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# Adjudicating Corporate Auctions

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*In light of recent developments in auction theory, this Article re-examines Delaware corporate law governing directors' actions when structuring the sale of a corporation. A foundational doctrine of Delaware law is that when the board of directors resolves to sell a corporation, it must obtain the highest price reasonably available. Auction theory posits that, in certain circumstances germane to corporate takeovers, revenues can be maximized through the use of ex ante precommitments to the rules of the auction. Delaware law, however, does not fully endorse directors' ability to make such precommitments, primarily out of the concern that the board will lock up a transaction for self-interested reasons.*

*The Article's core claim is that current Delaware law is unduly averse to precommitment devices that set the rules of the game in corporate auctions. Such devices can help maximize shareholder value and do not create the positional conflict that animates much of corporate takeover jurisprudence. Courts should draw a distinction between ex ante precommitments, characterized by ambivalence concerning the identity of the winning bidders, versus midstream or ex post lock-ups, in which the board favors a known buyer.*

## Introduction

When a board of directors resolves to sell the corporation, it must structure the sale so as to obtain the highest price reasonably available. In the landmark case *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court held that, when a sale of the corporation becomes inevitable, the "directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders . . . ."[1] Post-*Revlon*, auctions[2] have become a pervasive feature of the modern takeover landscape.[3] Indeed, a recent survey of four hundred large-scale takeovers with a total deal value of over $1 trillion found that over half of the sales involved a process of competitive bidding rather than private negotiations with selected buyers.[4]

Yet, Delaware corporate law currently leaves in doubt the legality of a tool useful to the value-maximizing auctioneer: the ability to pre-commit to the rules

1.     506 A.2d 173, 182 (Del. 1986). This Article follows standard practice within the literature by focusing on Delaware corporate law due to the jurisdiction's status as the national leader in corporate matters. The arguments presented herein are generalizable to any jurisdiction whose law imposes *Revlon*-like obligations on corporate fiduciaries.

2.     As used herein, "auction" refers generally to any competitive bidding process, as opposed to private negotiations between a buyer and seller. The related term "structured sale" or "structured auction" (used interchangeably herein) refers to a competitive bidding process in which the rules of the game differ from the standard ascending-price auction described in Part I.

3.     Paul Povel & Rajdeep Singh, *Takeover Contests with Asymmetric Bidders*, 19 REV. FIN. STUD. 1399, 1399 (2006) ("Selling firms by inviting competitive bids has become increasingly popular in practice . . . .").

4.     Audra L. Boone & J. Harold Mulherin, *How Are Firms Sold?*, 62 J. FIN. 847, 850-52 (2007).

of the auction.[5] In a series of recent cases, the Delaware courts have struggled with the fiduciary propriety of these precommitments and have reached ambiguous and sometimes contradictory decisions.[6] Indeed, one Vice-Chancellor questioned, in dicta, whether such agreements are ever enforceable.[7] Looming over these cases is the Delaware Supreme Court's decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*, which forbids a target (i.e., selling) board from fully locking up a transaction with a particular counterparty.[8] Instead, the board is legally obliged to include a "fiduciary out" clause in the acquisition agreement, which contractually preserves the target board's right to cancel the agreement should it subsequently receive a better offer.[9]

Such restriction, which in other work I term the fiduciary precommitment constraint,[10] would likely foreclose the use of First Price Sealed Bid ("FPSB") auctions, in which bidders agree to make their best and final offers and the seller agrees that the highest bidder wins the auction at the price bid. Absent the seller's ability to credibly commit to those rules, bidders will alter their strategies. Specifically, as the losing bidders can simply top the winning bidder after the initial auction ends, the bidders will treat the structured sales process as if it were a standard ascending price auction (also known as an "English" auction), in which bidders iteratively increase their offering prices until only one bidder remains. Auction theory, the branch of applied economics that studies auction design, posits that English auctions are not necessarily optimal from the seller's perspective.[11] Thus, modern auction theory finds itself at odds with Delaware takeover jurisprudence.

This tension is particularly problematic because the Delaware courts derive both of these aspects of Delaware law, i.e., the value maximization mandate and the restrictions on precommitments, from principles of fiduciary obligation.[12] Takeovers are one of the most important events in the life cycle of a corporation and are of particular financial significance to the corporation's shareholders. The

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5. Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 26 (2003) (noting that Delaware merger and acquisition jurisprudence exhibits "hostility to precommitment strategies"); Povel & Singh, *supra* note 3, at 1412 ("The ability to credibly commit to the [auction] procedure is, of course, central to its success in extracting the highest possible transaction price.").

6. *See infra* Part III.C.

7. *In re* RehabCare Grp., Inc. S'holders Litig., C.A. No. 6197-VCL, tr. at 46 (Del. Ch. Sept. 8, 2011).

8. 818 A.2d 914, 938-39 (Del. 2003) (holding that a fully locked-up merger was void as a per se violation of the target board's fiduciary obligations).

9. *Id.* at 938 ("We hold that the NCS board did not have authority to accede to the Genesis demand for an absolute 'lock-up'.... Instead of agreeing to the absolute defense of the Genesis merger from a superior offer, however, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer.").

10. *See* Jay B Kesten, *Shareholder Political Primacy*, 9 VA. L. & BUS. REV. (forthcoming Sept. 2015); Jay B Kesten, *Towards a Moral Agency Theory of the Shareholder Bylaw Power*, 85 TEMP. L. REV. 485, 498 (2013).

11. *See infra* Part I.B.

12. *See infra* Part III.A-B.

value-maximization norm acknowledges that a sale of the company represents shareholders' last chance to receive a premium price for their equity. The restriction on precommitments is a prophylactic rule, which prevents potentially unfaithful directors from locking up transactions motivated by self-interest. Thus far, Delaware courts have struggled to balance these competing policy considerations and have failed to provide a principled standard for reviewing directors' decisions when conducting a corporate auction.[13]

This Article develops a theoretically rigorous position on the use of ex ante precommitment devices to facilitate value-maximizing corporate sales. In particular, this Article synthesizes recent developments in auction theory, which models optimal auction mechanism design (but pays little attention to the dynamics of fiduciary obligation), with sensitivity to the need for judicial oversight of corporate fiduciary behavior in the high-stakes context of corporate mergers and acquisitions. The notion that corporate precommitment devices can, in the abstract, create value is not novel. Other commentators have examined the merits of commitment strategies in several corporate law contexts, such as merger lock-ups,[14] anti-takeover devices,[15] and board governance.[16] However, there has been no sustained effort to analyze the merits of ex ante precommitments to the rules of the auction itself and, in particular, the use of contractual precommitment devices to simulate FPSB auctions.[17]

This Article's core claim is that Delaware corporate law should allow neutral ex ante precommitment devices that facilitate a FPSB auction, as such mechanisms can maximize shareholder value and do not create the positional conflict that animates much of Delaware's takeover jurisprudence. Courts should draw a principled distinction between ex ante precommitments, characterized by ambivalence concerning the identity of the winning bidders, versus midstream

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13.    *See infra* Part III.C.

