A FRESH LOOK AT DEAL PROTECTION DEVICES:
OUT FROM THE SHADOW
OF THE OMNIPRESENT SPECTER

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ABSTRACT

Determining the appropriate standard of review to apply to the utilization of deal protection devices has long been a subject of debate among academics, practitioners, and jurists. This is so because deal protection devices continually evolve. Consequently, it is nearly impossible to develop a "one size fits all" standard of review. This article analyzes the existing standards of review and demonstrates that no single approach is capable of serving as an ideal standard for the various different circumstances under which deal protection measures arise.

By revealing the shortcomings of each approach, this analysis reveals the desirable characteristics that a beneficial and effective standard of review must possess. This article proposes a model standard of review consisting of a series of inquiries for the court to perform that encompasses all of these characteristics. This standard of review promises to retain all the benefits of the current approaches while abandoning most of their shortcomings. This model is applied to a hypothetical that exemplifies how it functions in practice. Despite some minor shortcomings, this series of inquiries meets the needs of the court and boards of directors alike, while also protecting the interests of shareholders.

Much has been written in the last few years about the subject of so-called "deal protection devices." Articles have described the emerging law in this area, suggested new approaches to reconcile the sometimes conflicting analyses that have emerged and recommended entirely new approaches to the subject. This article will take a fresh look at "deal protection devices" and propose an optimal standard of review.

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Obviously, we are not writing on a blank slate. The Delaware Court of Chancery has struggled with the subject over the years. In late 1999, the court of chancery issued a trio of interesting decisions\(^2\) that some have argued were internally inconsistent in several important respects.\(^3\) To date, the Delaware Supreme Court has touched, but not yet definitively addressed the subject.\(^4\)

The pages that follow will briefly review the types of "deal protection devices" that have emerged in the last decade, describe several suggested approaches to developing a standard of review of deal protection devices and set forth our view of an approach that could be utilized in the future.

I. DEAL PROTECTION DEVICES

There is no definitive catalog of "deal protection devices" that has been or could be compiled, because the term describes a class of devices that is fluid, adaptable and bounded only by the imagination of counsel. Several devices, such as termination fees, "no-shop" provisions and stock options have emerged as standard in merger agreements, whereas other, more exotic deal protection devices have been deployed with varying degrees of success over time.\(^5\)

The first challenge, therefore, in describing an "optimal" standard of review for such a broad and fluid category of potential devices, some of which have vastly more profound effects on economic activity than others, is to postulate a principle that is broad and flexible enough to encompass a series of devices, which itself is so broad as to escape the boundaries of a precise definition. Because the law evolves only as specific facts are

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\(^3\)See, e.g., Mark A. Morton et al., What is the Appropriate Standard of Review for Deal Protection Measures?, 8 CORP. GOVERNANCE ADVISOR, 13 (July/Aug. 2000). Note, however, that the Honorable Myron T. Steele, the author of In re IXC Communications, discussed the subject at the 2001 Tulane Corporate Law Institute and suggested that the differences in the approach to the cases may best be reconciled not so much on doctrinal grounds as on a review of the specific facts of each case, including a careful review of the process followed by the board in each of the cases (unpublished remarks of the Honorable Myron T. Steele, Mar. 2, 2001).


\(^5\)Other exotic devices include asset options, payment of fees to banking institutions to secure their agreement not to lend to competing deals (so called "dry up" fees), and various types of rights plans that are redeemable only with the passage of time, whether or not the stockholders of the target company accepted the deal proposed, or expressed a preference for some other.
presented to courts, the jurists who have faced the challenge of determining how best to deal with this broad and changing catalog of devices have rarely enjoyed the luxury of describing a principle or series of principles that could or should apply broadly to all potential "deal protection devices." Instead jurists have dealt with each case as it was presented, which perhaps explains at least some of the divergence in the approaches that have evolved over time.

For purposes of this article, we will broadly define "deal protection devices" as any contractual provision the effect of which is to make a favored transaction more likely of consummation and less able to be assailed by an interloper. Note that our definition does not contemplate that the "deal protection device" is necessarily found in the merger agreement between the parties, but instead in any contract that is entered into with the purpose or intent of "protecting" the transaction itself.

II. A SHORT CATALOG OF APPROACHES TO JUDICIAL REVIEW OF DEAL PROTECTION DEVICES

Over time, several approaches have emerged to develop a meaningful standard of review for deal protection devices, both from courts and commentators.

