

OPTIONALITY IN MERGER AGREEMENTS

BY BRIAN JM QUINN*

ABSTRACT

The credit crisis of 2008 and the subsequent collapse of a number of high-profile acquisition transactions put a spotlight on contracting practices that embedded optionality into merger agreements by way of the reverse termination fee and its attendant triggers. This article examines whether reverse termination fees are a symmetrical response to the seller's judicially-mandated fiduciary termination right and whether such fees represent an efficient transactional term. A series of Delaware cases over the last decade limited the degree to which buyers could rely on deal protection measures in merger agreements to prevent a seller from accepting a superior second bid resulting in a judicially-created fiduciary put. Where courts require seller termination rights, it is possible that buyers might attempt to negotiate symmetrical "optionality" for buyers elsewhere in the merger agreement. This article investigates whether the termination triggers that accompany reverse termination fees are that symmetrical response. Using a sample of 644 acquisitions from 2003 through 2008, which includes 105 transactions where strategic buyers negotiated a reverse termination fee, this article provides an empirical account of the use of reverse termination fees by strategic buyers, including the first taxonomy of reverse termination fee triggers. This article concludes first that reverse termination fee triggers are not a symmetrical response to the judicially mandated seller's fiduciary termination rights. Second, to the extent reverse termination rights mimic termination rights in size, they may be inefficient terms. The results of this study provide some guidance to courts as they are asked to assess the viability of reverse termination fees and the degree of optionality embedded in the modern merger agreement.

*Assistant Professor of Law, Boston College Law School. The author is grateful for the support of the Boston College Law School Summer Research Fund and for the participation of faculty in presentations at Boston College Law School and Washington & Lee Law School. Thanks also to Chuck Whitehead, Afra Afsharipour, Steven Davidoff, and Elizabeth Nowicki for comments on earlier drafts and to Aaron Fine (BCLS, '10) for research assistance.

TABLE OF CONTENTS

	<i>Page</i>
I. INTRODUCTION	790
II. THE SELLER'S FIDUCIARY PUT.....	794
III. THE MATERIAL ADVERSE CHANGE CLAUSE AND THE SYMMETRY HYPOTHESIS	801
IV. BUYER OPTIONALITY AND LEGAL RULES	805
V. REVERSE TERMINATION FEES AND THE SYMMETRY HYPOTHESIS	809
A. <i>Buyer's Fiduciary Put</i>	813
B. <i>Buyer's Financing Contingency</i>	817
C. <i>Buyer's Regulatory Put</i>	820
D. <i>Buyer's Representation/Warranty Termination Right</i>	821
E. <i>Buyer's Option to Close</i>	822
VI. REVERSE TERMINATION FEES AND INEFFICIENT TERMS	824
VII. CONCLUSION	828

I. INTRODUCTION

At the height of the credit bubble of 2008, a series of high profile acquisition transactions collapsed, resulting in contentious litigation in the Delaware courts. These collapsed transactions exposed relatively new contracting practices that embedded increased buy-side optionality into merger agreements by way of the reverse termination fee. This article examines whether the reverse termination fee is a symmetrical response to the seller's judicially-mandated fiduciary put and whether such fees represent an efficient transactional term.

A series of Delaware cases over the last decade limited the degree to which buyers could rely on deal protection measures in merger agreements to prevent a seller from accepting a superior second bid resulting in a judicially-created fiduciary put.¹ This development generated some controversy around, as well as interest in, whether buyers might negotiate for a symmetrical put of their own in response. Merger agreements are, after all, highly negotiated documents. A judicially-mandated term that has a significant impact on the economics of a transaction creates an incentive for

¹See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 936 (Del. 2003) (requiring an effective fiduciary out); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 109-10 (Del. Ch. 1999) (limiting the use of overly restrictive no-shop/no-talk provisions); *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999) (limiting the use of overly restrictive no-shop/no-talk provisions).

parties to adapt. Where courts require seller termination rights, it is possible that buyers might attempt to negotiate symmetrical "optionality" for themselves elsewhere in the merger agreement.² Initial inquiries focused on the potential role of the Material Adverse Change (MAC) clause in merger agreements as a source of symmetrical buyer optionality.³

The credit crisis and the litigation that ensued as buyers attempted to unwind transactions provides an opportunity to reexamine the question of buyer optionality, this time with a focus on the use of reverse termination fees by strategic buyers. During the credit bubble, financial buyers began to negotiate additional optionality in their merger agreements through increasing reliance on reverse termination fees.⁴ In the extreme, private equity buyers were able to effectively negotiate a series of rights in combination with a reverse termination fee that constituted the equivalent of an option for the buyer.⁵ Toward the end of the credit bubble strategic buyers began to import strategies of private equity buyers, heightening their reliance on reverse termination fees and potentially increasing the degree of optionality in merger agreements.⁶ The reversal of fortunes accompanied by the credit crisis led to a series of cases in Delaware challenging propriety of increased buy-side optionality in merger agreements.

This article relies on a sample of 644 acquisitions from 2003 through 2008. The sample includes 105 transactions (16%), in which strategic

²Professor Elizabeth Nowicki raised the issue of optionality embedded into the structure of private equity transactions with reverse termination fees at the 2008 Tulane Institute Conference. See Elizabeth Nowicki, *Private Equity Deals of 2007: Lessons to Learn* 4 (2008), available at <http://ssrn.com/abstract=1430213>. Professor Steven Davidoff has also focused on optionality embedded in the structure of private equity transactions. See Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 505 (2009) (analyzing attempts by private equity firms to terminate pending acquisitions throughout the Fall of 2007 and 2008 and the use of reverse termination fees in private equity transactions).

³See Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 332 (2005).

⁴See Davidoff, *supra* note 2, at 496–97.

⁵See *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810, 816–17 (Del. Ch. 2007). In *United Rentals*, the seller agreed to a \$100 million reverse termination fee payable in the event the buyer refused to close the transaction. In addition, the seller agreed that the reverse termination fee would be its sole recourse in the event the buyer refused to close, thus preventing the seller from seeking an equitable remedy, like specific performance, to force the buyer to close. The combined effect was to create a pure option for the buyer. *Id.*

⁶This is not the only example of strategic buyers importing acquisition strategies from financial buyers. For example, the go-shop provision was initially used as a mechanism by which boards of sellers might satisfy their fiduciary duties when selling to a financial buyer without an auction. The go-shop, however, was quickly adopted by sellers' boards when selling to strategic buyers as well. See Guhan Subramanian, *Go-Shops v. No-Shops in Private Equity Deals: Evidence and Implications*, 63 BUS. LAW. 729, 731 (2008).

buyers negotiated a reverse termination fee to revisit the inquiry of buy-side optionality. This article asks, given recent experience, first, whether reverse termination fees tied to buyer termination rights are a symmetrical response to a seller's fiduciary put. The seller's fiduciary put permits the seller to terminate a transaction, pay a fee, and then pursue a transaction with an alternate buyer. To be symmetrical, the buyer's option must permit the *buyer* to terminate the present transaction, pay a fee, and then pursue a transaction with an alternate *seller*. Next, I ask whether such fees represent an efficiency enhancing transactional term such that the party which is best able to bear the costs associated with a termination does so.

In answering those questions, this article makes three contributions to the literature. First, this paper builds on earlier work by Professors Ronald J. Gilson and Alan Schwartz, who analyzed the role of the MAC clause and raised the potential importance of symmetry in response to the seller's fiduciary put.⁷ Professors Gilson and Schwartz concluded that though the MAC clause does not represent a symmetrical response to the seller's fiduciary put, with its extensive carve-outs, it is nevertheless an efficient term in a merger agreement. Professors Gilson and Schwartz did not analyze reverse termination fees as a symmetrical response to the seller's fiduciary put. This article examines the role played by reverse termination fees in potentially generating additional optionality for buyers. This article also assesses the claims that reverse termination fees may be a negotiated response to the development of the seller's judicially-mandated fiduciary put.⁸

Second, using this sample of strategic transactions with reverse termination fees, this article provides an empirical account of the use of reverse termination fees by strategic buyers, including the first taxonomy of

⁷Professors Gilson and Schwartz consider and then discard the possibility that seller termination fees might be symmetrical responses to the judicially-mandated fiduciary termination rights. They note that such fees are artificially constrained by fiduciary obligations and are thus not appropriate responses. See Gilson & Schwartz, *supra* note 3, at 336.

⁸There is a small but growing list of scholars now focusing on the question of the role of reverse termination fees in merger agreements. See, e.g., Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees* 63 VAND. L. REV. (forthcoming 2010), available at <http://ssrn.com/abstract=1568951> (discussing the development of the use of reverse termination fees by strategic buyers before and after the recent credit bubble); see also Elizabeth Nowicki, *Reverse Termination Fee Provisions in Acquisition Agreements* (3rd Annual Conference on Empirical Legal Studies Papers, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1121241; Davidoff, *supra* note 2. Some observers believe that the reverse termination fee is an obvious response to the seller's fiduciary put. See Posting No.5 to Steven M. Davidoff, *A Farewell to Specific Performance*, N.Y. TIMES (Deal Professor Blog), <http://dealbook.blogs.nytimes.com/2008/02/29/a-farewell-to-specific-performance> (Mar. 3, 2008, 16:35 EST).

reverse termination fee triggers. This article concludes with the development in the use of reverse termination fee triggers during the credit bubble. Earlier transactions in the sample include triggers only for fiduciary reasons and thus appear to be a concession to perceived legal requirements. Later transactions however include a wider diversity of triggers that appear to generate more optionality for strategic buyers than might be required by the Delaware courts. Triggers in the later-appearing transactions include financing contingencies, regulatory termination triggers, and triggers in the event of a failure of a buyer's representations. Additionally, some buyers have been able to negotiate an option that permits them to refuse to close a transaction, notwithstanding the fact that all conditions to the buyer's obligation to close have been met; the only consequence is to pay the reverse termination fee. After analyzing the taxonomy of termination triggers that accompany reverse termination fees, this article concludes that although termination triggers in some cases generate additional optionality for buyers, none of the triggers represents a symmetrical response to the seller's fiduciary put.

Finally, this article analyzes the efficiency aspects of reverse termination fees. Reverse termination fees are more or less efficient to the extent they assign the costs associated with exogenous risks to the buyer who, as between the buyer and the seller, is the party in a better position to bear the cost of such exogenous risks.⁹ This holds true because buyers who will run the combined business post-closing are in a better position to bear such costs. However, given the diversity of triggers and the varying sizes of reverse termination fees, it is not possible to conclude that such fees and their accompanying triggers are uniformly inefficient terms.

Although a reverse termination fee may enhance efficiency because it assigns the cost of an exogenous risk to the buyer, artificial limits on the size of such fees may limit the ability of parties to more efficiently assign such costs. For example, custom and practice have dictated that reverse termination fees, the strike price for the buyer's put, closely resemble termination fees in size. Absent a fiduciary constraint, there is little reason to believe that this should be the case. Buyers' boards could well agree to larger termination fees without fear of violating their fiduciary duties. Consequently, reverse termination fees that mimic termination fees in size may leave more of the costs associated with exogenous risk with the seller than may be efficient. In that respect a buyer's reverse termination fee provision that is linked in size to a seller's termination fee may be a sub-

⁹See Gilson & Schwartz, *supra* note 3, at 339.

optimal term.¹⁰ It also suggests that larger reverse termination fees than are customary may be appropriate in many circumstances.

To the extent reverse termination fees and their triggers do not appear to be negotiated responses to the seller's fiduciary put, the conclusions drawn from this article can help inform parties, *ex ante*, as they negotiate such fees as well as courts, *ex post*, as they are required to assess the appropriateness of the reverse termination fee remedy.

