

## NORMALIZING MATCH RIGHTS

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Early in October of this year the Chancery Court handed down its opinion in *In re Cogent, Inc. Shareholder Litigation*.<sup>1</sup> In many respects, the ruling was pedestrian. Shareholders of Cogent, a Delaware corporation in the business of providing automated fingerprint identification systems, challenged management's decision to sell the corporation to the 3M Company for \$10.50/share in cash.<sup>2</sup> The essence of the shareholders' challenge focused on supposed inadequacies in the sales process that, according to the plaintiffs, resulted in a breach of the directors' *Revlon* obligations.<sup>3</sup> The shareholders further alleged that deal protections and other provisions in the merger agreement were preclusive, arguing that such provisions made it unlikely that a potential bidder lurking on the edges of the transaction might come forward.<sup>4</sup>

Of course, not every flaw in a company's sales process necessarily runs afoul of *Revlon* analysis. Rather, courts will make a determination "regarding the adequacy of the decisionmaking process employed by the directors," as well as a determination as to the "reasonableness of the directors' [decisions]" in light of information known to them at the time they made those decisions.<sup>5</sup> "Reasonableness" is the touchstone for a court's review of director decisions under *Revlon*, not perfection.<sup>6</sup> Given that standard, it was not surprising that Vice Chancellor Parsons ruled, at the preliminary injunction stage, that the plaintiff

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<sup>1</sup> \_\_\_ A.3d \_\_\_, No. 5780-VCP, 2010 WL 4491331 (Del. Ch. Oct. 5, 2010).

<sup>2</sup> *Id.* at \*1.

<sup>3</sup> *Id.* at \*5.

<sup>4</sup> *Id.*

<sup>5</sup> *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 (Del. 1994).

<sup>6</sup> *Id.*

shareholders did not have a reasonable probability of success on the merits, thereby declining to prevent the transaction from moving forward.<sup>7</sup>

What is more remarkable about the recent *Cogent* opinion is the extent to which the Chancery Court accepts, without much of a critical eye, the use of matching rights in merger agreements that implicate *Revlon* duties. Matching rights permit the bidder who holds them to preempt any subsequent, higher bid and step into the second bidder's shoes. These rights come in many forms. Explicit, or formal, matching rights require that the seller engage in good faith negotiations with the initial bidder upon receipt of a second bid for a period of time to allow the initial bidder to meet the higher, subsequent bid. Less formal matching rights simply buy the initial bidder time and information about the second bid, during which time the initial bidder can consider whether to make a matching bid or not. To the extent that such rights in their various forms work to advantage initial bidders over subsequent bidders, their use should at least raise apprehensions under *Revlon*, precisely because *Revlon* was animated by the court's concern that directors treat second bidders fairly. Instead, beginning with *In re Toys "R" Us Shareholder Litigation*<sup>8</sup> in 2005, the Chancery Court institutionalized what can only be understood as a *per se* acceptance of matching rights in merger agreements.<sup>9</sup>

The Chancery Court regularly eschews the adoption of bright-line rules in favor of highly contextualized, fact-specific analyses of director decisions to agree to deal protections in merger agreements. Indeed, the Chancery Court has consistently rejected arguments from defendants that deal protection measures, such as termination fees, are simply customary deal terms.<sup>10</sup> Thus, the court understands and acknowledges that, when they are sufficiently large, termination fees can act as a deterrent and be unfair to subsequent bidders. In some circumstances, it might be unreasonable for Boards to agree to large termination fees and still act in a manner consistent with their *Revlon* duties. While the court has avoided setting out bright-line rules with respect to termination fees, it has not refrained from looking at such fees carefully before passing judgment.<sup>11</sup> The same cannot be said of the court's increasingly lax scrutiny of matching rights.

And this is where the recent *Cogent* opinion is remarkable. Rather than engage in a nuanced analysis of the reasonableness of matching rights within the context of each merger agreement, the court has apparently come to accept matching rights

<sup>7</sup> *In re Cogent, Inc.*, 2010 WL 4491331 at \*22.

<sup>8</sup> 877 A.2d 975 (Del. Ch. 2005).

<sup>9</sup> See, e.g., *In re 3Com S'holders Litig.*, No. 5067-CC, 2009 WL 5173804 (Del. Ch. Dec. 18, 2009); *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, (Del. Ch. 2007); *La. Mun. Police Emps.' Ret. Sys. v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007); see also *In re Dollar Thrifty S'holder Litig.*, No. 5458-VCS, 2010 WL 3503471 (Del. Ch. Sept. 8, 2010).