14.    Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare*, 29 J. CORP. L. 569, 605-13 (2004) (applying game theory to model the economic benefits of offering deal lock-ups during the course of merger negotiations).

15.    Bainbridge, *supra* note 5, at 22-23 (discussing anti-takeover mechanisms, such as "fair price shark repellents" and nonredeemable poison pills, as precommitment devices); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 476 (2003) (arguing that "shareholders may rationally entrench board power [with respect to negotiating takeovers and adopting takeover defenses] because shareholders on their own cannot pursue an effective selling strategy").

16.    *See, e.g.*, Lynn Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 669 (2004) (arguing that "investors may be serving their own interests by binding themselves to board [governance]").

17.    *See, e.g.*, William T. Allen, *Overview of Process Issues in Going Private Transaction, in* GOING PRIVATE 2011: DOING THE DEAL RIGHT 52 (2011) (querying whether "an auction or quasi-auction process [that] contractually obligates bidders not to overbid . . . is . . . enforceable . . ."); Kahan & Rock, *supra* note 15, at 477 (noting that the process of "devising and implementing a selling strategy . . . has not been properly emphasized in the takeover literature"). One notable exception is Christina M. Sautter, *Auction Theory and Standstills: Dealing with Friends and Foes in a Sale of Corporate Control*, 64 CASE W. RES. L. REV. 521, 527-31 (2013), which discusses some aspects of auction theory in the takeover context. This Article differs significantly from Professor Sautter's contribution as to both methodology and policy prescription.

or ex post lock-ups, in which the board favors a known buyer. The latter should be subjected to the more searching analysis governing takeover defenses and deal protection devices; the former should be governed only by *Revlon*'s range of reasonableness review and not the more rigid frameworks set out in *Unocal/Unitrin* (which bars deal protection devices that are either coercive or preclusive) or *Omnicare* (i.e., the fiduciary precommitment constraint described above).[18]

Resolving these issues is both timely and necessary in light of recent efforts by target boards to simulate FPSB auctions via intricate contractual agreements with potential bidders.[19] Briefly, targets require bidders to sign a "standstill" agreement in order to gain access to the target's confidential financial (or other) information prior to commencing the auction process. The standstill prohibits losing bidders from making subsequent bids. One particularly strong form of standstill, termed a "Don't Ask, Don't Waive" agreement, prevents bidders from even requesting that the target board waive the no-subsequent-bids condition.[20] As noted above, the Delaware Chancery Court has wrestled with the interplay between these standstills and target boards' fiduciary obligations, but it has reached varying (and limited) conclusions as to the propriety of target boards' conduct.[21] The Delaware Supreme Court has not yet addressed the issue squarely, but its fiduciary precommitment jurisprudence casts substantial—and, in my view, improper—doubt on the legality of these structures.

Before proceeding, several caveats are in order concerning the scope of this Article and its claims. First, this Article does not attempt to resolve the ongoing uncertainty about which transactions trigger *Revlon* obligations. While subsequent cases attempt to draw those boundaries,[22] several commentators

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18.    See Part III.A-B for more detail on these lines of cases.

19.    Both judges and academic commentators have noted the increasing importance of these contractual devices. *See, e.g.,* Plaintiff's Motion for Preliminary Injunction and the Court's Ruling, *In re* Ancestry.com S'holder Litig., C.A. No. 7988-CS at 19 (Del. Ch. Dec. 17, 2012) (remarking that judicial review of these agreements was an important "emerging issue" for corporate law); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 659 (2004) ("Surprisingly, despite their important implications for the interplay between negotiated and hostile acquisitions, standstill agreements have not received attention from modern academic commentators.").

20.    See Part III.C. for a more detailed treatment of these contractual arrangements.

21.    *See, e.g.,* Koehler v. NetSpend Holdings. Inc., C.A. No. 8373-VCG, 2013 WL 2181518, at *19-20 (Del. Ch. May 21, 2013) (finding that standstill agreement contributed to unreasonableness of board conduct); Plaintiff's Motion for Preliminary Injunction and the Court's Ruling, *In re* Ancestry.com S'holder Litig., C.A. No. 7988-CS (advising, without deciding, that standstill agreement was not per se invalid but cautioning against improper use); Telephonic Oral Argument and the Court's Ruling, *In re* Complete Genomics, Inc. S'holder Litig., C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012) (enjoining enforcement of standstill agreement).

22.    *See, e.g.,* Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1289-90 (Del. 1994) (holding that *Revlon* applies "in at least the following three scenarios: (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company; (2) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control") (footnotes omitted) (citations omitted).

observe that the categories remain far from clear.[23] This Article sets aside that doctrinal dispute: the discussion herein assumes *Revlon*'s applicability, i.e., that the board is obliged to conduct a value-maximizing sale. Second, this Article takes no position on the normative desirability of *Revlon*'s value-maximization principle, which has been challenged, especially in the financial literature, on grounds of allocative efficiency.[24] The analysis herein adopts the traditional corporate law perspective that directors' fiduciary obligations in this context run to the shareholders alone and do not require them to balance social welfare or economic efficiency considerations.[25] Finally, nothing in this Article should be read to suggest that FPSB auctions are always value maximizing. As discussed further below, certain conditions favor other types of auctions, including the standard English auction. Moreover, a robust literature examines the relative merits of auctions versus private negotiations,[26] and recent scholarship suggests that the optimal sales strategy may depend in part on the unique circumstances of the selling firm and universe of potential buyers.[27] The arguments presented in this Article pertain only to transactions in which the board conducts a structured sale that invites competitive bidding.

The Article proceeds in four parts. Part I describes the theoretical determinants of optimal auction design. Recent advances in auction theory suggest that there is no single optimal auction structure. If certain conditions obtain, FPSB auctions may generate higher returns for the seller than English

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23. *See, e.g.*, WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 545 (4th ed. 2012) ("The questions of what *Revlon* duties are and when they are triggered continue to haunt Delaware law."); Stephen M. Bainbridge, *The Geography of Revlon-Land*, 81 FORDHAM L. REV. 3277, 3281 (2013) ("In recent years . . . the Delaware Chancery Court has gotten lost in *Revlon*-land. A number of chancery decisions have drifted away from the doctrinal parameters laid down by the Delaware Supreme Court.").

24. *See, e.g.*, Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27, 29 (1991) (arguing that the law should bar corporate auctions entirely because, inter alia, "[t]here is . . . no moral or distributional case for benefitting target shareholders as a group rather than benefitting society as a whole").

25. Indeed, a target board would almost certainly breach its fiduciary duty if it proposed a transaction at a price lower than the highest bid made because it believed the bidder's CEO was unduly optimistic about the potential synergies between the firms.