This article proceeds in the following manner: Part Two provides a brief overview of the judicial development of the seller's fiduciary put providing context for the development of buy-side optionality. Part Three provides a brief overview of Gilson and Schwartz's analysis of the role and incentive effects of the MAC in the merger agreement. Gilson and Schwartz evaluated the claim that MAC clauses in merger agreements provide additional optionality for buyers and were thus a symmetrical response to the judicially created fiduciary put.¹¹ Part Four reviews the legal rules related to termination fees as they potentially apply to buyers. Part Five relies on data collected from transactions with strategic buyers during the period from 2003-2008 to create an account of the role that reverse termination fees played in generating buy-side optionality. Part Five also includes taxonomy of reverse termination fee triggers. This taxonomy shows that none of the reverse termination triggers in the sample represents a symmetrical response to the seller's judicially-mandated fiduciary put. Part Six evaluates the role played by reverse termination fees and their triggers and concludes that, unlike the MAC, it is not possible to argue that reverse termination fees are uniformly efficient. Where reverse termination fees shift risks onto sellers that are more appropriately borne by buyers they will tend to be inefficient terms.¹² On the other hand, where they appear to assign costs to buyers that are appropriately borne by buyers, such fees may reflect more efficient terms.¹³ Part Seven summarizes and concludes.

II. THE SELLER'S FIDUCIARY PUT

Following the Delaware Supreme Court's important triad of takeover cases of the 1980s,¹⁴ in particular the court's decision in *Paramount*

¹⁰Implicit is that sellers in agreeing to a reverse termination fee keep available the option of availing themselves of a damages remedy in the event a buyer decides to walk from a merger agreement in breach of its terms.

¹¹Gilson & Schwartz, *supra* note 3, at 332.

¹²*See id.* at 349.

¹³*See id.*

¹⁴*See Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989); *Revlon, Inc. v.*

Communications, Inc. v. Time Inc., there was some confusion amongst practitioners whether Delaware common law would permit sellers in stock-for-stock transactions to completely lock-up a transaction through the use of deal protection measures, also known as “bulletproofing.”¹⁵ In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the court made it clear that a decision to completely lock-up a transaction would not survive the court's enhanced scrutiny.¹⁶ However, following the court's subsequent decision in *Time*, many deal-makers believed that when engaging in a transaction not subject to enhanced *Revlon* duties (e.g. a stock-for-stock deal not involving a change in control) a seller's board might be permitted to tie the hands of the seller's directors in the face of a topping bid and thereby prohibit directors from responding to later, superior offers.¹⁷ Consequently, deal-makers adopted a practice of bulletproofing transactions whenever possible to provide transactional certainty for buyers, but at the expense of a seller's ability to consider subsequent events.¹⁸

In a series of decisions over the past decade the Delaware courts have made it clear that, notwithstanding the fact a selling board may not be subject to *Revlon* duties, there are limits to a selling board's ability to tie its own hands and irrevocably commit its' shareholders to a transaction.¹⁹ For example, the decision by a seller's board to adopt deal protection measures with the intent of defending a corporate policy is subject to intermediate, or

MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); *Unocal Corp. v. Mesa Petrol., Co.*, 493 A.2d 946 (Del. 1985).

¹⁵See generally *Paramount*, 571 A.2d 1140. The reasoning for this interpretation is that because the decision to engage in a transaction for stock where the board is pursuing a long-term corporate strategy is accorded the deference of business judgment, a board's decision to adopt defensive measures to protect that decision should also be accorded the deference of business judgment. See 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, 1 (explaining this doctrinal confusion); Brian JM Quinn, *Bulletproof: Mandatory Rules for Deal Protection*, 32 *J. CORP. L.* 865, 867 (2007) (describing and defining “bulletproofing”).

¹⁶See *Revlon*, 506 A.2d at 182, 185 (holding that where a break-up of a corporate enterprise is inevitable or there is a change of control, the selling board has a duty to seek out the highest price reasonably available for stockholders).

¹⁷Indeed, in *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 39–41 (Del. 1994), it seems clear that Paramount, having closely read the *Time* decision, structured a transaction that it believed would mimic the requirements of *Time* so as to avoid triggering *Revlon* duties. While Paramount's legal advisors may have miscalculated when they ostensibly advised their clients that a change of control did not trigger *Revlon* duties, they also ran afoul by permitting the board of Paramount to agree to deal protection measures that, in effect, restricted the fiduciary duties of the seller's board. See *id.*

¹⁸See Richard E. (Rick) Climan et al., *Negotiating Acquisitions of Public Companies*, 10 *U. MIAMI BUS. L. REV.* 219, 263–64 (2002); see also *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 (Del. Ch. 1999) (noting that this has become a common practice in stock-for-stock transactions).

¹⁹See *ACE*, 747 A.2d at 107–08 (noting that a board may not contract away its fiduciary obligations and that the fiduciary language in *QVC* is not limited to *Revlon* scenarios).

Unocal, scrutiny even though the board's decision to enter into a particular transaction might otherwise be entitled to the deference of the business judgment rule.²⁰ In short, corporate boards are not permitted to contract away their fiduciary obligations even when such decisions may be expected to receive the deferential protection of the business judgment rule.²¹

In applying *Unocal* scrutiny, courts engage a two-step analysis. This analysis treats decisions to select a merger partner differently from decisions to protect a board's selection of that merger partner. On the one hand, courts accord the directors' decision to select a merger partner and enter into a merger agreement with a buyer, the deference of the business judgment rule.²² On the other hand, the directors' decision to protect those decisions with deal protection measures is subject to intermediate scrutiny.²³ This bifurcated analysis leaves unfettered a board's ability to select a merger partner while at the same time placing a judicial limit on the selling board's right to negotiate the merger contract. This judicial limit is the source of the fiduciary termination currently present in all merger agreements.²⁴

Although decisions in this area were initially controversial (notably *Omnicare, Inc. v. NCS Healthcare, Inc.*), they are not likely to be entirely overturned.²⁵ This is true because of the importance of the interests at stake, with two in particular. The first is the importance of the shareholder franchise.²⁶ Unlike other commercial contracts that a board might enter into on behalf of the corporation, only the merger agreement is accompanied by a statutory shareholder voting requirement, thus making the contract contingent on shareholder approval.²⁷ If that vote is to be meaningful, then

²⁰*Unocal* analysis is not limited to situations where boards take action to defend a transaction from an identified challenger. It also applies in the absence of a challenge where the board adopts defensive measures to deter a potential challenge from appearing. See *McMillan v. Intercargo Corp.*, 768 A.2d 492, 506 n.62 (Del. Ch. 2000).

²¹See *QVC*, 637 A.2d at 50–51 (citing *Wilmington Trust Co. v. Coulter*, 200 A.2d 441, 452–54 (Del. 1964)).

²²*Unocal*'s intermediate standard is not applicable in the context of board responses to offers to merger. Because the board is required by statute to recommend (or not) a merger transaction, its decision not to support a merger is given the presumptive protection of the business judgment rule. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1375 n.16 (Del. 1995).

²³See *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 958 (Del. 1985).

²⁴*Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 918 (Del. 2003) (holding that selling boards violate their fiduciary duties by not including an effective fiduciary termination right in merger agreements).

²⁵The Delaware Supreme Court's decision in *Omnicare* was widely criticized when it was initially announced in 2003. See *Quinn*, *supra* note 15, at 876–77 (summarizing these critiques).

²⁶See generally *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (explaining that it is critical shareholders have a vote over board members).

²⁷DEL. CODE ANN. tit. 8, § 251(b), (c) (2006).

the board of the seller may not irrevocably commit the shareholders of the corporation to a merger agreement in a manner that negates the effectiveness of such a vote.²⁸ As a consequence, the requirement for a shareholder vote limits the contracting rights of boards in ways that boards are not limited when they enter into other contracts on behalf of the corporation. A selling board that agrees to a merger agreement, and in the process irrevocably commits selling shareholders to a merger, reduces the shareholder vote to no more than a mere contrivance and exceeds its grant of authority as an agent of the shareholders. Thus, board actions that constrain or place limitations on the effectiveness of the statutorily-required shareholder vote may go too far.²⁹

Second, the board has broad statutory obligations requiring that it not tie its own hands at critical junctures in the corporate existence.³⁰ Section 141(a) of the Delaware General Corporation Law vests authority to manage the corporation, subject to the limitations of the corporate law and the articles of incorporation, in the hands of the board.³¹ The board's unique position as an agent of shareholders and statutory steward of the corporation

²⁸See *Omnicare*, 818 A.2d at 935–36.

Although the minority stockholders were not forced to vote for the Genesis merger, they were required to accept it because it was *a fait accompli*. The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished *a fait accompli*. In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect. Those tripartite defensive measures—the Section 251(c) provision, the voting agreements, and the absence of an effective fiduciary out clause—made it "mathematically impossible" and "realistically unattainable" for the *Omnicare* transaction or any other proposal to succeed, no matter how superior the proposal.

Id. at 936.

²⁹*Blasius Indus.*, 564 A.2d at 659 ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

³⁰See *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107–08 (Del. Ch. 1999) (noting that a board may not contract away its fiduciary obligations); see also *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 238 (Del. 2008) (holding that boards may not adopt bylaws that preclude them from acting pursuant to their fiduciary duties).

³¹Section 141(a) states, in relevant part:

Board of directors; powers . . . (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a) (2006).

places special requirements on it to act, especially in the context of a merger and other end-of-corporate-life transactions.³² These obligations to actively manage the corporation do not end with the signing of a merger agreement, nor do they end upon a successful shareholder vote. They are "unremitting" and continue until the end of the corporation's existence.³³ Consequently, when a board agrees to a merger that lacks an effective fiduciary termination right, the board effectively closes its eyes to potential subsequent developments and violates its statutory obligation to manage the corporation.³⁴

That is not to say that a board's fiduciary duties prevent it from ever entering into *any* agreements that irrevocably commit the corporation to one action or another. Indeed, boards authorize the corporations they manage to enter into such contracts on a daily basis. For example, a board might authorize management to sign a long-term lease at the top of the market—thus committing the firm to undesirably high lease payments over a long period of time. Courts, however, do not attempt to invalidate such leases after the real estate market goes into a down-cycle on the grounds that a board may have violated its fiduciary duties in entering into such a lease at the top of the market.³⁵ Such contracts are properly within exclusive purview of the board and are granted the deference of the business judgment rule. Courts give this deference in part because it would be wholly impractical for shareholders to assert and for courts to review claims against directors for entering into agreements associated with the day-to-day management of the corporation. It is for precisely this reason that section 141(a) carves out space for boards to manage the corporation.³⁶ At the same time, however,

³²See *Omnicare Inc.*, 818 A.2d at 924 (illustrating that a company's board is the appropriate party to act during a merger); *Paramount Commc'n Inc. v. QVC Network Inc.*, 637 A.2d 34, 49–50 (Del. 1993) (explaining the Board's duty to secure stockholders the best value that is reasonably available); *ACE Ltd.*, 747 A.2d at 107 (discussing proposal "out" in merger agreements).

³³See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1292 (Del. 1998).

³⁴See *ACE Ltd.*, 747 A.2d at 106 (finding that no-talk provisions are pernicious 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").

³⁵See *Omnicare*, 818 A.2d at 939 n.88 (holding, "[m]erger agreements involve an ownership decision and, therefore, cannot become final without stockholder approval. Other contracts do not require a fiduciary out clause because they involve business judgments that are within the *exclusive* province of the board of directors' power to manage the affairs of the corporation"); see also *Grimes v. Donald*, 673 A.2d 1207, 1214–15 (Del. 1996) (holding that "business decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action," and refusing to hold that a poorly drafted agreement was invalid merely because it produced unfavorable results).

³⁶See DEL. CODE ANN. tit. 8, § 141(a) (2006).

there is a marked difference between such contracts and a merger agreement. Unlike a lease, a merger agreement affects the fundamental rights and expectations of shareholders and is subject to statutory regulation.

In *Omnicare*, the court recognized the tension between a board's contracting rights and its fiduciary obligations to shareholders when the court placed limits on the board's ability to contract in the merger context.³⁷ Gilson and Schwartz call the requirement that sellers negotiate for an effective fiduciary termination right in a merger agreement a "seller's put option."³⁸ Since 2003, this judicially-mandated put has been universally present in all merger agreements.³⁹ The price of this put option is the termination fee paid by the seller to the initial bidder, which is customarily negotiated as part of the termination right.