A. "Business Judgment" Review

The first of these approaches is the so called "business judgment" standard of review. This approach does not appear to be the prevailing approach in the case law. Although perhaps no subject in the corporation law has been written about more than the "business judgment rule," the standard basically reflects a recognition that judges (and others involved in the corporate governance process) are typically not trained as business persons. Consequently, a system that encourages risk taking and entrepreneurial activity must give some degree of deference to business persons and avoid second guessing of routine business decisions by those who may not have the skill set necessary to make informed judgments about such decisions, i.e., disgruntled shareholders, plaintiffs' lawyers and the judiciary as an institution. When deployed as a standard of review, the business judgment rule instructs jurists to presume that the directorial

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*It is worth noting, of course, that some of our jurists do indeed have training in business and economics. For example, former Chancellor William T. Allen is now a professor of law and economics at a highly regarded university. The authors' description of the so called business judgment rule is not intended to express any lack of respect for the talented men and women of the judiciary.*
conduct under review was the product of good faith, due care and a scrupulous adherence to the best interests of the stockholders.

Cases that have utilized the business judgment standard of review to analyze deal protection measures have done so on the reasoning that the deal protection measures in a contract are merely part of a much larger series of provisions in a transaction which are the result of an often intricate and complex negotiation. Accordingly, to dilate upon only the deal protection provisions of a contract without understanding what the negotiator for the target company may have secured in exchange for such provisions necessarily sees only a part of the picture. For example, one could postulate a case where a negotiator secured a very clear (and favorable) definition of "material adverse change" (MAC) in the contract in exchange for a somewhat higher break-up fee or modestly more aggressive package of deal protections. Of course, the trade could be far more complex, since representations, warranties and closing conditions are often negotiated in detail in a merger agreement. Since the court, as a practical matter, lacks the opportunity to review in each instance the entirety of the negotiating history of each transaction it is asked to assess in a preliminary injunction proceeding, focusing on only one provision or series of provisions in a given agreement is artificial and likely to be unfair to the negotiator's complex task which is to achieve a favorable overall result.

In our view, irrespective of whether business judgment review is optimal for deal protection measures, this argument in favor of its application is sound. To make a fetish of deal protection devices without consideration of other, often more highly negotiated and practically important provisions implicitly assumes that the other terms and conditions of the contract are not meaningful to shareholders or, at least, not as meaningful. Persons experienced in negotiating such contracts would disagree. For example, in an economy buffeted by wild swings in securities valuations, the precise language of a material adverse change provision may actually be far more important to shareholders than the wording of a "no-shop" clause or a break-up fee.

One need not dig deeply into the archives to prove this point. In late 2000, Verizon's merger with NorthPoint ended abruptly when Verizon walked away from the transaction, asserting that a material adverse change had occurred, which resulted in litigation in Delaware and California and in NorthPoint filing for bankruptcy. Even more recently, the IBP/Tyson merger broke apart allegedly over a material adverse change, resulting in litigation that eventually led to a court-ordered merger.\footnote{See In re IBP, Inc. Sh'holders Litig., No. 18373, 2001 Del. Ch. LEXIS 81 (Del. Ch. June 15, 2001).} A host of other non-
litigated divorces have occurred as a result of the market and spending collapse in the high tech industry in the first quarter of 2001, including the Ariba-Agile, Proxim-Netopia, and Palm-Extended Systems transactions, all of which terminated without litigation or payment by either side.

B. Proportionality Review

A second approach to the subject, that appears to be the current prevailing standard of review for deal protection devices in Delaware, is "proportionality review." The concept of proportionality review, widely credited to a 1985 decision of the Delaware Supreme Court,\(^8\) actually has its roots in earlier Delaware jurisprudence in Cheff v. Mathes.\(^9\) The principle announced in Cheff and later expanded in Unocal and its progeny is an acknowledgment of human frailty and a reflection of judicial distrust of directorial decisions made in the context where a director could be influenced by a desire to maintain his or her position and the emoluments of directorial office, even absent direct, personal financial interest of a more easily quantified type. This standard of review does not automatically presume that the challenged conduct was in good faith and taken upon full information. Rather, it places upon the director the burden of demonstrating that the challenged conduct was taken in response to a threat to corporate policy and effectiveness, and the challenged conduct was proportional to that threat.\(^10\)

While proportionality review has correctly been lauded as a flexible and useful form of judicial review of directorial conduct, proponents of this standard of review have little response to the reasoning articulated by the proponents of the first or "pure" business judgment approach. For example, applying proportionality review to parts of a complex whole ignores the reality of the negotiation process inherent in every transaction.