<sup>10</sup> See, e.g., *La. Mun. Police Emps.' Ret. Sys.*, 918 A.2d at 1181 n.10 (Del. Ch. 2007).

<sup>11</sup> See *id.*

in their various forms as almost non-negotiable standard terms. Vice Chancellor Parsons dealt with matching rights in the agreement, thusly:

After reviewing the arguments and relevant case law, I conclude Plaintiffs are not likely to succeed in showing that the no-shop and matching rights provisions are unreasonable either separately or in combination. Potential suitors often have a legitimate concern that they are being used merely to draw others into a bidding war. Therefore, in an effort to entice an acquirer to make a strong offer, it is reasonable for a seller to provide a buyer some level of assurance that he will be given adequate opportunity to buy the seller, even if a higher bid later emerges.<sup>12</sup>

Unlike the *Cogent* court's exacting discussion of the appropriateness of the termination fee, which included a lengthy discussion of the correct approach to calculating such fees,<sup>13</sup> the court's review of the use of matching rights in the merger agreement was anything but nuanced. While the courts in *In re Dollar Thrifty* and *Toys R Us* were ultimately dismissive of the deterrent power of matching rights, the court in those cases at least attempted to put matching rights in the context of the Board's considerations. Before *Cogent*, the court was willing to seriously entertain claims that matching rights were unreasonable. The *Cogent* decision suggests the beginnings of a body of case law that treats matching rights as a customary term, *per se* acceptable, and therefore not the proper subject of an exacting judicial review. This is unfortunate.

Unlike discussions of macroeconomic policy, there are no two-handed economists when it comes to the incentives generated by matching rights.<sup>14</sup> Matching rights work to deter subsequent bids when held by an initial bidder. In the context of common value auctions (e.g., with financial buyers), the effect of a matching right is to deter subsequent bidders and appropriate rents to the initial bidder. Of course, given that common value buyers place roughly equal value on the seller, society is agnostic as to who ultimately wins a bidding contest.<sup>15</sup> The

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<sup>12</sup> *In re Cogent, Inc.*, 2010 WL at 4491331 \*9 (internal citation omitted).

<sup>13</sup> *Id.* at \*11.

<sup>14</sup> See, e.g., Sushil Bikchandani, Steven A. Lippman & Reade Ryan, *On the Right-of-First-Refusal*, 5 ADVANCES THEORETICAL ECON. 1 (2005); Jeremy Bulow & Paul Klemperer, *Why Do Sellers (Usually) Prefer Auctions?*, 99 AM. ECON. REV. 1544 (2009); Albert H. Choi, *A Rent Extraction Theory of Right of First Refusal*, 57 J. INDUS. ECON. 252 (2009); Hayley Chouinard, *Auctions With and Without Rights of First Refusal and National Park Service Concession Contracts*, 87 AM. J. AGRIC. ECON. 1082 (2005); A. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699, 714 (1987); David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1 (1999).

<sup>15</sup> See generally Choi, *supra* note 14.

seller's directors are under an obligation to obtain the highest price reasonably available for shareholders, but should not be agnostic to the distribution of the surplus created as a result of the transaction. Reasonable boards should not agree to transaction mechanisms that systematically result in the distribution of a transaction surplus to initial buyers by deterring subsequent buyers with a comparable willingness to pay.

On the other hand, where matching rights are present with private value bidders (e.g., strategic acquirers), the presence of the matching right deters subsequent bidders from making offers, thus making it possible for lower valuing initial bidders to acquire the seller. Such a result is inefficient from a societal standpoint and results in systematically lower prices for selling shareholders.<sup>16</sup> The economic analysis of the effects had by an initial bidder's matching rights on subsequent bidders in both cases is clear: they tend to deter subsequent bids in favor of the initial bidder.

Economic theory suggests that courts should employ a more nuanced and serious approach to reviewing the use of matching rights. At the very least, courts should subject matching rights to the same level of scrutiny as that applied to termination rights. Indeed, there are circumstances—for example, in transactions with controlling shareholders—where courts should be quite circumspect of the use of such rights. In such circumstances, the presence of matching rights would be preclusive of a competitive topping bid. On the other hand, where the directors have shopped the company and have negotiated the matching rights for additional value from an acquirer, or to end a played out auction, then courts should not stand in the way of a well informed Board deciding to accept them. In either situation, the court should refrain from treating matching rights as a standard contract term that requires little analysis.

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<sup>16</sup> *Id.*