The judicial mandate in *Omnicare* made the decision controversial amongst academics and practitioners alike. One argument raised against the requirement for a fiduciary put is that the presence of a seller's put will lead to inefficiencies in the market for corporate control.⁴⁰ Furthermore, some argue that a potential bidder may become afraid of being forced to play the role of "stalking horse" every time it makes a bid for a seller unless initial bidders are provided with transactional certainty.⁴¹ As a result, potential bidders will be less likely to make the transaction specific investments required to search for targets and, as a consequence, fewer transactions will take place.⁴² Those transactions that do take place, according to this argument, will take place at a discount with potential buyers putting something less than their best bid on the table in anticipation of a bidding contest, or because buyers anticipating that they might lose a bidding contest, could lower their valuation of the target.⁴³

Ultimately, these arguments are without much force. First, the initial stalking-horse bidder is a common device used to generate competitive auctions in the bankruptcy context.⁴⁴ If the argument against the fiduciary put had any real force, one might expect to see creditors in the bankruptcy context object to the use of a stalking-horse bidder over a negotiated sale; yet

³⁷*Omnicare*, 818 A.2d at 939 (holding that a selling board violates its fiduciary duties by not including an effective "fiduciary out" clause in the merger agreement).

³⁸See Gilson & Schwartz, *supra* note 3, at 336.

³⁹All the merger agreements in the author's sample included effective fiduciary termination rights for the seller.

⁴⁰For a summary of these arguments, see Quinn, *supra* note 15, at 876-77.

⁴¹See *id.*

⁴²*Id.*

⁴³*Id.*

⁴⁴See *In re Regan*, 403 B.R. 614, 619 n.3 (B.A.P. 8th Cir. 2009).

they do not. So long as the termination fee attendant to the fiduciary termination fee is properly priced, then there will always be a market incentive for firms to search for potential targets and there will always be an incentive for initial bids.⁴⁵

Second, it seems counterintuitive to expect a risk averse initial bidder to respond to a lack of deal certainty by putting forward a low-ball bid. One expects an inverse relationship between the price offered for a seller and the likelihood of a second bidder appearing. Lower premia signal buying opportunities for potential second bidders, and should therefore draw second bidders into a bidding contest. Conversely, higher initial bids make the value of a topping bid marginally lower, thus dissuading second bidders from making potentially unsuccessful bids. A risk averse buyer seeking transaction certainty can achieve such certainty through the pricing mechanism. The closer a risk averse bidder's initial bid is to its private valuation of the target, the more likely it will be to close the transaction.

Finally, a rule that permits lower valuing bidders to bulletproof transactions and prevent higher-valuing second bidders from successfully acquiring targets raises transaction costs and generates unnecessary inefficiencies. Such a rule is difficult to justify because it permits sales to lower valuing buyers when a higher valuing second bidder is present.⁴⁶ To the extent there are gains to be made, such a rule assigns these gains to the initial bidder and not stockholders of the seller, thereby creating a potentially perverse incentive for shareholders of sellers to not engage in sales.

Recent experience with go-shop provisions in merger agreements appears to back the view that increased uncertainty associated with a seller's option does not necessarily lead to lower prices or inefficiencies in the marketplace.⁴⁷ Go-shop provisions are a relatively recent innovation in merger agreements and represent seller optionality in the extreme.⁴⁸ Rather than irrevocably committing the seller to an initial bidder, the go-shop provision permits the seller to attempt to use the initial merger agreement to generate an auction.⁴⁹ If critics of Delaware's imposition of a seller's

⁴⁵In earlier work, Gilson noted that if bidders are able to secure toe-holds or get other compensation that there will always be a market incentive for parties to engage in search, even if the initial bidder is only seeking to generate an auction and not actually interested in gaining control. See generally Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) (discussing tender offers).

⁴⁶Hanson and Fraidin nevertheless make this argument. See Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1794 (1994).

⁴⁷See Subramanian, *supra* note 5, at 731.

⁴⁸See *id.* at 730.

⁴⁹*Id.*

fiduciary put were correct, then the advent of these go-shop provisions—representing a very high degree of seller optionality—should have resulted in less competition for deals at lower prices for sellers as initial bidders retreated from the marketplace. However, Professor Guhan Subramanian finds that transactions with go-shop provisions tend to expose sellers to more competition and exhibit higher prices for the seller.⁵⁰

The effect of the court's rule requiring effective fiduciary termination rights is the creation of a seller's option in every merger agreement.⁵¹ The option is exercisable upon the appearance of an alternate buyer presenting a superior offer. The strike price of this option is the termination fee. The size of the strike price is limited by a seller's fiduciary obligations.⁵² To the extent fiduciary obligations are a binding constraint on the *size* of the strike price for the seller's option, such constrained obligations may be inefficient. However, given the importance of a director's fiduciary duties to shareholders and the corporation, we accept the potential for such an outcome.

III. THE MATERIAL ADVERSE CHANGE CLAUSE AND THE SYMMETRY HYPOTHESIS

It was in the context of the judicially-mandated put that observers began to consider the implications of increased seller optionality in the merger agreement. Gilson and Schwartz evaluated the role of the MAC clause in merger agreements in light of the development of the seller's fiduciary put.⁵³ Gilson and Schwartz put forward a hypothesis that buyers may be adapting to the seller's put by negotiating a symmetrical "buyer's put" in the form of the modern MAC.⁵⁴ Although they did not ultimately conclude that the MAC clause is a symmetrical buy-side response to the seller's fiduciary put, they left open the possibility that buyers might be responding elsewhere in the merger agreement.⁵⁵ Notwithstanding that conclusion, they concluded the MAC with its carve-outs is an efficient term

⁵⁰This is consistent with the outcome suggested by Quinn. See Quinn, *supra* note 15, at 865–67. Subramanian finds that transactions with go-shop provisions tend to be higher priced and subject to more competition. See Subramanian, *supra* note 5, at 731.

⁵¹See *Energy Partners, Ltd. v. Stone Energy, Corp.*, 2006 WL 2947483 (Del. Ch. Oct. 11, 2006), reprinted in 32 DEL. J. CORP. L. 551 (2007).

⁵²See *infra* Part IV (discussing the limitations on term fee sizes).

⁵³Gilson & Schwartz, *supra* note 3, at 330.

⁵⁴While the MAC has been a common feature of merger agreements for some time, Gilson and Schwartz note that the increase in carve-outs to the MAC in recent years might indicate a different use for the provision. *Id.* at 332.

⁵⁵See *id.*

because it places the costs of an unforeseeable exogenous event on the buyer, the party best able to bear such a cost.⁵⁶

The seller's option permits the seller to put the initial transaction back to the acquirer when a foreseeable, but exogenous, event (such as a higher, second bid) causes the initial bid to no longer be the most valuable option available to the seller. Similarly, the MAC permits the buyer to terminate the merger agreement should an exogenous event have a materially adverse effect on the target such that the target and the combined business no longer match the business expectations of the buyer.⁵⁷ While the material adverse change clause in a merger agreement appears to provide the acquirer with a valuable option, the MAC differs from the seller's fiduciary option in a number of important respects.

First, in order to achieve some negotiated symmetry, one might expect sellers to receive payment for the inclusion of a valuable MAC option, but it is not obvious they do. The MAC appears in the merger agreement as a condition to closing, and, in the event the MAC is triggered, no payment is required to be paid to the seller.⁵⁸ Unlike the fiduciary termination rights with respect to which parties negotiate an explicit fee, in order for the MAC term to be priced, parties must revisit the price term of the merger agreement following negotiation of the MAC term. To the extent parties do not revisit the price term, the finalized MAC represents a free option for buyers.

Second, in its traditional form, the MAC is very broadly defined. Any materially adverse changes in prospects of the target prior to closing would be sufficient to trigger the buyer's option to walk.⁵⁹ This trigger is vague, imprecise, and tied to unforeseeable, exogenous events. In recent years parties have taken to specifying foreseeable events or states of being to carve-out from the MAC trigger.⁶⁰ These carve-outs are heavily negotiated and include exceptions from the MAC for a host of foreseeable events outside the control of the seller, including events that affect the market as a whole, affect the target in a manner not disproportionate to the industry in which the target operates, or are related to the announcement or pendency of

⁵⁶*Id.* at 345-46.

⁵⁷In *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001), the court held that a material adverse change is an exogenous event, the effect of which is to substantially affect in a durationally negative manner the ability of the acquirer to conduct the combined business going forward.

⁵⁸See Gilson & Schwartz, *supra* note 3, at 330.

⁵⁹See Eric L. Talley, *On Uncertainty, Ambiguity, and Contractual Conditions*, 34 DEL. J. CORP. L. 755, 788 (2009).

⁶⁰See Gilson & Schwartz, *supra* note 3, at 345-46; STEVEN M. DAVIDOFF, *GODS AT WAR* 65 (2009) (noting the development of carve-outs and exceptions in MACs in merger agreements).

the transaction.⁶¹ The effect of such carve-outs is to shift the risk of the occurrence of a large category of foreseeable exogenous events away from sellers and onto the shoulders of buyers.⁶² Sellers are left bearing the risk

⁶¹As an example, the following definition of a modern material adverse effect (change) with its extensive carve-outs was included in the Brocade/Foundry merger agreement.

"Company Material Adverse Effect" shall mean any effect, change, claim, event or circumstance that, considered together with all other effects, changes, claims, events and circumstances, is or would reasonably be expected to be or to become materially adverse to, or has or would reasonably be expected to have or result in a material adverse effect on, (a) the business, financial condition, cash position, liquid assets, capitalization or results of operations of the Acquired Corporations taken as a whole, (b) the ability of the Company to consummate the Merger or any of the other transactions contemplated by the Agreement or to perform any of its covenants or obligations under the Agreement, or (c) Parent's ability to vote, transfer, receive dividends with respect to or otherwise exercise ownership rights with respect to any shares of the stock of the Surviving Corporation, but, subject to the next sentence, shall not include: (i) effects resulting from (A) changes since the date of the Agreement in general economic or political conditions or the securities, credit or financial markets worldwide, (B) changes since the date of the Agreement in conditions generally affecting the industry in which the Acquired Corporations operate, (C) changes since the date of the Agreement in generally accepted accounting principles or the interpretation thereof, (D) changes since the date of the Agreement in Legal Requirements, (E) any acts of terrorism or war since the date of the Agreement, (F) any stockholder class action or derivative litigation commenced against the Company since the date of the Agreement and arising from allegations of breach of fiduciary duty of the Company's directors relating to their approval of the Agreement or from allegations of false or misleading public disclosure by the Company with respect to the Agreement, or (G) the termination since the date of the Agreement of the agreements identified in Schedule I to the Agreement pursuant to their terms; (ii) any adverse impact on the Company's relationships with employees, customers and suppliers of the Company that the Company conclusively demonstrates is directly and exclusively attributable to the announcement and pendency of the Merger; or (iii) any failure after the date of the Agreement to meet internal projections or forecasts for any period. Notwithstanding anything to the contrary contained in the previous sentence or elsewhere in the Agreement: (x) effects resulting from changes or acts of the type described in clauses "(i)(A)," "(i)(B)," "(i)(C)," "(i)(D)" and "(i)(E)" of the preceding sentence may constitute, and shall be taken into account in determining whether there has been or would be, a Company Material Adverse Effect if such changes or acts have, in any material respect, a disproportionate impact on the Acquired Corporations, taken as a whole, relative to other companies in the industry in which the Acquired Corporations operate; and (y) any effect, change, claim, event or circumstance underlying, causing or contributing to any litigation of the type referred to in clause "(i)(F)" of the preceding sentence, or underlying, causing or contributing to any failure of the type referred to in clause "(iii)" of the preceding sentence, may constitute, and shall be taken into account in determining whether there has been or would be, a Company Material Adverse Effect.

Brocade Commc'ns Sys., Current Report (Form 8-K), at Exhibit 2.1 (July 24, 2008).

