a bilateral negotiation, there is every reason to expect that a serial buyer will be much more experienced, and hence a better negotiator, than a one-off seller.

90. *See* McAfee & McMillan, *supra* note 59, at 703 (noting the importance of the ability of a seller to credibly commit to a sales mechanism in order to induce higher prices); *See also* SCHELLING, *supra* note 62, at 22-24 (commenting on the desirability of credible commitments).

91. Professor Bebchuk justified an "auctioneering rule" based partly on the reasoning that such a rule would raise premia for sellers in negotiated acquisitions. *See* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1044 (1982).

92. This assumes that diversified shareholders hold proportional equity positions in both the buyer and the seller.

93. Fraidin and Hanson make a market-based argument in support of the use of deal protection. They

This leads to two conclusions related to open transactions. First, undiversified sellers will do better in securing surplus. Second, society (including diversified investors) will be better off for relying on open transactions rather than bulletproofed ones because there is a social welfare gain when assets are placed with their highest-valuing bidder. The proper measure of a legal rule should be whether the rule enhances social welfare—good legal rules will enhance social welfare. Despite the ad hoc approach taken by the Delaware courts with regard to the question of bulletproofing, a result that limits the ability of selling boards to agree to bulletproofing will be socially optimal.

VIII. CONCLUSION

This Article argues for a mandatory rule limiting the ability of sellers to bulletproof acquisitions. Although the initial response to the Delaware Supreme Court's decision in *Omnicare* was almost wholeheartedly negative and accompanied by talk of a rapid reversal by the courts, the decision's mandatory rule limiting the ability of boards to bulletproof transactions will ultimately prove socially optimal. Sellers can still rely on compensatory devices to cover the transaction specific investments required to generate initial bids, thus mitigating the potentially negative implications of structuring transactions open to a post-signing market check. Additionally, limiting the ability of sellers to bulletproof transactions raises the likelihood that when a sale occurs, the highest-valuing buyer will end up with the target—a socially optimal result. Notwithstanding its doctrinal deficiencies, the holding in *Omnicare* will result in an improvement in social welfare.

A mandatory rule against bulletproofing has two direct effects on a transaction. First, it mitigates the diversification and agency problems associated with sellers by exposing the transactions they negotiate with buyers to market review, thereby ensuring that sellers can retain relatively more of the surplus than they would if a transaction were bulletproof. Second, it ensures allocative efficiency by creating opportunities for sellers to end up in the hands of the highest-valuing buyer without inefficient serial sales. From an economic perspective, limiting agency costs and enhancing social welfare are laudable goals that can reasonably underpin mandatory rules against bulletproofing without having to resort to the ad hoc contortions of the deal protection line of cases.[94] Rather than seek

argue that in the event a seller ends up with a lower-valuing buyer, a secondary transaction (or a "pre-sale") will occur in order to move the seller to the highest-valuing bidder. *See* Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1794 (1994). This is true only if the subsequent buyer's valuation is high enough to cover the transaction costs of the two transactions. It also ignores the real life consequences of a corporate sale (layoffs, business disruption, etc.) that make the prospect of a back-to-back sale remote. Professor Gilson argues persuasively that a series of such sales are not efficient. *See* Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 62-63 (1982). In any event, Fraidin and Hanson do not make a persuasive argument why the marginal benefits associated with a secondary transaction should accrue to the initial buyer and not the shareholders of the seller when it is within the power of the seller to secure this surplus without bulletproofing.

94. Though there are competitive benefits for sellers associated with negotiated transactions open to the potential of subsequent bids, the mandatory rule against bulletproofing does not require that selling boards automatically engage in auctions. The benefits associated with openness are latent and do not require any active auctioning process. Indeed, in some circumstances negotiating with a sole buyer will be the best way to sell a company. In such a case, a mandatory rule against bulletproofing improves a seller's initial bargaining position. *See* Guhan Subramanian & Richard Zeckhauser, *For Sale, but How? Auctions Versus Negotiations*,

to reverse the ruling in *Omnicare*, observers should seek to reinforce the rule, if not the reasoning, as the proper policy outcome.[95] Indeed, the recent increase in the use of "go-shop" provisions in merger agreements provides some evidence that the market has accepted at least the intuition of the mandatory rule.[96]

Though requirements to include effective fiduciary termination provisions in all merger agreements may effectively end the ability of sellers to bulletproof transactions, there remain a small number of deal protection devices that are not affected by the presence of an effective fiduciary termination right in a merger agreement. Rights of first refusal fall into that category. Rights of first refusal are not affected by the requirement for a fiduciary out.[97] However, in certain circumstances, rights of first refusal can be a potentially potent deterrent to subsequent bids. Courts should look carefully at the anti-competitive effects of rights of first refusal. If these rights preclude the possibility of bid competition, then their use should be prohibited. Further empirical research on the potential anticompetitive effects of rights of first refusal should provide courts with guidance on whether, and under which circumstances, such provisions should be permitted.

NEGOTIATION, Oct. 2004, at 2, 3-5 (describing a process for determining whether negotiation or auction is more appropriate in the sale of a firm).

95. Though critical of the *Omnicare* ruling for the reasons related to the need to improve a seller's credibility in making commitments to buyers, Professor Griffith nevertheless concludes his discussion of *Omnicare* by calling for a mandatory "market check" rule. *See* Griffith, *supra* note 6, at 615. A "market check" rule is similar in effect to the rule announced in *Omnicare*. *See id.*

96. This, of course, assumes that "go-shops" are being employed in order to promote auctions rather than as a deal protection device themselves. This question has not yet been empirically studied. *See* Sorkin, *supra* note 8.

97. The chancery court in *Toys "R" Us* approved the use of a termination fee combined with a right of first refusal in order to end a fully-played out auction. *See In re* Toys "R" Us, Inc., S'holder Litig., 877 A.2d 975, 1021 (Del. Ch. 2005).