Moreover, outside the context of a direct threat to corporate policy and effectiveness (i.e., the contracting parties locked up the deal to fend off unwanted party "X"), proportionality review becomes difficult to apply. For example, assume that a deal was locked up at the acquirer's request in exchange for a price collar, MAC concession, or other important deal points. In such a case, there is no "threat" to which the deal protection devices are

\(^8\) Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
\(^9\) 199 A.2d 584 (Del. 1964).
\(^10\) To be complete in a description of proportionality review, one would also describe the supreme court's decision in Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995), and its gloss on the Cheff/Unocal cases. Unitrin focuses upon the prong of proportionality review which addresses the reasonableness of the directors' action, and concludes that the action taken can not be "coercive" or "preclusive" in nature.
directly responsive. Instead, the "threat" is one of adverse market movements, or deterioration in a merger partner's business prospects. Indeed, these are "threats" that are not addressed by the deal protection provisions in the contract, but instead by completely different provisions. In the hypothetical where deal protection provisions were traded off for representations, warranties or closing conditions, the jurist must be able to apply the proportionality analysis beyond the narrow focus on the deal protection provisions of the contract. In this context, however, the analysis probably makes the least sense, since it was designed as a check on subtle varieties of self interest, which are recognized as present in the takeover context.

C. An Informational and Market Based Approach

Other courts and commentators have suggested that one way to review deal protection devices is to seek to determine whether the devices tend to limit the ability of the board to become fully informed about the decisions directors are called upon to make. This approach tends to frown upon deal protection devices to the extent that they limit or eliminate the ability of directors to learn about whether the proposed transaction is likely to maximize corporate welfare. Thus, under this approach, a transaction that contained a "no-shop" provision without a fiduciary "out" would be subject to criticism, because it would tend to preclude the board from gathering information about an unsolicited proposal to allow it to determine whether the favored transaction continued to be worthy of its support and recommendation to the shareholders. This approach is difficult to apply to all types of deal protection devices, and was likely never intended as an approach with which to analyze all such devices.

D. Process Centric Review

The authors have previously suggested that a useful approach to review of deal protection measures would involve an examination of the process employed by the board in attempting to become informed prior to agreeing to the transaction, and the further ability of the board to continue to become informed as the transaction progressed. This approach is a "first cousin" to the one described above, but one that proposes a greater focus on the steps taken by the board which led up to the decision to endorse a particular transaction. While this approach is consistent with the deference typically afforded to substantive decisions made by disinterested directors,

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11Varallo & Raju, supra note 1.
it arguably could be more difficult to reconcile (in all cases) with the statutory role afforded to stockholders in connection with mergers and other organic changes involving a corporation.

E. The Franchise Primacy Model

Another approach that has recently been examined focuses on the extent that deal protection devices impact upon the shareholders' ability to vote for or against a transaction. Under this approach, the court would, at least within a range of reasonableness, examine primarily whether any part of the contracts at issue tended to deprive shareholders of the free exercise of their franchise, either because such contracts were preclusive or coercive of a free vote. Thus, a break-up fee would be analyzed in part to determine whether it would be likely to deter a second, uninvited bidder, thus impacting information flow and potentially economic return. More importantly, this analysis would also determine whether the break up fee was triggered in such a way as to coerce stockholders to vote for, rather than against, a transaction. For example, a break-up fee payable on a so called "naked no vote," i.e., triggered solely in the event that shareholders were to vote against a transaction (regardless of the presence or absence of a competing proposal, or later consummation of such a proposal) would be struck down under this approach as directly coercive of shareholder choice in the merger.

This approach blunts the criticisms argued in favor of the "business judgment" approach. By focusing on possible effects on the franchise, it moves away from a narrow focus on particular provisions of a contract. On the other hand, in its "pure" form, the approach is troublesome in that it would appear to place less emphasis on the ability of directors to constantly gather information and monitor a transaction as it evolves and is exposed to the marketplace. Taken to its extreme, if a reviewing court were to focus solely upon the effect of deal protection measures upon the shareholder franchise, one could make a respectable argument that transactions could include a "no out" no-shop provision for some reasonable length of time necessary to prepare the proxy statement and present the transaction to shareholders.