⁶²See Gilson & Schwartz, *supra* note 3, at 346.

associated only with unforeseen future events.⁶³ But because a symmetrical response to the seller's fiduciary put should shift the risk of foreseeable exogenous events onto the shoulders of the seller, the modern MAC, with its carve-outs, is not likely a symmetrical response to the seller's fiduciary put.⁶⁴

Gilson and Schwartz recognize that notwithstanding the failure of the symmetry hypothesis to find its counterpart in the MAC clause, the clause may yet still play an important efficiency role.⁶⁵ Efficient deal terms are those that place the burden of an exogenous risk occurring on the party best able to bear the cost of it.⁶⁶ In this manner, the inefficiencies associated with a particular adverse outcome are minimized. For example, in the MAC negotiated in the Brocade/Foundry transaction above, the parties carved out from the definition of a MAC any "changes since the date of the Agreement in general economic or political conditions or the securities, credit, or financial markets worldwide."⁶⁷ Because the buyer intends to run the combined business in the future as between the buyer and the seller, the buyer is better positioned to accept the risk of foreseeable changes in the business climate that might adversely affect the profitability of the combined entity.⁶⁸ In the event of unforeseeable adverse events there is no reason to expect that the buyer would be better positioned to bear the loss than a seller. Consequently, leaving the costs of an unforeseeable adverse event with a seller does not necessarily lead to an inefficient result.

While the MAC may fail as a symmetrical response to the seller's fiduciary put, the question still left open is whether buyers have responded to this judicial development by negotiating a symmetrical put for themselves elsewhere in the merger agreement. Or, have the courts created advantages for sellers by mandating seller optionality, leaving initial bidders at a structural disadvantage in the marketplace?

⁶³Talley also recognizes the role played by the MAC. In his analysis he divides the problem the MAC seeks to address into "risk" and "uncertainty." "Risk" refers to randomness whose probabilistic nature is extremely familiar and can be characterized with objective probabilities (such as the outcome odds that attend the roll of a fair die). 'Uncertainty,' in contrast, refers to randomness whose probabilistic behavior is extremely unfamiliar, unknown, or even unknowable." Talley, *supra* note 59, at 759.

⁶⁴Gilson and Schwartz recognize the effect of these carve-outs and consequently reject the symmetry hypothesis as explaining the development of the modern MAC. See Gilson & Schwartz, *supra* note 3, at 332.

⁶⁵*Id.* at 347.

⁶⁶This is consistent with efficient risk allocation principles—the risk of some event happening is left with the party best able to bear the cost of the event occurring. See *generally id.*, at 345–47 (explaining the more efficient risk bearer).

⁶⁷See Brocade Commc'ns Sys., Inc., *supra* note 61.

⁶⁸See Gilson & Schwartz, *supra* note 3, at 346.

IV. BUYER OPTIONALITY AND LEGAL RULES

During the run up to the collapse of the recent credit bubble, increasing attention was paid to the extent of buyers' optionality in merger agreements beyond the modern MAC and other customary closing conditions.⁶⁹ Why buyers demand, and more importantly, why sellers agree, to additional optionality beyond customary closing conditions are questions worth attempting to answer. For their part, courts have not yet mandated that buyers include buyer-friendly termination rights in their merger agreements akin to those required under *Omnicare*.⁷⁰ Consequently, that such rights are now increasingly common raises a question whether parties might be negotiating additional optionality to create symmetrical responses to the seller's judicially-mandated put, and if they are, whether the additional optionality reflects a result that enhances efficiency.⁷¹

Buy-side optionality in merger agreements is problematic for a number of reasons. On the one hand, the effect of reverse termination rights is to create an option for the buyer following a triggering event. Option contracts—even if they are option contracts to buy an entire company—are not troublesome from an analytic perspective, provided they are appropriately priced. At the same time, when courts are called on to evaluate termination fees, they treat such fees as defensive measures, subject

⁶⁹For example, in *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810, 814–16 (Del. Ch. 2007), a case typical of those attracting attention, a private equity acquirer was able to negotiate an effective option into the merger agreement by providing for a reverse termination fee as the sole remedy for the seller in the event the buyer refused to close the transaction. When credit conditions worsened, the transaction no longer looked viable from the point of view of the acquirer. Davidoff, *supra* note 2, at 502–05. The private equity acquirer then declined to close the transaction and paid the reverse termination fee. The buyer in the URI case was able to create an option by a \$100 million termination fee payable in the event the buyer refused to close the transaction. *United Rentals*, 937 A.2d at 816. In addition, the seller gave up any rights to seek specific performance of the contract in a court of equity. *Id.* at 817, 819. Such arrangements have become relatively common in the context of transactions with private equity buyers in recent years and are increasingly common amongst strategic buyers. See Davidoff, *supra* note 2, at 502–05.

⁷⁰See generally *Omnicare Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) (requiring seller's boards to have a fiduciary out).

⁷¹On the other hand, reliance by strategic buyers on buy-side termination rights and reverse termination fees could simply be an importation of financial buyer practices. See John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1301 (2001) (noting how standards in agreements are often adopted by lawyers). During the recent credit bubble, strategic buyers imported another private equity buyer innovation—go-shop provisions—into their merger agreements. See Subramanian, *supra* note 5, at 730. With respect to reverse termination fees and triggers, strategic buyers appear to have imported from the private equity context fiduciary termination rights and fees first and then followed with other triggers.

to tests of reasonableness.⁷² It is not so clear, however, that reverse termination fees always play a defensive role. To the extent the fees represent the strike price of an option and not a defensive measure, the court's current approach to evaluating their size may not be entirely appropriate.

Of course, boards of buyers have the same basic fiduciary obligations as the boards of sellers.⁷³ However, due to the structure of the transactions and the burden of proof placed on directors in litigation, the degree to which buyer and seller boards comport with those basic obligations is tested differently. At the most elementary level, a board's decision to enter into a merger agreement, including the decision to enter into an option contract, is protected by the deference granted board decisions by the business judgment rule.⁷⁴

There are, however, limited exceptions to this analysis. Where the acquirer's board adopts measures that protect the merger agreement from subsequent attack, such measures, to the extent they can be properly characterized as defensive, will be subject to *Unocal*-level scrutiny if they are motivated by a desire for management entrenchment or have the effect of coercing the acquirer's shareholders to vote in favor of the transaction for any reason other than the transaction's own merits.⁷⁵

Without the threat of either management entrenchment or the possible coercive effects on a shareholder vote, there is no impetus for intermediate scrutiny.⁷⁶ With respect to buyers, the problem of management entrenchment is not consistently present as a latent threat to the interests of the buyer's shareholders in the same way that it is with respect to the seller's shareholders, because the controlling interests of a buyer's management are not typically at stake in an acquisition.⁷⁷

⁷²"If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness.'" *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995) (citing *Paramount Commc'ns Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994)).

⁷³Boards of buyers and sellers both have fiduciary duties of care and loyalty. Henry Ridgely Horsey, *Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 975-76 (1994) (discussing generally director's duties of care).

⁷⁴*See Time Inc.*, 571 A.2d at 1142 (applying business judgment to a board's decision to pursue an acquisition strategy).

⁷⁵*See Unocal Corp. v. Mesa Petrol., Co.*, 493 A.2d 946, 955 (Del. 1985) (applying heightened scrutiny when the board adopts measures to defend corporate policy).

⁷⁶In *Unocal*, the court pointed to the "omnipresent specter" of self-interested managers seeking to entrench themselves as a motivating factor in deciding to engage in closer scrutiny of transactions where the board protected corporate policy with deal protection measures. *Id.* at 954.

⁷⁷*See id.* (describing "omnipresent specter" of board conflicts of interest). While there are facts that might occur that can suggest management entrenchment as a motivation for a particular

In addition, the buyer's shareholders do not always have voting interests at stake in an acquisition. Where the buyer is a constituent corporation, but the consideration used is cash, the buyer's shareholders will typically not have a statutory right to vote on the transaction in question.⁷⁸ Also, in the event the buyer relies on a triangular merger structure to accomplish the transaction, the buyer's shareholders do not have a statutory right to vote to approve the transaction.⁷⁹ In such a situation, the threat that particular deal provisions, including the size of a reverse termination fee, may coerce shareholders of a buyer to approve a transaction is non-existent. Without either the threat of management entrenchment or shareholder coercion, a buyer's decisions to provide sellers with transactional certainty through the use of deal protection measures should therefore not generate a heightened scrutiny by the courts.

There are a subset of transactions, however, that might implicate *Unocal* scrutiny for acquirers. First, there are those transactions where the acquirer is a constituent corporation in a transaction, and a shareholder vote is required to approve the merger.⁸⁰ In these cases, the decision of an acquirer's board to protect the transaction will be subject to intermediate scrutiny in order to assure the required shareholder vote is not a meaningless exercise.⁸¹ Alternatively, where the acquirer is not a constituent corporation, but a stockholder vote of the parent is required pursuant to either the articles of incorporation or stock exchange rules (for example NYSE Rule 312) to issue the stock used as consideration in the transaction; decisions to protect the transaction may also be subject to *Unocal* level scrutiny.⁸²

In that subset of transactions where such considerations are relevant, there is reason to believe that buyers would be constrained by their fiduciary obligations to not 'bulletproof' and provide sellers with absolute transactional certainty.⁸³ Where those buyers are relying on reverse termination fees, the size of such fees may be constrained by the buyer's board's fiduciary

form of transaction (a *Time*-like restructuring, for example), such cases are not the norm. *See Time*, 571 A.2d at 1148.

⁷⁸Subject to certain conditions. *See* DEL. CODE ANN. tit. 8, § 251(f) (2006).

⁷⁹Although, the board may be required to vote to approve a share issuance pursuant to stock exchange rules. *See* NYSE, Inc., Listed Company Manual § 312 (2009).

⁸⁰*See* *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659–60 (Del. Ch. 1988).

⁸¹"The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests." *Id.* at 659.

⁸²Not all shareholder votes in the merger context are required statutory votes. Stock exchange rules require a vote of shareholder approval when issuing more than 20% of the outstanding shares. The minimum vote required pursuant to these rules is less than would be required to approve a merger. *See* NYSE, Inc., Listed Company Manual § 312 (2009).

⁸³*See* Quinn, *supra* note 15, at 872.

obligations.⁸⁴ The limits with respect to size of the reverse termination fee reside at the point where its size could cause a shareholder to vote for the transaction for reasons other than the transaction's merits and thus acts like a penalty.⁸⁵

On the other hand, in transactions where the consideration is cash, in transactions where an immaterial amount of stock is used as consideration, or in transactions structured as triangular mergers, the fiduciary limitations described above should not be a limiting factor with respect to the type and nature of deal protection measures deployed by buyers to provide sellers with transactional certainty. A buyer may irrevocably commit to a seller by not negotiating for itself any termination rights, thereby providing a seller total transactional certainty. In most cases, such a commitment should survive judicial scrutiny. Only where the buyer's shareholders franchise is threatened might a court subject such commitments by the buyer to enhanced review.

This logic also holds with respect to an acquirer's use of reverse termination fees. Though the reasonableness analysis articulated in *Brazen v. Bell Atlantic Corp.* continues to operate, the concern for the potentially coercive effect on a shareholder vote is non-existent where the buyer's shareholders are not required to vote to approve the transaction in question.⁸⁶ Without a threat of shareholder coercion, parties should be free to set the strike price of the buyer's option at a level that is mutually acceptable to the parties and perhaps more reasonably approximates the seller's damages without judicial interference.⁸⁷

⁸⁴There are fiduciary constraints against the excessively large termination fees. Such limitations are acceptable when a court must balance damages caused by a termination on the one hand and fiduciary obligations to seller's shareholders on the other. In that case, the court has developed a textured approach to reviewing the appropriateness of the size of such fees. In *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 48 (Del. 1997), the Delaware Supreme Court equated termination fees with a liquidated damages provision in contract and applied a two prong approach to reviewing their size. First, damages must be uncertain or incapable of calculation; and second, the amount agreed must be reasonable. *Id.*

⁸⁵*See id.* at 50 (citing *Williams v. Geier*, 671 A.2d 1368, 1382–83 (Del. 1996)). In *In re Toys "R" Us S'holder Litig.*, 877 A.2d 975, 1015–16 (Del. Ch. 2005), the Chancery Court emphatically rejected a rule that termination fees would be per se reasonable so long as they were under a prescribed level of say three percent. In *Louisiana Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007), the court outlined a context specific approach to determining the reasonableness of termination fees.