26. *See generally* Audra L. Boone & J. Harold Mulherin, *Is There One Best Way to Sell a Company? Auctions Versus Negotiations and Controlled Sales*, 21 J. APPLIED CORP. FIN. 28 (2009); Robert G. Hansen, *Auctions of Companies*, 39 ECON. INQUIRY 30 (2001); Jeremy Bulow & Paul Klemperer, *Auctions Versus Negotiations*, 86 AM. ECON. REV. 180 (1996); Kenneth R. French & Robert E. McCormick, *Sealed Bids, Sunk Costs, and the Process of Competition*, 57 J. BUS. 417 (1984).

27. Boone & Mulherin, *supra* note 26, at 28 ("The main lesson . . . from our research on the M&A sales process is that one size does not fit all. Where conventional wisdom and common sense suggest that all sellers should implement a wide-ranging auction, our findings suggest that information costs between sellers and buyers can severely limit the apparent benefits of an auction. And so decisions by sellers to impose constraints on the number and kinds of bidders and otherwise 'manage' the selling process to reduce information costs can actually create value."); *accord* Boone & Mulherin, *supra* note 4, at 871 (conducting an empirical analysis, and finding that "that the wealth effects to targets are comparable in both auctions and negotiations").

auctions.[28] Specifically, the outcome of the auction depends on the risk preferences of the bidders and the target, the number of potential bidders, the distribution of those bidders' valuations for the asset at auction, and the relative strength of the bidders who choose to participate in the structured sale. Part II maps these theoretical insights onto target boards' decision-making processes and illustrates that (i) several factors weighing in favor of FPSB auctions likely exist in many circumstances germane to real-world corporate takeovers; and (ii) structuring a value-maximizing sale is a complex matter, rife with decisions requiring the board's business judgment. Part III turns to the current legal landscape governing corporate auctions, and it describes recent attempts to simulate FPSB auctions and the legal responses thereto. This Part demonstrates that FPSB auctions, when employed by a well-informed and properly motivated board, are consistent with the foundational policy concerns underlying *Revlon* and its progeny, even though they may run afoul of Delaware courts' antipathy towards precommitment devices. This antipathy is largely misplaced, and Part IV develops in more detail the framework for judicial oversight of the auction process described above. Recognizing that not all boards are properly motivated, this Part also identifies relevant criteria by which to measure the reasonableness of the board's actions, even given a facially neutral precommitment device.

I. Auction Theory and Optimal Mechanism Design

Auction theory is a rapidly developing branch of applied economics with a meaningful record of successful real-world applications.[29] Governmental and regulatory bodies have applied its insights to construct complex mechanisms for the sale of assets as varied as spectrum licenses for radio, television and cellular coverage, carbon dioxide abatement, electrical power, timber, and U.S. Government Treasury bills.[30]

Auction theory's two main goals are: (i) to model the strategic behavior of bidders in the context of various auction structures; and (ii) based on these findings, to predict the optimal mechanism design from the perspective of the seller.[31] As such, auction theory provides important guidance for sellers seeking to maximize their gains—a matter of critical importance for a loyal corporate

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28. Some commentators suggest that the optimal procedure in many cases involves a sequential strategy that includes a FPSB auction. *See* Povel & Singh, *supra* note 3, at 1400. The merits and limitations of the Povel & Singh mechanism are discussed further in Part IV.

29. FLAVIO M. MENEZES & PAULO K. MONTEIRO, AN INTRODUCTION TO AUCTION THEORY 1 (2005) ("The theory of auctions is one of the most successful modern economic theories. Its success is reflected in a coherent body of theory but also in its ability to provide insights into many practical policy issues.").

30. PAUL MILGROM, PUTTING AUCTION THEORY TO WORK xii-1 (2004).

31. Ken Hendricks & Robert H. Porter, *An Empirical Perspective on Auctions, in* 3 HANDBOOK OF INDUSTRIAL ORGANIZATION 2073 (M. Armstrong & R. Porter eds., 2007). Some auction theorists also investigate allocative efficiency. *See, e.g.,* MILGROM, *supra* note 30, at 33-34; William Samuelson, *Auctions in Theory and Practice, in* GAME THEORY AND BUSINESS APPLICATIONS 295, 298 (Kalyan Chatterjee & William F. Samuelson eds., 2001).

board, which must use its business judgment to structure a sale of the company reasonably aimed at obtaining the best deal for shareholders.

This Part begins with an overview of the game-theoretical methodology employed to model auctions. As a threshold matter, these models require classification of the type of good for sale into private value, common value, or affiliated value items, terms that will be explained below. Corporations are typically treated as private or affiliated value goods. Next, this Part describes the four basic auction structures (English, Dutch, FPSB, and Second Price Sealed Bid) and the associated equilibrium bidder strategies for each. This Article focuses primarily on the distinctions between English and FPSB auctions. By modeling bidder behavior, one can determine the seller's expected revenue for each structure. These results depend on several features of the seller, bidders, and bidding environment, such as risk aversion, the distribution of bidders' values for the item at auction, the number of potential bidders, and the relative strength of those bidders. This Part concludes with a summary of these theoretical findings and draws conclusions about the determinants of optimal auction design for target corporations.

Auction theory's central insight is that competitive bidding processes can be modeled as Bayesian games, i.e., games in which players have imperfect information.[32] This modeling involves solving for the Bayesian-Nash equilibrium, which is the set of strategies that constitute each player's best response(s) given her beliefs about other players' actions.[33] Put plainly, a Bayesian-Nash equilibrium is the situation in which each player would truthfully answer "yes" if asked whether she was choosing the best action for herself, based on what she thinks the other players will do.[34] By deriving bidders' equilibrium strategies, these models generate predictions about optimal auction design from the perspective of the seller.[35]

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32.     MENEZES & MONTEIRO, *supra* note 29, at 11. Technically, a Bayesian game is one in which at least some players do not know the payoffs of the others, and are thus said to have incomplete information. *See* DREW FUDENBERG & JEAN TIROLE, GAME THEORY 209 (1995). To model these games, it is necessary to introduce a prior move by nature, which determines each player's "type" (in the context of auctions, his valuation of the item for sale) from a probability distribution. This transforms the game from one of incomplete information into one of imperfect information in which players are merely uninformed about prior moves in the game. John C. Harsanyi, *Games with Incomplete Information Played by "Bayesian" Players, I-III. Part I. The Basic Model*, 14 MGMT. SCI. 159 (1967). From there, the game can be analyzed with standard game theory techniques.