In his thought provoking paper delivered to the NYU Seminar in Corporate and Business Law in January 2001, The Honorable Leo E. Strine, Jr., while advocating this approach as an appropriate standard to be applied to the review of stock for stock merger agreements, also noted the possibility that a provision that entirely disabled the target board of directors

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12 Strine, supra note 1.
from acting for some period of time could well run afoul of the Delaware Supreme Court's decision in *Quickturn Design Systems, Inc. v. Shapiro.* Thus, while the approach is both interesting and potentially useful, it can not stand alone as a standard of review. Indeed, one could argue that focusing greater attention on stockholder choice leads to an entirely new set of dilemmas as the courts are forced to explore the degree to which deal protection devices are, or are not, coercive of stockholder choice and the degree of coercion which will justify intervention in given circumstances.

III. A SUGGESTED APPROACH TO ANALYZING DEAL PROTECTION DEVICES

If anything is clear from the foregoing, it is that each of the approaches that have been debated so far have both laudable and problematic aspects. In addition, no single approach appears to be optimal in and of itself. Each implicitly contemplates that the historically flexible notions of equitable jurisprudence will be available as a "backstop" to deal with the unanticipated case or the one which does not "fit" into the standard of review which has been developed.

A. What Characteristics Should the "Optimal" Standard Have?

For purposes of describing an "optimal" standard of review, therefore, we begin by rejecting each of the approaches cataloged above as sub-optimal for the reasons described. What, then are the principles that should guide the development of an "optimal" standard of review?

Surely, all would agree that there is great value in a standard that yields a predictable outcome when applied. The benefits of predictability and certainty in corporate transactions are too widely noted to be the subject of serious discussion. A corollary to this principle is that the standard should not, in and of itself, have a negative impact on economic activity, and should encourage, rather than discourage the role of entrepreneurship and risk taking.

From the point of view of those who must apply such a standard, an "optimal" standard is likely to be one that is not rigid, but flexible in application, and does not require the jurist to "stretch" uncomfortably to fit a new and unanticipated set of facts under its rubric. Thus, focusing solely on a "threat to corporate policy and effectiveness," however useful in the context of unwanted takeover activity, is not the sort of standard that is flexible enough to be applied cleanly both in and outside of the takeover context. Notwithstanding that, this is exactly what the court of chancery is

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called upon to do when reviewing any "defensive" device. Likewise, an optimal standard would be one that does not require the jurist to have special training in economics, or disciplines other than law.

Finally, an optimal standard of review would also recognize the importance of the shareholders' franchise in the statutory merger context, and take account of the statutory role played by shareholders when considering the degree of discretion to be afforded to directors. Of course, any such standard would also give due deference to the "bedrock" principle of Delaware law that directors, not shareholders, manage the business and affairs of Delaware corporations, but would balance that principle with the statutorily assigned role of shareholders in the system.

There are, undoubtedly, any number of other important principles that should be considered in developing an "optimal" standard of review. For purposes of brevity, however, this optimal standard is primarily based on the foregoing principles.

B. A New Paradigm For Review of Deal Protection Measures

In our view, describing a new paradigm for review of deal protection measures need not begin and end with a carefully worded test to be applied in each case. It is, perhaps, a shortcoming of lawyers and judges that we tend to attempt to reduce very complex concepts to a phrase or series of word equations, which uniformly fail to capture the endless mutations of the very conduct that we are aiming to review. Take, for example, the Cheff-Unocal-Unitrin paradigm. Defensive measures are to be approved by the trial court if: (1) directors carry a burden of showing a reasonably perceived threat to corporate policy and effectiveness; (2) the response to that threat is not "draconian," i.e. preclusive or coercive; and (3) otherwise reasonable in relation to the threat posed. While the case law test has been lauded as flexible in application, as stated it evokes visions of flow charts and a series of binary "if-then" propositions.

Instead, we chose to describe our "optimal" standard of review as a series of inquiries for the court to perform which are as far removed from the talismanic as possible. In our "optimal" standard of review, a court would analyze deal protection measures by considering the following questions.

First, what is the specific measure designed to protect against, and how does it relate to the rest of the agreement or agreements?

Second, what, if anything, did the board get in exchange for agreeing to this provision or package of provisions and what process did it follow in agreeing to the subject transaction?