⁸⁶*See Brazen*, 695 A.2d at 48. For the same reason, courts are wary of termination fees payable on a "naked" no vote by shareholders. As a consequence, a director's fiduciary obligations to shareholders are a constraining factor on the size of allowable termination fees.

⁸⁷Although courts are loathe to set a level at which a termination fee will be per se objectionable, courts have approved fees in the range of 3% of transaction value and as large as 6% of transaction value. *Ex ante*, one might reasonably estimate that the seller could suffer damages

The value of the buyer's option is equal to the difference between the buyer's alternative minus the strike price of the option. A judicial constraint on the size of the reverse termination fee may result in buyers receiving excess gains without an accompanying increase in economic efficiency.

V. REVERSE TERMINATION FEES AND THE SYMMETRY HYPOTHESIS

This article relies on data from the SDC Platinum M&A database from 2003 through 2008 for evidence of buy-side optionality and attempts to discover whether the reverse termination triggers and the reverse termination fee are efficient transaction terms engineered in response to the judicially created seller's put.⁸⁸ Termination triggers available to buyers are diverse in nature compared to the narrow set of circumstances the seller's fiduciary put provides. Consequently, such triggers are likely not symmetrical responses to the seller's fiduciary termination right. With respect to efficiency, I am unable to conclude that reverse termination fees do not enhance efficiency.

I searched for mergers involving non-bankrupt Delaware targets, and strategic buyers with a transaction value over \$100 million. I collected transactions where consideration consisted of cash, stock, or a combination. This permitted me to include transactions in which the buyer's shareholders would be required to approve a share issuance in connection with the transaction. I excluded transactions in bankruptcy because there are special fiduciary concerns in sale of firms in bankruptcy. These searches returned 644 transactions during the period (the "sample").⁸⁹

Reverse termination fees, or fees payable by an acquirer to a seller in the event the merger agreement is terminated following the occurrence of certain events, are a relatively common transaction term in the sample; 105 transactions (16%) had one form of a buy-side termination trigger accompanied by a reverse termination fee. Although seller fiduciary

equal to well in excess of 6% of enterprise value and that a reverse termination fee of that size might be appropriate. See Crawford, 918 A.2d at 1181 n.10; Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1559 (1996) (noting that termination fees that induce initial bidders, as opposed to anticipatory lockups may be useful in generating auctions).

⁸⁸SDC Platinum, Thomson Reuters Financial Database, http://thomasreuters.com/products_services/financial/financial_products/deal_making/investment_banking/sdc.

⁸⁹Although optionality with respect to financial buyers received some popular attention toward the end of the recent credit bubble, I do not collect transactions with financial buyers. This is because financial buyers employ acquisitions structures which exhibit a high degree of optionality. In particular, financial buyers rely on special purpose vehicles to acquire targets. These vehicles and their parents typically lack the financial resources to complete a transaction without external financing. Accordingly, the ultimate buyer attempts to structure the transaction to place these vehicles at a point as remote as possible from the parent fund.

termination rights and accompanying termination fees are found in 100% of transactions in the sample, it is not obvious, notwithstanding the recent increase in popular attention to reverse termination fees, that buyers have adopted reverse termination fees as a symmetrical response to the seller's judicially-mandated fiduciary termination right. Since 2003, there has not been a demonstrable increase in the relative frequency of reverse termination fees in transactions with strategic buyers (see *Figure 1*). Reverse termination fees are present in just over 18% of the sample transactions between 2003-2004 period. During the 2007-2008 period, nearly 16% of sample transactions included a reverse termination fee.

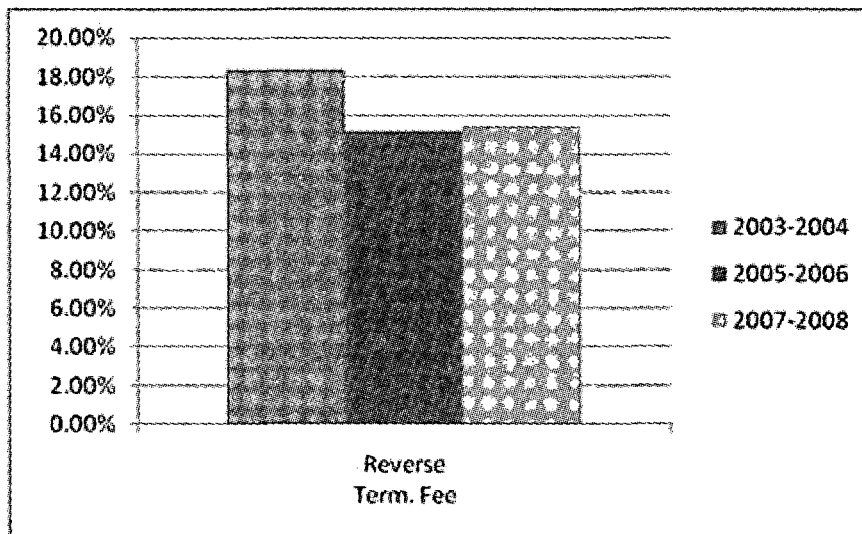


Figure 1: Prevalence of Reverse Termination Fees (2003-2008)

Although there are no bright-line rules with respect to the size of reverse termination fees and termination fees, they are subject to broad fiduciary limitations.⁹⁰ These fiduciary limitations do not, however, bind acquirers to the same degree that they bind sellers.⁹¹ Notwithstanding the freedom of buyers and sellers to negotiate more liberal reverse termination fees, practice and custom demonstrate a high degree of path dependence—meaning that reverse termination fees and termination fees tend to be equal in size. The majority of the sample transactions with reverse termination

⁹⁰See *supra* Part IV (discussing fiduciary duties with respect to termination fees).

⁹¹See *supra* Part IV (discussing fiduciary duties with respect to reverse termination fees).

fees (79 or 75.2%) have reverse termination fees that are equal in size to the termination fee.

For those transactions where the termination fee and the reverse termination fees diverge from custom and practice, i.e. they are not equal, the reverse termination fees tend to be larger than the termination fee (19% or 73.1%).⁹² This tendency appears to indicate that, to the extent parties move away from a path-dependent outcome, they may be attempting to negotiate a strike price for a buyer's option that reflects a more reasonable approximation of damages suffered by the seller without regard to fiduciary constraints. To the extent this is true, it is an efficiency enhancing result.

The average size of termination fees for transactions in the sample is 2.94% of transaction value (4.69% of enterprise value). The average size of reverse termination fees in the sample is slightly larger, at 3.29% of transaction value (3.07% of enterprise value).⁹³ Where reverse termination fees are larger than the termination fees, the average reverse termination fee is significantly larger than the range generally considered acceptable for termination fees in Delaware.⁹⁴ These relatively large reverse termination fees tend to be associated with particular triggers, for example antitrust and regulatory approval triggers and, as a result, do not likely raise the concerns that cause *Unocal* scrutiny.⁹⁵

It appears that when parties negotiate the size of the reverse termination fees, they key it to the size of the termination fee in the merger agreement. Analytically, there is no reason to believe, *ex ante*, that a reasonable estimate of seller's damages in the event of buyer's termination, or that the value of the buyer's option to terminate, should always be equal to buyer's damages. One can observe that a buyer's termination may result in damages to a seller (e.g. the seller is "damaged goods") that are higher than those a buyer suffered in the event of a seller's termination. Indeed, there are a number of situations where this will not be the case. Parties may agree to fee equivalence for the sake of negotiating simplicity or comity, rather than

⁹²In such cases, the larger reverse termination fees are most often triggered by antitrust/regulatory conditions. While antitrust conditions are an unconventional condition to performance in a merger agreement, typically failure of this condition does not result in a payment by either party. Where parties are assigning costs to the buyer in the event of the failure of this condition, they are not consequently paying for any additional optionality. See *infra* Part VI.

⁹³Termination fees measured as a percentage of enterprise value is thought by some to be a better metric because enterprise value includes the net value of any cash that might be acquired in the transaction. See *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 997 (Del. Ch. 2005) (using enterprise value in assessing the reasonableness of the termination fees).

⁹⁴See *supra* note 87 and accompanying text (discussing acceptable ranges for termination fees).

⁹⁵See *infra* Part VI (discussing regulatory triggers).

due to a more complex analysis of either the value of the option to terminate to the buyer or the potential damages incurred by the seller of a termination by the buyer.

The economic value of the buyer's option to terminate is equal to the difference between the value of the alternative to the buyer, or in the case of a reverse termination fee coupled with a fiduciary trigger, an alternative acquisition and the reverse termination fee (the strike price).⁹⁶ To the extent that current negotiating practice results in parties artificially constraining the size of the buyer's reverse termination fee, such a practice could result in the seller bearing more of the cost of a termination than might be efficient.

Although termination fees paid by the seller to the buyer are uniformly tied to the judicially-required fiduciary termination rights, triggers for reverse termination fees are not nearly as uniform. Reverse termination fee triggers fall into one of several categories: fiduciary termination rights, regulatory/antitrust triggers, financing contingencies, representation and warranty triggers, and the buyer's "option to close" trigger.

⁹⁶See RICHARD BREALEY & STEWART MYERS, *PRINCIPLES OF CORPORATE FINANCE* 597 (2000) (defining the value of an option); RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 231-44 (1995) (defining the value of an option).

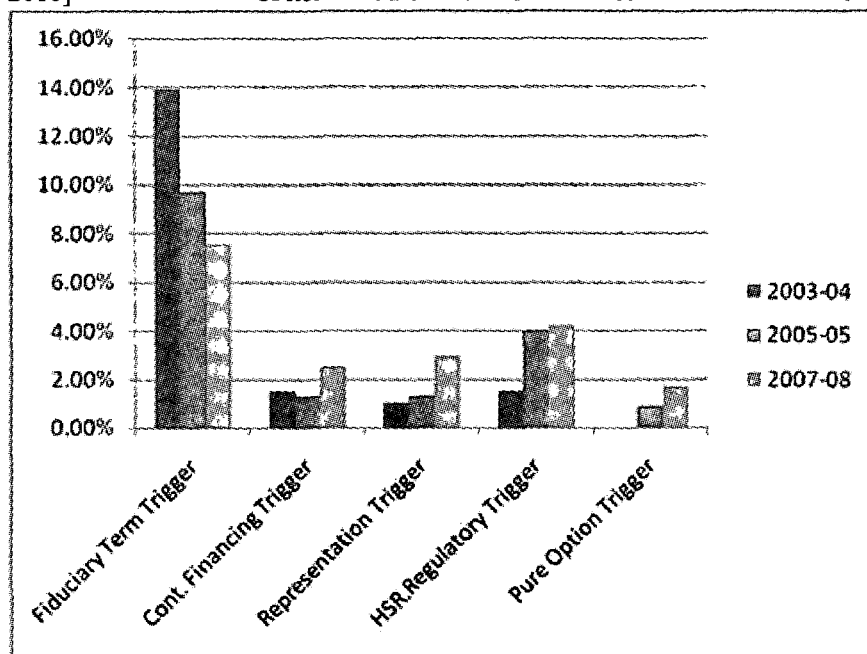


Figure 2: Prevalence of Reverse Termination Fee Triggers (2003-2008)

The most common of these triggers present in the data set is the fiduciary termination right that is triggered with a superior offer for the acquirer. The second most common reverse termination trigger present in the data set is the regulatory trigger that provides for a payment by the buyer in the event that the relevant government authorities do not approve the transaction. Other triggers from transactions in the data set include financing contingencies and payments that are prompted by the buyer's inaccurate representations and warranties (including the buyer's financing representations). Finally, a small number of buyers in the data set have negotiated for the right simply to pay a fee to terminate a transaction. In the following taxonomy of reverse termination fee triggers, I assess the degree to which each trigger could possibly be a symmetrical response to the judicially-mandated fiduciary termination right. Ultimately, I find that none of the most common reverse termination fee triggers can properly be considered a symmetrical response to the judicially-mandated fiduciary termination right.