33.     MENEZES & MONTEIRO, *supra* note 29, at 7 ("[E]ach player chooses a strategy contingent on his type—that is, he uses a Bayesian decision function. We can then apply the Nash equilibrium notion to these decision functions: each player forms a best response strategy of choosing the best Bayesian decision functions, based on the best response strategies of other players (who are choosing their Bayesian decision functions."); Sudipto Dasgupta & Robert G. Hansen, *Auctions in Corporate Finance, in* 2 BIDDING STRATEGIES, FINANCING AND CONTROL, MODERN EMPIRICAL DEVELOPMENTS 87 (B. Espen Eckbo ed., 2010).

34.     LOUIS KAPLOW & STEVEN SHAVELL, DECISION ANALYSIS, GAME THEORY, AND INFORMATION 46 (2004).

35.     *Id.* at 65-68.

In an auction, bidders lack important information.[36] In a *private value* auction, each bidder knows her own subjective valuation for the object being sold, but she is unaware of other bidders' valuations, which almost certainly differ from her own.[37] The textbook example of a private value auction is the sale of artwork, in which bidders have idiosyncratic views of the merits of a unique item.[38] Making some assumptions about bidders' beliefs concerning other bidders' valuations, we can model this uncertainty to determine equilibrium bidder strategies.

In *common value* auctions, the actual value of the object being sold is the same for all potential bidders, but bidders have varying levels of information about that true value.[39] The prototypical example is the sale of mineral rights, where bidders have sufficiently similar costs of extraction.[40] Here, too, we can determine equilibrium bidder strategies because when a bidder reveals information about her estimate of value (i.e., her "signal"), that revelation will affect the remaining bidders' own estimates.[41]

In the real world, most auctions are neither purely private value nor purely common value. These mixed auctions are typically referred to as *affiliated value* auctions. Sales of companies illustrate this point. At one level, the resale value of the target's assets or the future cash flows from those assets as currently deployed are uncertain (in the sense that they cannot be estimated with great precision), but the present value of those assets and cash flows is the same for all potential acquirors at the initial stage.[42] Yet, at least some acquirors also have an element of private value resulting from idiosyncratic synergies with the target or unique business plans moving forward. These mixed-value auctions can be modeled as well.

It is also worth distinguishing between financial and strategic buyers. Financial buyers are typically investment firms that acquire companies for three possible purposes: (i) to break them up and sell off their component parts; (ii) to hold in their portfolio and derive the benefits of the target's cash flows; or (iii) to fix some managerial or operational defect within the target and then re-sell the firm at a profit (or some combination of these three purposes). The economic literature typically treats financial buyers as common value actors,[43] but this is an oversimplification. For example, while the former two categories listed above

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36.     If all parties had perfect information about the value of the object and about other bidders' valuations, modeling auctions would be trivial. PAUL KLEMPERER, AUCTIONS: THEORY AND PRACTICE 12 (2004).

37.     *Id.* at 13.

38.     Samuelson, *supra* note 31, at 296-300.

39.     *Id.*

40.     JOHN H. KAGEL & DAN LEVIN, COMMON VALUE AUCTIONS AND THE WINNER'S CURSE 2 (2002).

41.     Dasgupta & Hansen, *supra* note 33, at 69.

42.     *Id.*

43.     *See, e.g.*, Povel & Singh, *supra* note 3, at 1400 (asserting that the "situation with financial buyers can be modeled as a common values environment").

reflect largely common value elements of the target, the last includes an element of private value that depends on the buyer's skill at corporate turnarounds.[44] Moreover, active financial buyers may also derive synergies across their portfolio companies.

By contrast, strategic buyers generally are operating companies that view the target's assets as complementary to their own. For example, they might seek an acquisition as: (i) part of a vertical integration strategy; (ii) a way of quickly creating economies of scale; (iii) a method of increasing market share; or (iv) an attempt to diversify their holdings. The value created as a result of those synergies largely depends on the unique combination of assets between the target and the acquiror and thus includes substantial elements of private value.[45] For these reasons, this Article focuses on private and affiliated value models.

The following sections build on this background to model the determinants of a seller's optimal auction design, beginning with a description of the standard auction mechanisms and the associated equilibrium bidder behavior.

## A. A Typology of Auctions and Equilibrium Bidder Strategies

Four basic auction types have been analyzed extensively. The most familiar is the ascending-bid or English auction, in which the auctioneer opens the bidding at a particular level—often the reserve price below which a seller will not sell—and then successively raises the price until only one bidder remains. That final bidder wins the object and must pay the value of her top bid.[46]

A descending-bid auction (also called a "Dutch" auction)[47] works in reverse: the auctioneer opens the bidding at a high price and then successively lowers the price until one bidder accepts the object at the offered price. That bidder wins the object at the stated price.[48]

In addition to these dynamic auctions, there are two standard forms of static or "sealed bid" mechanisms. In the FPSB auction described briefly in the Introduction, each bidder independently submits a single bid without seeing any of the other bidders' bids.[49] The highest bidder wins the object at the price that

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44.     B. Espen Eckbo, *Bidding Strategies and Takeover Premiums: A Review*, 15 J. CORP. FIN. 149, 166 (2009) ("Since bidders tend to have different skill levels in terms of managing the target assets, it is often assumed that the valuations . . . are uncorrelated across bidders—a private value.").

45.     Povel & Singh, *supra* note 3, at 1400 ("[T]rade buyers may be interested in a target because of possible synergies that are not available to other bidders; this situation can be modeled as a private values environment.").

46.     KLEMPERER, *supra* note 36, at 11.

47.     This terminology is slightly confusing since many investment bankers use the term "Dutch Auction" to refer to the second-price sealed bid auction. *See id.* at 11 n.10.

48.     *Id.* at 12.

49.     *Id.*

she bid.[50] Second-price sealed bid ("SPSB") auctions follow the same structure, but the winning bidder pays a price equal to the second-highest bid.[51]

Given these auction structures, how should a rational bidder bid? With private values, the English and SPSB auctions have the clearest dominant strategy: truth telling.[52] In an ascending auction, the dominant strategy is to remain in the bidding until the price reaches your own estimate of value; this strategy performs at least as well as any other, regardless of what the other players do.[53] If the second-highest bidder drops out of the bidding before you, you will win the auction and pay that bidder's price (plus any minimum bidding increment). If the bidding continues past your true value, you cannot improve your position by making additional bids since they will only result in a net loss if you win the auction.

A similar dominant strategy obtains in the SPSB auction. Assume your true value is $v$, the highest bid other than yours is $a$, and your actual bid is $x$. If you bid less than your true value ($v - x$), but your discounted bid remains higher than $a$, then you win the auction and pay $a$ for the object—the same amount you would have paid if you bid $v$. If $a > v$ (i.e., there is a bid higher than your valuation), then you lose the auction regardless of whether you bid your true value or less. However, if $v > a > v - x$, then you will have lost an auction that you otherwise could have won. Thus, you do not gain by bidding less than your true value, and you may well lose out on winning the auction and obtaining the surplus $v - a$.