Third, what is the effect of the provision on the ability of the board to continue to gather information about the underlying transaction up until the shareholders are asked to vote on it?
Fourth, what is the effect of the provision on the ability of the board to provide its frank and current assessment of the transaction to shareholders when they are called upon to vote for or against it?

Finally, are the shareholders able to enjoy a meaningful and informed exercise of their franchise without penalty or coercion implicit in their vote (in a transaction in which the statute provides for a shareholder vote)?

Where the board could show that: (1) in approving a particular measure it was attempting to address a corporate, as opposed to personal, interest; (2) it followed a deliberate process; (3) the substance of the measure itself did not preclude the emergence of competing offers or the ability of the board to understand such offers; (4) the board was at all times free to provide its then current assessment of the transaction to shareholders; and (5) the shareholder vote was not coerced in any way, a provision (or package of provisions) would survive scrutiny. In the event that the board was unable to carry its burden under this approach, the challenged provisions would not automatically be stricken. Rather, as under current law, the challenged provisions would be subject to validation if the board was able to demonstrate that they were "entirely fair" to shareholders.14

Note that the suggested inquiry does not focus on the specific terms of the proposed deal protection device. Instead, it focuses primarily on the device's effect on the board's ability to be informed and to inform shareholders of its best current judgment, and ultimately obtain an uncoerced and meaningful shareholder vote.

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14In his recent speech at New York University, Vice Chancellor Strine suggested that the court should consider the possibility of "paring back" excessive deal protection devices rather than invalidating them. Strine, supra note 1, at 941 n.71. While this is an interesting idea, we respectfully suggest that this approach would not be optimal for at least two reasons. First, this approach would place the court in precisely the role played by the negotiators of the contract. Without understanding all of the negotiation history, wielding the "blue pencil" may result in an outcome that upsets a carefully balanced negotiation. With all due respect to our courts, it is also fair to ask if this is a judgment that we believe our courts (or those jurists less familiar with business and economics sitting in other states) are institutionally equipped to make. Our approach would not provide for the court to wield a "blue pencil" but would instead call for invalidation of the offending provision unless the board could demonstrate its entire fairness. Second, adopting a "blue pencil" approach arguably would create a significant disincentive for prospective acquirers to ensure that the deal protection measures they seek are reasonable. Under the present approach taken by courts, there is arguably an incentive for a potential acquirer to seek only reasonable deal protection measures because if excessive deal protection measures are sought and subsequently struck down, the acquirer is left with no protection at all. On the other hand, under a "blue pencil" approach, there is no incentive for an acquirer to moderate its demands for excessive deal protection measures because even if such measures are found to be excessive, a court will merely reduce the impact of such measures to a reasonable amount. By removing any downside to acquirers who insist on excessive deal protection measures, a "blue pencil" approach would tilt the negotiations with respect to deal protection measures decidedly in favor of acquirers.
Under this approach, a court would be free to consider the inter-
relationship of various provisions in the parties' agreements and how they
evolved through negotiation. Likewise, the board would be able to trade off
a more robust package of deal protections for concessions in other areas of
the agreement it deemed to be important and in the best interests of
shareholders. The constraint on this ability of the board to grant more robust
deal protections would be the predicted or likely effect on the emergence of
unsolicited third party proposals. Rather than stop the analysis based upon
whether a particular break-up fee fell within a pre-determined range of
outcomes, (2-3.5% of equity, for example), the board would instead be free
to take advice from its financial advisor in a transaction that a particular fee
would, or would not, tend materially to impede the development of
competing proposals. Thus, were a competent financial advisor to advise
the board that, given the size of the transaction, the nature of the industry
and the likely other bidders, a break-up fee of 6% would not, in all
likelihood, materially impede a competing bid, a reviewing court would
approve the 6% fee, regardless of the "range" of break-up fees which has
emerged in the case law. Likewise, where a company and its likely buyers
were all extremely cash constrained, a reviewing court might take a closer
look at a transaction in which 2% of the equity value in the deal was pegged
as the break-up fee without any particular analysis of the impact of such a
fee simply because it had "always been done that way."

This approach would also condemn the broadly used "duty to
recommend" provision in a merger agreement, at least to the extent that it
did not include a broad "fiduciary out" provision. The development of
contractual provisions that purport to require the board to continue to
recommend a transaction, regardless of changed circumstances, is highly
questionable under current law. Specifically, the notion that the parties are
able to contract away the fiduciary obligations of the target board by defining
the circumstances in which the deal could be terminated, ignores the
universe of possible circumstances in which the directors, in good faith,
determine that, although there is no MAC as defined by the contract, they
can no longer recommend the transaction due to unanticipated changes in
factual circumstances. Our suggested approach would explicitly deal with
this by focusing on whether the board was at all times free to provide its best
current assessment of the transaction to the shareholders.