A. Buyer's Fiduciary Put

Where the buyer is required to obtain shareholder approval, merger agreements may provide for a fiduciary termination right tied to shareholder approval of the acquirer's shareholders. A buyer's exercise of its fiduciary

termination right is the most common trigger for a reverse termination fee. In the case of the buyer's fiduciary termination right, the value of the option is equal to the difference between the option's strike price and the value to the buyer of an alternative transaction that the acquirer might pursue following termination of the initial transaction.

A buyer's fiduciary termination right is present in just over 10% of the sample transactions with strategic buyers and is present in 71.2% of transactions with any reverse termination fee, making the buyer's fiduciary put the most common reverse termination fee used by buyers. Where the acquirer is required to obtain shareholder approval, merger agreements commonly provide for a buyer's fiduciary termination right equivalent to the seller's fiduciary put. Where stock is a significant component of the consideration in the proposed merger, thus requiring a shareholder vote, 90% of the transactions that required a vote of the acquirer's shareholders also included a buyer's fiduciary termination right. In those transactions that did not include a significant component of stock in the consideration, no buyers enjoyed a fiduciary termination right. This leads to the conclusion that buyers tie the use of a fiduciary put to the issuance of new shares.

Fiduciary termination rights are often negotiated to mirror a seller's fiduciary termination rights. In a typical case from the dataset, a buyer might negotiate for a fiduciary termination right.⁹⁷ A typical buyer's fiduciary termination right provides that in the event a third party proposes an alternative transaction to the acquirer before the vote of the acquirer's shareholders, the acquirer's board would have the right to consider the alternative proposal. Should the board decide that the subsequent proposal is a superior proposal to that of the seller, then the acquirer would have the right to terminate the merger agreement with the seller, triggering the

⁹⁷For example, in PAETEC's 2007 acquisition of McLeod, the parties included a buyer's fiduciary termination right, the text of which mirrored, for the most part, the text of the seller's fiduciary termination right. The text, in part, follows below:

An "Alternate Transaction" means any (i) transaction to which any Person . . . , directly or indirectly, acquires or would acquire more than 20% of the outstanding voting power of . . . Buyer Common Stock . . . whether from . . . Buyer . . . or pursuant to a tender offer or exchange offer or otherwise, (ii) transaction pursuant to which any Person . . . acquires or would acquire control of . . . Buyer . . . , or (iii) merger, share exchange, consolidation, business combination, recapitalization or other similar transaction involving . . . Buyer . . . as a result of which the holders of shares of . . . Buyer Common Stock . . . immediately prior to such transaction would not, in the aggregate, own more than 80% of the outstanding voting power of the surviving or resulting entity . . .

McLeod USA Inc., Prospectuses and Communications (Form 425), Ex. 2.1 at 63 (Sept. 17, 2008), available at <http://www.sec.gov/Archives/edgar/data/919943/000119312507202309/dex21.htm>.

payment of a reverse termination fee and permitting itself to be sold to the second coming acquirer.

At first glance, a buyer's fiduciary termination right appears to be symmetrical to the fiduciary termination right enjoyed by a seller. Upon closer inspection, this right differs in a number of important respects. First, the seller's judicially-mandated termination right permits the seller to use market mechanisms to ensure that it is sold to the highest bidder.⁹⁸ The announcement of the initial bid may have the effect of alerting potential bidders to make topping bids for the seller.⁹⁹ If, subsequent to the announcement, an exogenous event occurred (for example, a higher bid) that caused the present transaction with the acquirer to no longer be the highest valuing use, then the seller would have right to exercise its option, pay a fee to terminate the transaction, and pursue the higher value alternative.¹⁰⁰ The costs of this termination, subject to a reasonableness standard, would be borne by the seller.¹⁰¹

The buyer's fiduciary termination right does not, however, expose the present transaction to market review in the same way. Were there to be symmetry, buyers would negotiate to ensure that they were receiving the highest value target possible. A symmetrical right would ensure that if, following the announcement of the initial acquisition, another potential target approached the buyer with an offer, the buyer would have an opportunity to consider that offer. In the event that the second offer resulted in a higher valued combined entity, then a symmetrical termination right would permit the buyer to terminate the initial transaction with the seller in order to purchase the second offeror.¹⁰² In this way, the buyer's fiduciary termination right would permit the buyer to use market mechanisms to ensure it received the highest possible value.¹⁰³

Instead, the buyer's termination right permits the buyer to terminate the transaction only when a third party offers to acquire the buyer.¹⁰⁴ While such language exactly mimics the language of the seller's fiduciary put, it is not symmetrical in its effect. If, subsequent to the transaction being announced, an exogenous event occurs which makes the transaction with the

⁹⁸ See Gilson & Schwartz, *supra* note 3, at 335.

⁹⁹ See *id.*

¹⁰⁰ See *id.*

¹⁰¹ See *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 48 (Del. 1997)

¹⁰² This assumes that the acquisition market is a consolidating market in which buyers have multiple sellers from which to choose when they make acquisition offers.

¹⁰³ In consolidating industries it is possible that a buyer might be able to generate a reverse auction through the announcement of an initial transaction.

¹⁰⁴ See Quinn, *supra* note 15, at 866.

target no longer the highest valuing use, a symmetrical response would permit the acquirer to terminate the transaction, pay a fee, and then pursue the highest valuing use. Consequently, the buyer's fiduciary termination right is not a symmetrical response to the seller's judicially-mandated fiduciary termination right. Viewed in this way, the buyer's fiduciary termination right provides the buyer with limited optionality, but no symmetry with respect to the buyer's fiduciary termination right.

Second, the seller's fiduciary termination right preserves the integrity of the selling shareholders' statutory right to approve or reject the merger.¹⁰⁵ The buyer's fiduciary termination right does not, in most cases, work to preserve the acquiring shareholders' statutory voting rights. For the most part, acquirer's shareholders have no statutory rights to approve or reject a merger. The reverse triangular merger, a common structure relied upon by many acquirers, permits buyers to complete an acquisition without a statutory vote of the acquirer's shareholders.¹⁰⁶ To the extent shareholders of the acquirer are required to vote in the context of a merger, they are typically asked to approve an issuance of the acquirer's stock to be used as consideration.¹⁰⁷ This stockholder vote occurs either because the acquirer's certificate of incorporation does not permit the acquirer to issue additional stock¹⁰⁸ or because such a vote is required pursuant to stock exchange listing rules.¹⁰⁹ In neither case are shareholders of the acquirer asked, nor required, to approve or reject the merger itself. Consequently, the buyer's fiduciary put does not protect the same rights as the seller's fiduciary put.

Whereas the seller's termination right provides for a passive market check to ensure the seller has an opportunity to consider mutually-exclusive, alternative transactions that might appear following the announcement of the

¹⁰⁵See DEL. CODE ANN. tit. 8, § 251(c) ("The agreement required by subsection (b) of this section shall be submitted to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement At the meeting, the agreement shall be considered and a vote taken for its adoption or rejection.").

¹⁰⁶In the triangular merger structure, the acquirer incorporates a wholly-owned subsidiary that acts as a constituent corporation together with the target corporation. The corporate acquirer is the sole stockholder of the acquisition subsidiary. Only the shareholders of constituent corporations have statutory voting rights with respect to the merger. See GILSON & BLACK, *supra* note 96, at 669.

¹⁰⁷See *id.* at 1045–46.

¹⁰⁸A shareholder vote may be required to amend the certificate of incorporation and thus increase the number of authorized shares. See DEL. CODE ANN. tit. 8, § 242.

¹⁰⁹For example, the New York Stock Exchange listing rules require shareholder approval in the event stock is used as consideration in a merger if such an issuance is equal to or in excess of 20% of the voting power or common stock outstanding before the transaction. See NYSE, Inc., Listed Company Manual § 312(c) (2009). The NASDAQ has similar voting requirements. See NASDAQ, Inc., Stock Market Rules § 5635(a) (2009).

initial transaction, the buyer's fiduciary termination right does not provide the buyer the same right. Indeed, in many cases, the buyer's put may permit the buyer to terminate the transaction with the seller even though the transactions are not mutually exclusive. In the event an alternate target appears, the buyer will not be permitted to terminate the transaction in order to pursue it, thereby reducing the effectiveness of the post-bid market check with respect to acquirers.

While the buyer's fiduciary put may provide some optionality, the value of the option is difficult to calculate. This is true because the alternative to the initial transaction is not a comparable target, but rather sale of the buyer itself. While a strategic buyer may be able to value the addition to its portfolio of a particular business, when faced with the prospect of being acquired by a third party, it may be difficult for the buyer to compare the transactions in a manner that can be appropriately valued.

B. Buyer's Financing Contingency

The financing contingency is relatively common among financial buyers who use thinly-capitalized special purpose vehicles to accomplish an acquisition. In a typical leveraged buy-out (LBO) by a financial acquirer, the acquirer raises committed financing only after a target has been identified.¹¹⁰ Because financing for these transactions is highly contingent, such transactions always include a substantial financing risk. Strategic buyers, on the other hand, have multiple potential sources of financing, including stock, retained earnings, and/or debt (backed by the balance sheet of the acquirer).¹¹¹ Consequently, financing contingencies are less common.¹¹² With respect to transactions in the sample, 1.95% of

¹¹⁰See GILSON & BLACK, *supra* note 96, at 398–404 (introducing the LBO process). Consequently, the typical LBO with a financial buyer almost always includes a financing contingency and thus an inherently high level of optionality. In the typical structure of a private equity sponsored transaction, the private equity fund is not a party to the merger agreement. See *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810, 814 (Del. Ch. 2007). The merger agreement is usually signed by a special purpose acquisition vehicle incorporated to act as the parent along with a merger subsidiary wholly-owned by the special purpose acquisition vehicle. See *id.* The acquisition vehicles are usually shell corporations without any ability to finance the transaction on their own. See *id.* The private equity sponsors stand in the background as investors in the parent vehicle thereby providing the acquisition vehicle with the financial capability to close the transaction. See *id.* at 814–15. Such was the case in *United Rentals. Id.*

¹¹¹Afsharipour, *supra* note 8, at 10 (making a similar observation)

¹¹²See Kevin A. Rinker & Shelby E. Parnes, *Something Old, New, Borrowed, and Blue*, THE DEAL MAGAZINE, July 29, 2009, <http://www.thedeal.com/newsweekly/community/something-old,-new-borrow-and-blue.php>.

transactions with strategic buyers included a financing contingency. While still low, the relative percentage of transactions in the sample including such contingencies has been increasing over time (*see Figure 2 above*). The financing contingency is the third most common termination trigger for strategic buyers appearing in 13.83% of the sample transactions that have reverse termination fees.