Similarly, bidding more than your true value ($v + x$) fares no better. If $v > a$, then you win in either event and still pay only $a$, i.e., the same amount as if you had bid your true value. If $a > v + x$, then you lose regardless of your bid. If, however, $v + x > a > v$, then you will "win" the auction but with a net loss of $a - v$. Thus, bidding higher than your true value can hurt you, but it can never help you. Given these two results, it is optimal to bid your true valuation, regardless of what the other players do.[54]

Thus, in private value auctions, the English auction is strategically equivalent to the SPSB auction.[55] If there are elements of common value, this equivalence may not fully hold because bidders will update their own beliefs about the true value of the object if they can observe other bidders dropping out (which they can do in an English auction but not in a SPSB structure).[56]

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50. *Id.*

51. *Id.* SPSB auctions are also termed Vickrey auctions, in recognition of William Vickrey's foundational paper on auction theory. *See also* William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FIN. 8 (1961).

52. KLEMPERER, *supra* note 36, at 13-14; Dasgupta & Hansen, *supra* note 33, at 61.

53. Samuelson, *supra* note 31, at 301.

54. For a similar derivation, see KLEMPERER, *supra* note 36, at 14 n.20.

55. *See* MENEZES & MONTEIRO, *supra* note 29, at 20.

56. *See* KLEMPERER, *supra* note 36, at 14.

However, even in common value auctions, the equivalence remains if there are only two bidders.[57] This is, in fact, the norm in corporate takeovers.[58]

The Dutch and FPSB auctions are also strategically equivalent, though equilibrium behavior is more complicated to model.[59] Here, truth telling is no longer a dominant strategy. Because the winning bidder pays her bid price, bidders will not bid an amount equal to their private value as this would guarantee a payoff of zero if theirs was the winning bid.[60] Instead, the optimal strategy is a function of both the probability of winning the auction (which increases with the amount bid) and the payoff (which decreases with the amount bid).[61] Bidders' equilibrium strategy is thus to assume they have the highest private value and to shade their bid lower—but by how much?

The amount of shading depends on a bidder's beliefs about the distribution of other bidders' private values and specifically on her view of the probability that she will win the auction given any particular bid.[62] More formally, bidders in a FPSB auction attempt to maximize their own expected utility ($u_i$) given their private valuation of the object ($v_i$), the likelihood of their winning the auction (Pr(win)), and the price they must pay if they win. In a FPSB auction, the winner pays her bid price, so price = $b_i$. Thus, $u_i$ = Pr(win) * ($v_i$ - $b_i$). If private values are independently distributed along an interval [0,1] and there are two symmetrical bidders,[63] player i's equilibrium bid function is $b_i(v_i)$ = (1/2) * $v_i$. Extending the bid function to an auction with N players, player i's equilibrium bid function is $b_i(v_i)$ = (N-1/N) * $v_i$.[64] In other words, player i's bid shading decreases as the number of bidders increases.[65]

## B. Revenue Equivalence Theorem and Its Assumptions

Given these equilibrium bidding strategies, one can draw some preliminary and rather startling conclusions about the relative expected revenue generated for each of the auction structures described above. Assuming each bidder is risk-

57.    *Id.*
58.    *See* Boone & Mulherin, *supra* note 4, at 852 (finding that there were, on average, 1.57 private bidders and 1.24 public bidders in the auctions in their sample).
59.    *See* VIJAY KRISHNA, AUCTION THEORY 16-20 (2002); MENEZES & MONTEIRO, *supra* note 29, at 17; Samuelson, *supra* note 31, at 300.
60.    KRISHNA, *supra* note 59, at 16.
61.    MILGROM, *supra* note 30, at 113.
62.    The intuition concerning the Dutch, descending auction is as follows: before each incremental decrease in bid, the bidder asks herself whether the bid price is at or below her private value. If so, she makes a determination of the likelihood that the next step down is, in fact, the next-highest bidders' likely bid. For a mathematical proof of the above description, see KRISHNA, *supra* note 59, at 16-20; and MENEZES & MONTEIRO, *supra* note 29, at 17. This Article does not analyze in any detail the use of Dutch auctions in the sale of companies.
63.    In this context, symmetrical denotes that all players believe their values are drawn from the same distribution.
64.    For derivations, see Samuelson, *supra* note 31, at 302-03; and KRISHNA, *supra* note 59, at 16-20.
65.    MENEZES & MONTEIRO, *supra* note 29, at 17.

neutral and has a private value independently drawn from the same probability distribution as all of the other bidders',[66] all four standard auctions will generate the same expected revenue for the seller.[67] This result is described as the Revenue Equivalence Theorem,[68] and the assumptions on which it rests are termed the benchmark model.

If revenue equivalence held strongly in the real world, then auction design would be more or less irrelevant. However, the benchmark model does not necessarily approximate real-world bidder behavior. The empirical research related to the Revenue Equivalence Theorem is voluminous.[69] However, broadly speaking, actual bidding behavior tends to approximate the equilibrium predictions for English and SPSB auctions but does not track as well the equilibrium prediction for the FPSB auction.[70] Specifically, in many cases, FPSB auctions generate greater than expected revenue for the seller.[71] In other cases, English auctions are preferable. Determining why and when is of substantial importance for a seller attempting to structure a sale that maximizes her revenue. This Section surveys the impact of relaxing several key assumptions from the benchmark model.

1. Risk-Averse Buyers

The benchmark case assumes that buyers are risk-neutral.[72] That is, they seek to maximize their *expected* profits without regard to variance (i.e., risk). To illustrate with a simple example, a risk-neutral actor would be ambivalent between a guaranteed payment of $50 and a coin-flip in which he receives $100 if the coin lands heads and $0 if the coin lands tails. Each option has the same expected value ($50). A risk-averse actor, by contrast, prefers the more certain outcome. Accordingly, a risk-averse actor would always opt for the guaranteed $50 rather than the more variable opportunity to win $100. In other words, risk-averse actors must be compensated for the variance to which they are subjected. In the example above, a risk-averse actor might even opt for a sum-certain of less than $50 (say, $45) rather than a 50% chance of winning $100.

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66. The benchmark model also takes for granted a fixed number of auction participants (N > 1). *See* KLEMPERER, *supra* note 36, at 131.

67. For the foundational findings, see Vickrey, *supra* note 51; Roger B. Myerson, *Optimal Auction Design*, 6 MATHEMATICS OPERATIONS RES. 58 (1981); and John G. Riley & William F. Samuelson, *Optimal Auctions*, 71 AM. ECON. REV. 381 (1981).

68. *See, e.g.*, KLEMPERER, *supra* note 36, at 16-19.

69. Though, as Samuelson notes, much of this empirical work derives from controlled auction experiments. *See* Samuelson, *supra* note 31, at 302.