Finally, our approach would determine whether the shareholders' vote
was subject to penalty or coercion by the terms of the transaction. Thus, the
"naked no vote" that triggered a break-up fee would be subject to challenge
under this approach, as would any provision or combination of provisions
which tended to cause the stockholders to vote for or against a transaction
for reasons unrelated to the bona fides of that transaction.
C. A Test Fit

A fictional hypothetical based on recent economic events helps illustrate the flexibility inherent in our proposed approach. Assume that a target company agrees to enter into discussions for a potential stock for stock merger with a larger strategic partner. The buyer insists upon a forty-five day exclusivity period to perform due diligence and negotiate a definitive merger agreement. The target agrees, but is successful in carving back the exclusivity period to thirty days. The parties negotiate and agree to the following package of deal protection measures. First, there is a break-up fee of 4.2% of the equity value of the deal (both parties have sufficient cash to pay the fee if triggered). The fee is triggered if the target board changes its recommendation, or if a higher offer is made and the target stockholders vote against the transaction. Although the target board knows that 4.2% of equity value is high, it negotiated for and received in exchange a very narrow MAC clause, which was significant in light of the target's expectation that its soon to be announced quarterly results would be perceived in the market as highly negative. Second, buyer receives a 19.9% stock option in the target that is triggered when the break-up fee is triggered. The stock option is exercisable at below the current market price with a "put" feature capped at the amount of the break-up fee. The stock option is uncapped, however, in the event of a cash exercise and sale in the market. Third, there is a no-shop provision with a "standard" fiduciary out provision. Fourth, the target board is required to recommend the merger to shareholders. There is no separate fiduciary out on the duty to recommend, but the target can terminate the merger agreement in the event of a MAC in buyer. The buyer can ask the target board to renew its recommendation at any time. Failure by the target board to do so triggers payment of the break-up fee. Finally, the target agrees, pursuant to section 251(c) of the Delaware General Corporation Law\(^\text{15}\) that it will convene a meeting of target stockholders to vote on the deal whether or not the board withdraws its recommendation.

While the merger is being negotiated during the thirty day exclusivity period, two unsolicited offers are received by target. Target informs both potential bidders that it is not free to talk to either at that time. Neither bidder puts forward a firm offer for target.

In early January 2001, the target and buyer sign a merger agreement. Soon thereafter, the market for buyer's product is disrupted. By early March 2001, buyer's stock (which had been trading at a high multiple given buyer's

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\(^{15}\)Section 251(c) allows a company to agree that a proposed merger will be submitted to the stockholders for a vote at an annual or special meeting even if the board determines to withdraw its recommendation to stockholders. Del. Code Ann. tit. 8, § 251(c) (2000).
high growth rate) has fallen 80%. In addition, the target's stock also has decreased significantly due to the overall market downturn, and as a result, the break-up fee, which is expressed as an absolute dollar amount in the contract, has increased to more than 20% of target's equity value.

In light of these developments, subsequent to the execution of the merger agreement, the target board demands to renegotiate the economic terms of the merger. The target board is able to procure a revised exchange ratio that provides a value that is materially greater than the value that would have been obtained had the exchange ratio not been revised. In exchange for the material increase in the exchange ratio, buyer demands that both sides eliminate from the merger agreement all MAC clauses and all fiduciary outs. Target conditionally agrees, subject to target reconfirming with the two unsolicited bidders that emerged prior to the execution of the merger agreement that they are no longer interested in target. The two unsolicited bidders reconfirm that they are no longer interested in a transaction with the target. Mindful of the lack of interest from other third parties and the target's impending earnings announcement that is expected to disappoint the market, the target board agrees to accept buyer's demands and executes a revised merger agreement.

Under our proposed approach, the analysis would focus on the effects rather than the substantive terms of the deal protection measures at issue. In this hypothetical, the deal protection measures whose effects have to be analyzed are (1) a break-up fee (expressed as an absolute dollar amount) which constituted 4.2% of equity value when the deal was initially signed but now constitutes over 20% of target's equity value; (2) a stock option with a capped put feature but an uncapped market exercise feature; (3) a no-shop provision with no fiduciary out; (4) an obligation for the target board to recommend the merger with no fiduciary out; and (5) the absence of any MAC provisions permitting target to back out of the merger.