The financing contingency permits the buyer to terminate the merger agreement and pay a fee in the event the buyer is unable to secure financing. The value of a financing contingency from the point of view of the buyer is the difference between the strike price and the avoided marginal cost of having to rely on equity financing to finance an acquisition for which debt financing is not available.¹¹³ Pursuant to the terms of a typical financing

¹¹³For example, Brocade's 2008 acquisition of Foundry Networks included a financing contingency:

8.3(f) If (i) this Agreement is terminated by Parent or the Company pursuant to Section 8.1(b) [drop dead date] or by the Company pursuant to Section 8.1(g) [failure of Parent Representations] and at the time of the termination of this Agreement (A) each of the conditions set forth in Sections 6 and 7 (other than the conditions set forth in Sections 6.6(b) and 7.5) has been satisfied or waived, (B) the Company is ready, willing and able to consummate the Merger, and (C) there exists an uncured Financing Failure, or (ii) this Agreement is terminated by the Company pursuant to Section 8.1(h) [financing failure], then Parent shall pay to the Company in cash, at the time specified in the next sentence, a nonrefundable fee in the amount of \$85,000,000 in cash (the "Reverse Termination Fee"). . . . Notwithstanding anything to the contrary contained in Section 5.6(b), Section 8.3, Section 9.12 or elsewhere in this Agreement, if this Agreement is terminated as set forth in the first sentence of this Section 8.3(f), the Company's right to receive the Reverse Termination Fee pursuant to this Section 8.3(f) shall be the sole and exclusive remedy of the Acquired Corporations and their respective stockholders and affiliates against Parent or any of its Related Persons (as defined below) for, and the Acquired Corporations . . . shall be deemed to have waived all other remedies (including equitable remedies) with respect to, (i) any failure of the Merger to be consummated, and (ii) any breach by Parent or Merger Sub of its obligation to consummate the Merger or any other covenant, obligation, representation, warranty or other provision set forth in this Agreement. Upon payment by Parent of the Reverse Termination Fee pursuant to this . . . The parties agree that the Reverse Termination Fee and the agreements contained in this Section 8.3(f) are an integral part of the Merger and the other transactions contemplated by this Agreement and that the Reverse Termination Fee constitutes liquidated damages and not a penalty. In addition, notwithstanding anything to the contrary contained in this Agreement, regardless of whether or not this Agreement is terminated, except for Parent's obligation to pay to the Company the Reverse Termination Fee if and when such Reverse Termination Fee becomes payable by Parent to the Company pursuant to this Section 8.3(f): (1) neither Parent nor any of Parent's Related Parties shall have any liability for (x) any inaccuracy in any representation or warranty set forth in Section 3.6 or Section 3.7 or any inaccuracy in any other representation or warranty relating to the Debt Financing (regardless of

contingency, the acquirer would be permitted to terminate the agreement and pay a fee in the event the merger agreement's outside date passed and the acquirer was unable to arrange financing for its acquisition of the seller.¹¹⁴ Under the terms of the agreement, the seller would not be permitted to seek specific performance in such circumstances in the event the acquirer terminated the transaction for lack of financing.¹¹⁵ The termination fee represented the seller's sole available remedy in the event the acquirer terminated pursuant to this provision.¹¹⁶ Without the contingency in place, the buyer would have been required to complete the transaction, the cost of which would be equal to the higher costs of equity financing. In absence of this contingency, a seller would typically be permitted to sue for breach and seek specific performance or damages should the buyer not be able secure financing to close the transaction.

Unlike the appearance of a topping bid for a seller, the ability of a strategic buyer to obtain external financing is not an entirely exogenous event.¹¹⁷ Strategic buyers are operating businesses with cash-flow and assets

whether such representation or warranty refers specifically to the Debt Financing), or (y) any breach of any of the Parent Financing Covenants, unless such inaccuracy or breach constitutes a Willful Breach by Parent; and (2) in the event of any Financing Failure, neither Parent nor any of Parent's Related Parties shall have any liability of any nature (for any breach of this Agreement or otherwise) to any Acquired Corporation or to any stockholder or affiliate of any Acquired Corporation. . . .

Brocade Commc'ns Sys., *supra* note 61, at Exhibit 2.1.

¹¹⁴See *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 108 (Del. Ch. 2007).

¹¹⁵See *United Rentals*, 937 A.2d at 815–16.

¹¹⁶See *Brocade Commc'ns Sys., Inc.*, *supra* note 61, at Exhibit 8.3(f).

9.12 Enforcement. Except as set forth in Section 8.3(f), in the event of any breach or threatened breach by Parent or the Company of any covenant or obligation of such party contained in this Agreement, the other party shall be entitled to seek: (a) a decree or order of specific performance to enforce the observance and performance of such covenant or obligation; and (b) an injunction restraining such breach or threatened breach; *provided, however*, that, notwithstanding anything to the contrary contained in this Agreement, (i) the Company shall not be entitled to seek or obtain a decree or order of specific performance to enforce the observance or performance of, and shall not be entitled to seek or obtain an injunction restraining the breach of, or to seek or obtain damages or any other remedy at law or in equity relating to any breach of, any of the Parent Financing Covenants, except with respect to a Willful Breach by Parent of the specific covenant or obligation sought to be enforced, and (ii) in the event of a Financing Failure, the Company shall not be entitled to seek or obtain a decree or order of specific performance to enforce the observance or performance of, and shall not be entitled to seek or obtain an injunction restraining the breach of, or to seek or obtain damages or any other remedy at law or in equity relating to any breach of, any covenant or obligation of Parent or Merger Sub.

Id.

¹¹⁷While the availability of financing may be an exogenous event for a thinly-capitalized

against which they are able to borrow should they require financing to accomplish a transaction. In addition, strategic buyers may also use their stock as acquisition currency. The endogeneity of finance may account for why such a small percentage of transactions involving strategic buyers rely on financing contingencies. To be a symmetrical response to the seller's fiduciary put, the financing contingency would have to respond to a foreseeable exogenous event that makes the present transaction less valuable to the buyer than the alternative. While the financing contingency may generate more optionality for buyers, it is not a symmetrical response to a foreseeable exogenous event, given the endogenous nature of the financing decision.

C. Buyer's Regulatory Put

All the transactions in the sample required the approval of antitrust or other regulatory authorities pursuant to the Hart-Scott-Rodino premerger notification rules.¹¹⁸ However, 2.85% of all the transactions in the sample included a trigger requiring the payment of a reverse termination fee in the event antitrust or other regulatory authorities failed to approve the transaction. Of the transactions with reverse termination fees, the regulatory trigger was the second most common, occurring in 20.2% of transactions in the sample.

The approval or disapproval by antitrust authorities is a foreseeable event, much like the potential for a competing second bid. To the extent a regulatory put provides optionality for buyers in response to a foreseeable exogenous event, then it may be considered a symmetrical response. However, in the absence of a reverse termination fee trigger, buyers are not typically required to close a transaction in the face of government opposition for antitrust or other regulatory reasons. Regulatory approvals are typically conditions to closing and not presumed when an agreement is signed.¹¹⁹ This is likely because parties often view regulatory approval as an exogenous

financial acquirer, this is not true of strategic buyers, which have multiple potential sources of financing. See Quinn, *supra* note 15, at 883.

¹¹⁸The Hart-Scott-Rodino Antitrust Improvement Act of 1976 requires certain proposed transactions submit notifications to the Federal Trade Commission and the Department of Justice prior completing the transaction. If either agency determines that the proposed transaction would be anticompetitive, they may seek injunctive relief to halt the transaction. Alternatively, they may seek a settlement with the parties that might require divestiture of certain assets among other potential remedies. Depending on the remedy sought, a challenge by antitrust authorities to a pending transaction may significantly alter the economics and make the proposed transaction less valuable to the parties. See Hart-Scott-Rodino Antitrust Improvement Act of 1976, 15 U.S.C. § 18a (2006).

¹¹⁹See Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 872 (2010).

event outside of the control of either the buyer or the seller. In the event required governmental consents are not obtained, then parties typically permit a buyer or seller to terminate the transaction without penalty.¹²⁰

Consequently, the inclusion of a regulatory put in a merger agreement does not generate additional optionality for buyers (or sellers for that matter) when compared to the more typical regulatory closing condition. In fact, the value of the buyer's regulatory put—if measured as the difference between the strike price of the option and the cost of complying with regulatory authorities' demands—generates a negative value for the buyer when compared to the more typical closing condition alternative. Thus the regulatory put cannot be understood to be a symmetrical response to the seller's judicially mandated fiduciary termination right. Rather, when parties negotiate to include a reverse termination fee tied to a failure to receive regulatory approval, the regulatory put will play an efficiency enhancing role.

D. Buyer's Representation/Warranty Termination Right

Sometimes parties negotiate termination rights coupled with a reverse termination fee in the event that the buyer's representations and warranties are no longer true at the time of closing. The representation trigger and accompanying reverse fee appears in 11.7% of transactions that have reverse termination fees and in 1.65% of all transactions in this sample. In the data the representation triggers usually appear in one of three circumstances: first, when the consideration is composed of mostly stock and buyers have already negotiated a fiduciary termination right,¹²¹ and second, when financing is contingent and buyers have already negotiated a financing contingency. In both situations, the representation trigger provides an alternate route to terminate the transaction in the event that either the buyer's shareholders fail to approve the accompanying share issuance or the buyer is unable to secure financing.¹²² In neither of these cases does this trigger generate any additional optionality for the buyer.

¹²⁰For example, typical conditions to a merger in both buyer and seller friendly agreements include a regulatory approval condition. In the typical agreement, inability of the parties to receive antitrust or regulatory results in either party having an option to terminate the merger agreement. See Climian et al., *supra* note 18, at 276, 280.

¹²¹See Metal Management Inc., Current Report (Form 8-K), at Exhibit 2.1 (Sept. 24, 2007) (one of only four transactions that deployed the devices in these circumstances).

¹²²See Brocade Commc'ns Sys., *supra* note 61, at Exhibit 2.1 (one of only three transactions that deployed the devices in these circumstances).

The third circumstance in which this trigger sometimes appears in the data set is when there are no other termination triggers and the trigger acts, in effect, like a back-door fiduciary termination right or a back-door financing contingency.¹²³ Buyers will usually warrant that they have sufficient financing or that the buyer's shareholders will have approved the issuance of shares required to complete the transaction. In the event financing is not available at closing or that the buyer's shareholders have not approved the issuance of the buyer's shares, then these warranties will not be true as of closing.

Unlike other termination triggers, the right to terminate with respect to inaccuracies in the representations and warranties lies with the *seller*, as is the case with financing contingencies and the buyer's fiduciary termination right. Consequently, the representation and warranty trigger does not generate additional optionality for buyers and is thus not considered a symmetrical response to the seller's fiduciary termination right.

E. *Buyer's Option to Close*

The final termination trigger mimics most directly a development from private equity. In the buyer's option to close, a termination may be triggered by the seller in the event that the buyer fails to close the transaction notwithstanding the fact that all conditions to closing have been met by the seller.¹²⁴ This right is accompanied by a reverse termination fee¹²⁵ and a

¹²³See Digene Corp., Current Report (Form 8-K), at Exhibit 2.1 (June 4, 2007) (one of only four transactions that deployed the devices in these circumstances).

¹²⁴See JDA Software Group Inc., Additional Definitive Proxy Soliciting Materials (Form DEF A 14A), at Exhibit 10.1 (Aug. 11, 2008).

7.1(d)(iii) if the Effective Time shall not have occurred on or before the date required pursuant to Section 1.2 due to Parent's or Merger Sub's failure to effect the Closing in breach of this Agreement, and at the time of such termination (treating such date of termination as if it were the Closing Date) the conditions set forth in Sections 6.1 and 6.2 (other than the delivery by the Company of the officer's certificate contemplated by Section 6.2(c)) have been satisfied or waived.

Id.

¹²⁵ See *id.*

7.3(b) In the event that this Agreement is terminated by the Company pursuant to Section 7.1(d)(i) or 7.1(d)(iii), or by Parent or the Company pursuant to Section 7.1(b)(i) at a time when the Agreement could have been terminated by the Company pursuant to Section 7.1(d)(iii) then Parent shall pay to the Company a termination fee of \$20,000,000 in cash (the "*Parent Termination Fee*"), it being understood that in no event shall Parent to be required to pay the Parent Termination Fee on more than one (1) occasion. If the Parent Termination Fee becomes payable pursuant to this Section 7.3(b), it shall be paid no later than three (3) Business Days after the termination of this Agreement pursuant to Section

limitation on the ability of the seller to seek equitable remedies in court (i.e. specific performance).¹²⁶ This series of rights effectively generates an option for the buyer to not close for almost any reason.¹²⁷

While the trigger in this case leaves the right to terminate the transaction with the seller, the lack of access to a specific performance remedy, coupled with a cap on monetary damages, effectively shifts the right to exercise this option to the buyer. In order for the buyer to trigger this option, the buyer can simply refuse to close the transaction.¹²⁸ The seller, having already given up the ability to seek equitable remedies like specific performance, is left with the choice to either not close and not seek damages or to invoke the seller's termination right and seek liquidated damages in the

7.1(d)(i) or Section 7.1(d)(iii).

Id.