70. *Id.* at 305 ("Given symmetric independent private values, actual bidding behavior approximates the equilibrium prediction for the [SPSB] auction and exceeds the risk-neutral equilibrium prediction for the [FPSB] auction. The [FPSB] auction generates greater expected revenue with an accompanying modest reduction in efficiency.").

71. *Id.* Samuelson notes that this increase in revenue may come at the expense of allocative efficiency. *Id.*

72. KRISHNA, *supra* note 59, at 37.

If bidders are risk-averse (but all other assumptions are held constant), the revenue equivalence principle no longer holds; FPSB auctions are likely to generate greater expected revenues than English auctions.[73] Risk-averse actors seek to maximize their utility rather than their expected profits.[74] For risk-averse bidders, the effect of a slightly lower surplus (by virtue of having won the auction by making a higher bid) has smaller utility consequences than does the possibility that making a lower bid causes them to lose an auction that they could have won if only they had bid more.[75] Thus, risk-averse bidders will bid higher than the equilibrium strategy predicts if it increases their odds of winning the auction, even though it may yield a smaller surplus.[76]

Accordingly, risk aversion does not impact strategies in an English auction. The dominant strategy—even for risk averse bidders—remains to bid up to one's true valuation.[77] Bidding higher than that can only lead to winning the auction but suffering a loss in the process.

On the other hand, in a FPSB auction, risk-averse bidders will bid more aggressively, i.e., shade their bids less than the equilibrium strategy predicts (though they will still bid less than their true valuation), thus increasing their probability of winning the auction at the cost of a reduced surplus from having won the auction.[78] More aggressive bidding in the FPSB auction leads to higher average bids, which in turn generates greater expected revenue for the seller.

The magnitude of this effect depends on the extent of the winning bidder's risk aversion. Samuelson reports that in experimental settings "subjects place average bids that are significantly above the risk-neutral equilibrium prediction . . . ."[79] This gap is most pronounced with only two bidders and gradually decreases as the number of bidders increases.[80] Accordingly, Samuelson suggests that a seller auctioning an item to risk-averse bidders may be best served by conducting an English auction to narrow the field down to two final-round bidders and employing a final-round FPSB auction to determine the winner between the remaining two.[81]

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73. *Id.* at 38-42. Krishna demonstrates that this result obtains regardless of whether one employs a constant relative risk aversion or constant absolute risk aversion utility function. *Id.* at 40-42.

74. *Id.* at 40.

75. *Id.*

76. *Id.* Krishna analogizes this behavior to buying insurance against the possibility of losing the auction. *Id.*

77. KLEMPERER, *supra* note 36, at 19. If there are common-value components, participants likely alter this strategy slightly to accommodate the auction rules regarding tie-breaking. *Id.* at 19 n.37.

78. *Id.* at 19; MENEZES & MONTEIRO, *supra* note 29, at 34.

79. Samuelson, *supra* note 31, at 302.

80. *Id.* at 302-03.

81. *Id.* at 303.

## 2. Risk-Averse Sellers

The benchmark model also assumes that *sellers* are risk-neutral. Assuming revenue equivalence holds, risk-neutral sellers should be ambivalent between the various auctions, which all generate the same *expected* revenues. A risk-averse seller, however, will select the auction structure with the least variance in outcomes. This behavior is analogous to the coin-flip example described above: if all else is equal, a risk-averse seller must be compensated for increased variability.

FPSB auctions are less variable than English and SPSB auctions.[82] In a SPSB auction, the winner pays a price that is set by the second-highest bidder.[83] By revenue equivalence, the winner of a FPSB auction will bid the expectation of that price.[84] Thus, in a FPSB auction, the seller's revenue is fixed—it depends only on the high bidder's bid. In an English or SPSB auction, however, revenue is variable (depending on the private value of the second-highest bidder) along a distribution with the same mean.[85] Thus, all else being equal, a risk-averse seller should prefer FPSB auctions to English and SPSB auctions.[86]

## 3. Affiliated Values

The benchmark model assumes that private values are *independently* drawn from the same distribution. In other words, none of the bidders' private values depends on any of the other bidders' valuations. This is, obviously, an artificial assumption in the context of corporate takeovers, since acquirors' estimates of value will include both idiosyncratic private value attributable to their unique plans for the target as well as elements of common value arising from the target's cash flows and assets.[87] In other words, the bidders' values are affiliated, not independent. In this context, affiliation means that if one bidder's signal (i.e., her estimation of value) is high, it is more likely that other bidders' signals are high as well.[88]

If the bidders' signals are affiliated, but all other assumptions of the benchmark model hold, English auctions will generate more expected revenues

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82.    For a mathematical proof, see Keith Waehrer et al., *Auction Form Preferences of Risk-Averse Bid Takers*, 29 RAND J. ECON. 179, 181-85 (1998).

83.    KLEMPERER, *supra* note 36, at 19.

84.    *Id.*

85.    *Id.*; Waehrer et al., *supra* note 82, at 180 ("[C]onditioned on the highest signal, revenue in a [FPSB auction] is nonstochastic; under the same conditioning, revenue in other auctions retains its randomness.").

86.    KLEMPERER, *supra* note 36, at 19. In cases where private values are independently distributed, risk-averse sellers should also prefer SPSB auctions to standard English auctions. *Id.*

87.    *See* MENEZES & MONTEIRO, *supra* note 29, at 57 (describing affiliated values as incorporating both private-value and common-value components); Samuelson, *supra* note 31, at 305 (same).

88.    KLEMPERER, *supra* note 36, at 48. Affiliated signals differ from merely correlated signals in that they satisfy this condition on every subspace of the variables' domain. *Id.*

than SPSB auctions, which in turn will generate more expected revenues than FPSB auctions.[89] This result obtains largely because of the "winner's curse" phenomenon in common-value auctions.[90] Recall that in a pure common-value auction the object for sale has identical value for all bidders, but each bidder has imperfect information about that true value. Accordingly, the winner of the auction will always be the bidder with the most optimistic estimate of that value. By definition, the bidder with the most optimistic estimate is also the most likely to have overvalued the object for sale—thus, the winner's curse.

In a FPSB auction, bidders are not only unaware of the item's true value; they are also unaware of how their estimate compares with those of other bidders. Thus, they must discount their estimates before making a bid. If all participants in the auction follow this pattern, the sale will generate less revenue.[91] The same dynamic applies to SPSB auctions, but here the participants will rationally discount their values slightly less since the winner need only pay the second-highest bidder's price. In an open English auction with more than two participants, however, bidders obtain valuable information by watching other parties bid and/or drop out. They can then gauge whether their initial estimate was overly optimistic and are thus more likely to bid closer to the true value of the object for sale.[92] The same basic rationale applies when bidders have affiliated values with a meaningful common-value component; bidders will discount their estimates more in auctions that provide them with less information about the optimism of their signal.[93] Thus, all else being equal, English auctions are expected to generate at least as much revenue as SPSB auctions and more revenue than FPSB auctions when values are affiliated.