The first factor under our approach focuses on what the specific deal protection measures are designed to protect against and how these measures relate to the rest of the merger agreement. The break-up fee originally agreed to is arguably designed to compensate the buyer for lost opportunity cost if the deal is "broken." Viewed from this perspective, it "protects" not the deal, but the buyer. The option also has "protective" features, but in a post-pooling world that we assume here, it is less likely that the option can be viewed to protect the transaction as opposed to the buyer's economic

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16The discussion herein regarding an analysis under our proposed approach is not meant to be comprehensive, but rather merely highlights some of the major issues and considerations that would be present in a comprehensive analysis.

17Of course, a MAC provision is not a "deal protection" provision based on our proposed definition.
interest in that transaction. Thus, the first prong of our proposed test is roughly neutral in application to these two devices. The lack of fiduciary outs and lack of any MAC provisions combined with the no-shop provision and the obligation to recommend the merger, however, do present significant issues. Obviously, the purpose of these provisions was for both parties to obtain maximum certainty that the merger would be consummated. In terms of putting these provisions in the context of the merger agreement as a whole, the most significant fact seems to be that reassuring the merger will be consummated accrues to the benefit of the target and not only the buyer. Again, this factor would appear to be neutral with respect to these provisions.

The second factor under our approach assesses what the target was able to procure in exchange for the deal protection measures at issue. In our hypothetical, the target board procured at least two significant benefits. First, it obtained a significantly higher value from the revised exchange ratio. Second, it obtained greater certainty that the merger would be consummated. While the economic benefits of the increased exchange ratio are readily apparent, the benefits from the increased certainty that the merger will be consummated should not be overlooked. Given the target's impending earnings announcement that is expected to disappoint the market and the lack of other suitors interested in the target, the elimination of the buyer's right to walk away is a valuable benefit to target.

The third factor analyzes the effect of the deal protection measures on the ability of the target board to continue gathering information until the shareholders are asked to vote on the merger. By definition, a no shop clause without a "fiduciary out" has the effect of precluding the target board from either exploring conditions in an unsolicited offer or negotiating with an unsolicited bidder. The lack of a fiduciary out has a material and adverse effect on the ability of the board to be continuously fully informed about the transaction it is recommending. Likewise, the fact that a once potentially reasonable break-up fee (stated in the agreement as an absolute dollar amount) has now ballooned to facially unreasonable levels due to market movements in buyer's securities, strongly suggests that it is less likely that an interested uninvited bidder would make a proposal (thus further impacting information flow to the target board).

The fourth factor under our approach focuses on the effect of the deal protection measures on the ability of the target board to provide its frank and current assessment as to the attractiveness of the merger as of the time of the shareholder vote. Here, the merger agreement prohibits the target board from (1) changing its recommendation of the merger to the shareholders, (2) negotiating with other potential suitors, or (3) terminating the merger agreement. Moreover, these prohibitions are not limited by or subject to any fiduciary outs. Likewise, if the board is asked to update its recommendation
and fails to do so, a break-up fee is owed. Accordingly, no matter how unattractive the merger becomes as of the time of the shareholder vote, the target board is powerless under the terms of the merger agreement to take any action to further the interests of the stockholders. Rather, the only remaining protection that the target shareholders have under the merger agreement is the shareholder vote itself.

The final factor under our approach inquires whether shareholders are able to enjoy a meaningful and informed exercise of their franchise without penalty or coercion. In the present hypothetical, there is no direct penalty or coercion with respect to the shareholder vote. After all, neither the break-up fee nor the stock option are triggered merely by shareholder rejection of the merger. The primary limitation on the shareholders’ exercise of their franchise is that they will not have the benefit of an updated recommendation from the target board with respect to the merger. Of course, if, by chance, a higher offer was present at the time of the vote there would be a significant coercive effect.