¹²⁶*See id.*

Section 7.3 (e) Notwithstanding anything herein to the contrary, (i) the maximum aggregate liability of Parent and Merger Sub for all Company Damages (inclusive of the Parent Termination Fee), shall be limited to an amount equal to the Parent Termination Fee plus any amounts that become due under Section 7.3(c) (the "*Parent Liability Limitation*"), and in no event shall the Company or any of its Affiliates seek (x) any Company Damage in excess of such amount, (y) any Company Damages in any amount if the Parent Termination Fee has been paid or (z) any other recovery, judgment, or damages of any kind, including equitable relief or consequential, indirect, or punitive damages, against Parent and Merger Sub or any other Parent Related Parties in connection with this Agreement or the Transactions and (ii) the Company acknowledges and agrees that it has no right of recovery against, and no personal liability shall attach to, in each case with respect to Company Damages, any of the Parent Related Parties, through Parent or otherwise, whether by or through attempted piercing of the corporate veil, by or through a claim by or on behalf of Parent against or any other Parent Related Party, by the enforcement of any assessment or by any legal or equitable proceeding, by virtue of any statute, regulation or applicable Law, or otherwise, except for its rights to recover the Parent Termination Fee or Company Damages subject to the Parent Liability Limitation, from Parent (but not any other Parent Related Party), in each case, subject to the Parent Liability Limitation and the other limitations described therein and herein. Subject to the limitations contained herein, recourse against Parent hereunder shall be the sole and exclusive remedy of the Company and its Affiliates against any other Parent Related Party in respect of any liabilities or obligations arising under, or in connection with, this Agreement or the Transactions.

Section 8.8 *Specific Performance*: . . . The parties further acknowledge that the Company shall not be entitled to an injunction or injunctions to prevent breaches of this Agreement by Parent or Merger Sub or to enforce specifically the terms and provisions of this Agreement and that the Company's sole and exclusive remedy with respect to any such breach shall be the remedy available to the Company set forth in Section 7.3.

Id.

¹²⁷*See Afsharipour, supra* note 8, at 38 (making a similar observation).

¹²⁸*See Choi & Triantis, supra* note, at 119, 872–73.

form of the reverse termination fee.¹²⁹ Although, as drafted, the termination right sits with the seller, the remedies create an effective option for the buyer.

Although this extreme form of optionality has attracted much of the popular and academic attention with respect to the use of reverse termination fees in the private equity context, it nevertheless represents only a very small percentage of reverse termination triggers in the transactions of the sample of strategic buyers (0.75%). The buyer's option to close is also a recent development. For example, for the period from 2003-2004, there were no transactions where strategic buyers included the equivalent of a buyer's option in the sample. For the period from 2007-2008, when this option appeared more often, it only appeared in 1.26% of transactions in the sample. Because the structure of this option permits the buyer to effectively terminate the transaction for any reason, and not just a foreseeable exogenous event that negatively effects the value of the initial transaction, this trigger is not symmetrical to the seller's fiduciary termination right.¹³⁰ Indeed, this right is over-inclusive, in that it provides buyers with the ability to terminate the merger agreement for any reason, therefore shifting all risk both exogenous and endogenous occurrences—foreseen and unforeseen—on the seller.

VI. REVERSE TERMINATION FEES AND INEFFICIENT TERMS

Although reverse termination fees and their accompanying triggers do not appear to be symmetrical responses to the imposition of a judicially-mandated seller's fiduciary termination right, they may nevertheless be efficient transaction terms. Transaction terms are efficiency enhancing when they cause the party best able to bear the cost of an adverse risk to bear that cost.¹³¹ Efficiency-reducing terms are those terms that place burdens on parties less capable of bearing them.¹³² To the extent reverse termination fees are privately negotiated, not subject to any structural inefficiency, and thus presumably a reflection of an efficient bargaining process, they are unobjectionable. In the absence of structural inefficiencies, parties are in the best position to estimate reasonable damages and determine as between the

¹²⁹See Afsharipour, *supra* note 8, at 32 and Davidoff, *supra* note 2, at 505, 515–517 (discussing the interplay between the reverse termination fee and specific performance).

¹³⁰See Choi & Triantis, *supra* note 119, at 872–73.

¹³¹See generally Gilson & Schwartz, *supra* note 3, at 345–47 (discussing whether buyer or seller is the more efficient risk bearer).

¹³²See *id.*

buyer and the seller which should bear the cost of a termination pursuant to one of the negotiated triggers. The size of the fee in those circumstances should also represent a reasonable approximation of an efficient strike price for the additional optionality that the termination trigger provides.

While some reverse termination fees (for example, the fee associated with the regulatory trigger) are efficiency-enhancing, there are at least two reasons to believe that some reverse termination fees may be inefficient terms. First, only seller's termination fees should be judicially constrained in terms of their size.¹³³ Unduly constraining seller's termination fee may risk an efficiency reducing result, causing an innocent buyer to bear a disproportionate cost of a seller's termination in the event that the seller terminates the present transaction to pursue a superior offer. The potential negative is offset by fiduciary considerations, which we deem to be sufficiently important.

Where buyers are using cash or a typical triangular merger structure, buyer's shareholders typically have no statutory right to vote, resulting in no possibility of coercion of the buyer's shareholders.¹³⁴ Thus, the fiduciary concerns that cause us to limit the upper range of termination fees are not present with respect to buyer's shareholders in most cases. The only consideration should be whether the reverse termination fee is a reasonable estimate of the damages. Fiduciary considerations should not play a role in the negotiation of the reverse fee's size when cash is the currency of the acquisition.

On the other hand, where stock is the currency for accomplishing the acquisition, buyers may be required to vote to approve the issuance of the shares. In such circumstances, buyers often employ a fiduciary termination trigger for the reverse fee. The presence of this trigger and a shareholder vote may raise concerns over the potential for shareholder coercion. Such concerns may be misplaced because the buyer's fiduciary trigger present in most agreements is tied to an acquisition of the buyer by a third party. In such cases, the initial transaction and the subsequent transaction are not mutually exclusive.¹³⁵ As a consequence, shareholders should be able to vote in favor of the issuance of stock with respect to the initial transaction as well as a merger in the subsequent transaction without fear of coercion. This is a

¹³³ See *supra* Part III.

¹³⁴ See GILSON & BLACK, *supra* note 96 (discussing triangular merger structure in general).

¹³⁵ Although a third party may condition its bid for the initial acquirer on a termination of the initial transaction, in these cases the initial transaction rarely precludes the second bidder from acquiring the buyer. In *Paramount Commc'n Inc. v. Time Inc.*, 571 A.2d 1140, 1151 (Del. 1989), the court alludes to this possibility when assessing the structural defenses erected by Time.

marked difference from the situation when one considers a termination fee. In that case, the transactions in question are mutually exclusive. Consequently, fiduciary considerations should not play a role when parties are negotiating the size of reverse fees when stock is the currency of the acquisition.

Second, when parties negotiate the size of a reverse termination fee, in a majority of cases of the sample (69.8%), parties agree to set reverse termination fees equal to the seller's termination fees that are paid by sellers. Perceptions of fairness during negotiations play an important role in reaching a consistent outcome in which termination fees and reverse termination fee mimic each other in size. It is, however, a mistake to assume that fairness dictates a reasonable estimate of damages upon termination be the same for both buyers and sellers. It is more reasonable to assume that the damages incurred by a seller following a termination pursuant to one of the reverse triggers is higher than the damages borne by a buyer in the event a seller terminates a transaction to pursue a higher, second bid. In the event the buyer terminates a transaction, this may result in the seller being viewed as "damaged goods" in the market place.¹³⁶ On the other hand, when the seller invokes its fiduciary termination right to pursue a higher, second bid, no such signal is sent.¹³⁷ Consequently, reverse termination fees limited to approximately the size of termination fees may be too low and thus be inefficient terms.

Such inefficiency appears to be the case where buyers include fiduciary termination rights in merger agreements. In 95% of these cases, the reverse fee is equal to the seller's termination fee in size. Buyers and sellers appear to accept the seller's fee as the default rather than negotiating a reasonable estimate of damages in the event of a buyer's termination. Consequently, the buyer's fiduciary termination trigger appears to be an inefficient term.

In most of the cases where parties diverge from the default position of setting the reverse termination fee equal in size to the termination fee, parties may actually be approximating an efficient term. In 74% of the transactions in the sample where the size of the reverse fees differs, reverse termination fees tend to be systematically larger than the termination fees. In particular, the asymmetry of fee sizes is concentrated in two groups. First, in

¹³⁶The "damaged goods" argument suggests the market will interpret a termination by the buyer as suggesting that the buyer learned something negative about the seller that made the seller less valuable to the buyer and thus not worth pursuing. See Climan et al., *supra* note 18, at 232.

¹³⁷Indeed, there is a strong argument to be made that a prudent buyer, having already made its best bid, should not chase a target with a higher bid and thus risk overpaying.

transactions that employ a regulatory trigger for the reverse termination fee, the reverse termination fee tends to be larger than the seller's termination fee. This accounts for 60% of the cases in which reverse termination fees are larger than termination fees. With respect to transactions that employ reverse termination fees, more than half (55%) have reverse fees that are larger than the seller's termination fees.

Typically, failure of the anti-trust/regulatory condition in a merger agreement would result in termination of the agreement with both sides bearing their own costs and not seeking damages as regulatory approval is a condition to closing. The inclusion of a regulatory trigger does not provide either side with additional optionality. Rather, the reverse termination fee with a regulatory trigger at least provides parties an opportunity to assign costs to the party best able to bear them. The evidence of larger reverse termination fees in certain circumstances suggests that where parties anticipate the transaction may be sensitive from a regulatory or antitrust perspective, they include regulatory termination triggers and actively negotiate a reasonable estimate of damages; rather than simply accept the default position, leaving the reverse termination fee equal to the termination fee in size. These fees are thus likely to be an efficient term.

The second group of transactions employing reverse termination fees likely to be efficiency-enhancing are where the buyer is able to negotiate the most extreme form of optionality—the buyer's option to close. With respect to transactions that employ the buyer's option to close, two-thirds of them in the sample have reverse termination fees that are larger than the seller's termination fees. Although the number of transactions employing the buyer's option is extremely small, it appears that when parties negotiate to provide buyers with this extreme form of optionality they diverge from customary practice and buyers, in fact, pay for the additional optionality. In most of these cases, the size of the reverse termination fees exceeded the termination by approximately 50%. However, in one case, the reverse termination fee was equal to 15.96% of the transaction value (15.78% of enterprise value), approximately 750% of the size of the termination fee.¹³⁸ Where parties are negotiating reverse termination fees of that magnitude, they are likely distributing costs to the buyer in an efficiency-enhancing manner.

¹³⁸See Seagate Tech. New, Current Report (Form 8-K), at Exhibit 99.1 (Dec. 21, 2005) (outlining the costs associated with Seagate's acquisition of Maxtor).

VII. CONCLUSION

Gilson and Schwartz analyzed the role of the MAC clause and postulated that the rising relative importance of the provision merger agreements might be a response to a judicial requirement for a seller's fiduciary put. Although Gilson and Schwartz concluded that the MAC clause does not represent a symmetrical response to the seller's fiduciary put, it is nevertheless an efficient term in a merger agreement. This article tested the proposition that the growing use of reverse termination fees in strategic transactions may produce a response to the mandated seller's put and that such fees, and the attendant triggers, generate symmetrical optionality for buyers. I find that reverse termination fees are not symmetrical responses to the judicially mandated fiduciary termination right. In some cases, the triggers associated with these fees generate additional optionality for buyers, though this additional optionality is not necessarily in response to foreseeable exogenous events. In other cases, these fees generate no additional optionality at all but simply assign costs to states that are typically conditions to closing.

Notwithstanding the fact that reverse termination fees and their triggers do not appear to be symmetrical responses, like MAC's, they may be efficiency enhancing. Given the diversity of triggers and the varying sizes of reverse termination fees, it is not possible to conclude that all reverse termination fees and their triggers are uniformly inefficient terms. To the extent the reverse termination fee acts to assign the costs associated with exogenous risks to the party in a better position to bear them (e.g. the buyer), such fees are efficiency enhancing. However, to the extent reverse termination fees mimic the termination fee in size, they tend to underestimate true actual costs to sellers of a buyer's termination. This is because their size is usually tied to the termination fee, and the termination fee's size is constrained by a balancing of fiduciary interests generally not applicable to buyers. Where reverse termination fees are tied to termination fees in size, they may result in less than optimal terms. This suggests that parties and courts should be willing to accept larger reverse termination fees than is currently the practice.