Several commentators, however, question the magnitude of this revenue advantage from both modeling and empirical perspectives. Li and Riley find that, in a two-bidder auction (the case most likely to exhibit a pronounced effect and also the most likely in a corporate takeover context),[94] the expected revenue advantage of the English auction is only one quarter of one standard deviation, even for very highly correlated values (p=0.7).[95] Similarly, Klemperer notes, "numerical analysis suggests the effects of affiliation are often tiny, even when bidders who exactly fit the assumptions of the theory compute their bids exactly

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89. KRISHNA, *supra* note 59, at 96.

90. KAGEL & LEVIN, *supra* note 40, at 1-4 (describing the winner's curse phenomenon).

91. Klemperer suggests that the mathematical results are better explained by types of private information revealed via the various auction processes. *See* KLEMPERER, *supra* note 36, at 127-28.

92. This holds true only if the auction structure allows bidders to observe this information. If not, then a given bidder can only ascertain that at least one other bidder remains, and the bidders' strategies converge towards a SPSB auction.

93. For a different explanation of this phenomenon, see KLEMPERER, *supra* note 36, at 48-50.

94. Boone & Mulherin, *supra* note 4, at 852 (reporting that corporate sellers receive, on average, fewer than two public bids).

95. Huagang Li & John G. Riley, 25 INT'L J. INDUS. ORG. 1269, 1282-84 (2007).

using the theory."[96] Samuelson reports several laboratory and field studies that find pervasive evidence of the winner's curse, suggesting that bidders do not discount their values as much as the equilibrium model predicts.[97] Menzes and Monteiro demonstrate that the effects of risk-aversion given risk-averse buyers (discussed above) reduce, and may overtake, the affiliation effect.[98] Finally, Krishna shows that sellers can increase expected revenues in affiliated FPSB auctions by releasing private information concerning the common-value elements of the object for sale.[99] Ultimately, Klemperer concludes that "there is no empirical evidence . . . that argues the affiliation effect is important."[100]

4. Asymmetrical Valuation Distributions

Finally, the benchmark model assumes that bidders' values are symmetric, in the sense that they are drawn from *the same* distribution. But there may exist categorically "strong" and "weak" bidders, whose valuations are drawn from different distributions altogether.[101] If so, this too may favor FPSB auctions.[102] In a SPSB or English two-bidder auction, the weak bidder's value determines the price a strong bidder must pay. If the weak bidder's value is sufficiently low, the winning bidder may win the auction for less than her equilibrium strategy bid in a FPSB auction.[103]

In a FPSB auction, when a bidder is recognized as stronger, competing bidders will likely bid more aggressively (i.e., closer to their own value) in the hopes that the strong bidder overplays her hand by shading her bid too far.[104] A rational, sophisticated strong bidder may compensate for this increased competition by shading her bid less than she would have otherwise. Both of these possibilities generate higher expected revenues for the seller. However, this dynamic is absent entirely from an English auction since a stronger bidder need

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96. KLEMPERER, *supra* note 36, at 129.

97. Samuelson, *supra* note 31, at 307-11. Empirical evidence on the magnitude of the winner's curse in corporate takeovers is mixed. Many commentators conclude that the winner's curse holds in the corporate takeover market. *See, e.g.*, Malcolm Baker et al., *Behavioral Corporate Finance, in* THE HANDBOOK OF CORPORATE FINANCE 145 (B. Espen Eckbo, ed., 2007); Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance, in* HANDBOOK OF THE ECONOMICS OF FINANCE 1053 (George M. Constantinides et al., eds., 2003); Richard Thaler, *Anomalies: The Winner's Curse*, 2 J. ECON. PERSP. 191 (1988). A recent study disputes those findings. *See* Audra L. Boone & Harold Mulherin, *Do Auctions Induce a Winner's Curse? New Evidence from the Corporate Takeover Market*, 89 J. FIN. ECON. 1, 18 (2008) (arguing that the empirical evidence "do[es] not support the presence of a winner's curse in the corporate takeover market").

98. MENEZES & MONTEIRO, *supra* note 29, at 73. *But see* Li & Riley, *supra* note 95, at 1269 (suggesting that—at least in their model—the effects of risk aversion were small as well).

99. KRISHNA, *supra* note 59, at 106-07.

100. KLEMPERER, *supra* note 36, at 130.

101. Part II.B provides examples of strong and weak bidders in the corporate takeover context.

102. KLEMPERER, *supra* note 36, at 129 (concluding that asymmetry can easily overtake the effects of affiliation).

103. Samuelson, *supra* note 31, at 312.

104. KLEMPERER, *supra* note 36, at 22.

only wait until the weaker bidder exits the auction at approximately her true lower value. Thus, in some cases, FPSB auctions will generate greater additional revenue than will English auctions.[105] Here, the wealth effect depends on the shapes of the bidders' value distributions. Klemperer explains that FPSB auctions are expected to generate more revenue where the distributions have similar shapes but different supports, i.e., upper and lower bounds. Conversely, English auctions are preferable where the distributions have different shapes but the same supports.[106]

Numerical analysis demonstrates that the wealth effect of asymmetric value distributions is particularly salient where there is a single strong bidder.[107] Where there are two or more strong bidders, however, revenue differences between the auction types are inconsequential.[108]

This result has a critical implication for an aspect of the auction process overlooked entirely in the benchmark model: the number of bidders who actually participate in the process.[109] The expected profitability of an auction depends critically on the number of bidders.[110] Indeed, Bulow and Klemperer demonstrate that a simple ascending auction with N+1 bidders is more profitable than any type of auction that can be run with N bidders.[111] Recall, for example that, in equilibrium, bid-shading in a FPSB auction is inversely proportional to the number of participants. Without at least two bidders, there is no auction at all.

In English auctions, the bidder with the highest valuation always wins. Thus, weaker bidders may simply not participate if the costs of entry are too high.[112] In real-world FPSB auctions, however, a strong bidder might submit a lowball bid, and a weaker bidder that is willing to bid aggressively may prevail. This is especially true if the strong bidder is less risk-averse than the weaker bidders. Thus, given asymmetric bidders, a FPSB auction is more likely to attract multiple bidders than an English auction.[113]

Recently, Povel and Singh have suggested that bidder asymmetries can be exploited even further in the context of corporate takeovers to form an "optimal"

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105.    MILGROM, *supra* note 30, at 151.

106.    KLEMPERER, *supra* note 36, at 22 ("[R]oughly speaking, [the FPSB] auction generates more revenue than the [SPSB] auction when bidders have distributions with the same shape (but different supports), whereas the open auction dominates when, across bidders, distributions have different shapes but approximately the same support.").