Despite the significant overlap and inter-relatedness among the various factors in our approach, we believe that neither the first factor nor the second factor militates in favor of applying the entire fairness standard to any of the deal protection measures at issue in the present hypothetical. We base this conclusion on the facts that the board seemed to employ an adequate process throughout the negotiations and that the target board was able to procure significant benefits in exchange for the deal protection measures at issue. Unlike the first or second factors, we believe that the third and fourth factors militate in favor of subjecting certain deal protection measures to scrutiny under an entire fairness standard of review. We reach this conclusion because the target board, by contractually agreeing not to change its recommendation under any circumstances, arguably has subverted the statutory duty of the board to provide to shareholders a recommendation of the merger as of the time of the shareholder vote. We also find troubling the lack of any fiduciary out with respect to the no-shop provision. This is not to say that the no-shop provision or the provision prohibiting the target board from changing its recommendation is automatically invalid. Rather, the proponents of this provision will have to demonstrate that it was entirely fair to target shareholders, which certainly is possible (perhaps even likely) given the difficulties the target was facing and the additional benefits that were extracted in return.

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18 The only action that the target board could consider taking is to cause the target to breach the merger agreement if the board concludes that it would be constructive for the target to do so.
As is evident from this discussion, the outcome under our approach will not necessarily differ from the outcome reached under the established proportionality standard. Nor is it meant to. Indeed, there has been relatively little debate or disagreement as to the appropriate outcome, as opposed to the appropriate analysis, in the context of the recent Delaware cases addressing deal protection measures. Here, the lack of fiduciary outs ultimately will lead to both the no-shop provision and the obligation to recommend the merger becoming subject to the entire fairness analysis under either this argument's approach or a traditional proportionality review.

In short, in the context of this hypothetical, the suggested approach steadfastly protects the shareholder franchise and upholds the board's obligation to make an informed and up-to-date recommendation while simultaneously affording significant latitude to the target board to promote shareholders' overall economic interests in exchange for agreeing to deal protection measures.

D. Benefits of the Suggested Approach

The suggested approach meets the goal of creating a flexible standard from which the court can review transactions without attempting to fit each new permutation of deal protection device into a particular formula for review. Accordingly, it is not likely to have a negative impact on risk taking and economic activity as it tends to avoid enmeshing the court in making judgments directly about the provisions themselves, as opposed to the articulated reasons for and effects of the provisions. The approach would also lead to a high degree of predictability, because, in many ways, the board is in a position to create a record which provides a favorable outcome of any post hoc scrutiny of the deal protection measure — provided that it is not coercive of the shareholder vote and that it does not purport to limit the ability of the board to inform shareholders fully of its views on the proposed transaction. While the approach does not give the board the benefit of "presumptions," the burden it places on the board in litigation is not great, and it preserves the law's demonstrated respect for the shareholders' statutory franchise and the primacy of the board in corporate governance.

Finally, our suggested approach dispenses with the first prong currently mandated by Unocal. It recognizes that Unocal, which was a "takeover" case, is not endlessly elastic, and frees the board and the jurist from having to articulate a threat to "corporate policy and effectiveness" before acting. In doing so, our approach also unhitches the analysis of deal protection devices from the policy rationale underlying Unocal: the

\[\text{Footnote: 19 The first prong mandated has been identified as the "threat analysis."}\]
"omnipresent specter that a board may be acting primarily in its own interests." We submit that these are concepts that are of little utility in the analysis of a typical deal protection measure, which typically will not be adopted in response to a hostile takeover threat.

E. Shortcomings of the Approach

We recognize that the suggested approach is a departure from some of the certainty that has settled around certain deal protection devices, like break-up fees. No longer would a fee that was within a pre-determined range be beyond challenge in each case, and the role of the financial advisor in setting a fee would be far more important in each case. Of course, the extent of the negotiation of this particular provision will be likely to expand, as the parties' expert financial advisors debate how large or small a fee can or must be in the particular case.

The approach may also provide a greater degree of discretion to the jurist than the corporate law "tests" which have evolved since the mid-1980s. While this added discretion is arguably beneficial in the hands of a sophisticated judiciary like that found in Delaware, it may be sub-optimal in application by a less sophisticated judiciary.

IV. CONCLUSION

The issue of deal protection devices and the appropriate standard of review to be applied when they are challenged will undoubtedly continue to be the subject of debate and case law decision into the foreseeable future. An approach to a new standard of review that focuses primarily upon economic and policy goals and which abandons any one specific approach to the subject, is most likely to meet the requisites for an "optimal" standard of review. As with any attempt to synthesize and rethink an area of law, however, it has obvious shortcomings, as well as any number of inherent difficulties in application which we are not likely to have anticipated.

20 Unocal Corp., 493 A.2d at 954.