107.    Li & Riley, *supra* note 95, at 1288; Eric Maskin & John Riley, *Asymmetric Auctions*, 67 REV. ECON. STUD. 413, 416 (2000).

108.    Samuelson, *supra* note 31, at 313.

109.    KLEMPERER, *supra* note 36, at 131 (noting that the benchmark model takes as given N bidders, where N>1).

110.    Samuelson, *supra* note 31, at 296.

111.    Bulow & Klemperer, *supra* note 26, at 180.

112.    Griffith makes a similar point, employing an extensive-form game theoretical analysis. *See* Griffith, *supra* note 14, at 605-13.

113.    Maskin & Riley, *supra* note 107 (finding that strong buyers prefer second-price auctions, whereas weaker buyers prefer first-price auctions).

sequential sales structure.[114] They suggest that targets should identify a strong bidder (in this case, defined as better-informed about the true value of the target corporation) and a weak bidder. The target then communicates exclusively with the strong bidder and informs her that she can buy the company if her price is sufficiently high. If so, the deal will be concluded without any competition. If not, she has the option to participate in a FPSB auction with the weaker bidder, but only if she is willing to bid a certain reserve amount. If she is unwilling to do either, the target will offer the company to the weak bidder at a price that the weak bidder is unlikely to reject. Povel and Singh argue that treating asymmetrical bidders differently by offering the strong bidder the carrot of certainty accompanied by the stick of losing the target to a weaker bidder if she tries to lowball generates the highest expected outcomes for the target.[115]

### 5. Optimal Mechanism Design: A Summary

Relaxing the assumptions of the benchmark model illustrates that the choice of structure may matter a lot to a seller designing a value-maximizing auction. Table 1 summarizes these determinants of optimal auction design.

Table 1: The Determinants of Optimal Auction Structure: Departures From the Benchmark Model

| Economic Variable | Favored Auction Mechanism | |
|---|---|---|
| | FPSB | English |
| Risk-Averse Buyers | X | |
| Risk-Averse Sellers | X | |
| Affiliated Values | | X |
| Asymmetrical Bidders (if distributions have similar shape, but different supports) | X | |
| Asymmetrical Bidders (if distributions have different shapes, but same supports) | | X |
| Single Strong Bidder vs. Weaker Bidders | X | |
| Multiple Strong Bidders | N/A | N/A |

Ultimately, standard English auctions may generate the highest expected revenues (or at least revenues that are not substantially dissimilar from other structures) in some cases. If certain conditions obtain, such as risk-aversion among the participants or certain asymmetrical value distributions among the

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114.    Povel & Singh, *supra* note 3, at 1400-01. The remainder of this paragraph describing their proposed structure is drawn from the same source.

115.    In Part IV, Povel and Singh's proposal is re-examined in light of the judicial review framework proposed in that Part.

bidders, the seller should prefer a FPSB structure. Additionally, in the presence of a single strong bidder, employing a FPSB structure may draw weaker bidders into the process when such bidders would have otherwise refused to participate in an English auction (which would have allowed the strong bidder to maximize her own surplus at the expense of the target). The following Part maps these theoretical insights onto a target board's real-world decision-making process.

## II. Structuring Corporate Auctions in the Real World: Empirical Evidence from the Takeover Market

Part I demonstrated that choosing an optimal auction mechanism requires an analysis of highly transaction-specific variables. In other words, this process involves substantial business judgment. This Part examines some of the factors that a loyal board might properly consider when deciding how to structure a value-maximizing sale of the company. The inquiry surveys when a target board, operating under real-world conditions, might reasonably conclude that a FPSB structure is more favorable than an English auction.[116]

### A. Risk Aversion in Corporate Takeovers

A foundational principle of behavioral economics is that most people are risk averse concerning potential gains.[117] However, while risk aversion is the super-majority position, there is nevertheless substantial heterogeneity in risk tolerances across the population.[118] As a class, American CEOs are "much more risk-tolerant than the lay population of similar age profile."[119] They are also more risk-tolerant than non-American CEOs.[120] Further, risk-tolerant CEOs are also more likely to make acquisitions.[121] Yet, even among American CEOs, there remains a wide variety of risk tolerances. Indeed, it is reported that nearly 10%

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116.     As noted in the Introduction, a board might also legitimately conclude, under the circumstances, that the best path forward involves private negotiations with one or more parties.

117.     Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 454 (1981) ("[T]he majority choice . . . is risk averse: a riskless prospect is preferred to a risky prospect of equal or greater expected value."). Tversky and Kahneman also report that the majority is risk-*seeking* with respect to losses. *Id.*

118.     Robert B. Barsky et al., *Preference Parameters and Behavioral Heterogeneity: An Experimental Approach in the Health and Retirement Study*, 112 Q.J. ECON. 537, 545 (1997) (noting that the response exhibiting the least risk tolerance is strongly modal but that there is nevertheless substantial heterogeneity in risk tolerances).

119.     John R. Graham et al., *Managerial Attitudes and Corporate Actions* 22 (May 22, 2012), http://ssrn.com/abstract=1432641. The risk tolerances of CEOs may be more important in this context than those of board members, given that CEOs self-report that they are the dominant decision-makers in buy-side mergers and acquisitions. *See* John R. Graham et al., *Capital Allocation and Delegation of Decision-Making Authority Within Firms* 15 (June 27, 2014), http://ssrn.com/abstract=1571527 (finding that nearly 50% of U.S. CEOs claim to make these decisions in near isolation).

120.     Graham et al., *Managerial Attitudes and Corporate Actions, supra* note 119, at 17.

121.     *Id.* at 21.

of CEOs surveyed were classified as displaying low risk tolerance.[122] Several studies, for example, report that CEOs' risk aversion may account for their desire to acquire firms outside of their core industries as a way of diversifying their own personal wealth.[123] Thus, at the very least, there is no *a priori* reason to assume that acquirors in the M&A market are uniformly risk-neutral, or to rely on broad generalizations or heuristics concerning the degree of acquirors' risk-aversion. To the contrary, the target board (along with its financial and legal advisors) should carefully investigate the risk profiles of potential acquirors to determine whether a FPSB auction might encourage bidders to bid closer to their true values.

The standard model may also underestimate the effects of risk-aversion because it assumes that losing bidders have payoffs of zero. In reality, however, bidders can suffer tangible loss if they fail to acquire a target. For example, when strategic bidders compete for a target within their industry, the loser may suffer harms as a result of the winner's increased market share or newfound economies of scale. More generally, there are search, diligence, and legal costs associated with making a bid.

In these cases, another tenet of behavioral economics—loss aversion—may amplify the bidders' risk-averse behavior. As Kahneman and his co-authors explain:

> [A] central conclusion of the study of risky choice has been that such choices are best explained by assuming that the significant carriers of utility are not states of wealth or welfare, but changes relative to a neutral reference point. Another central result is that changes that make things worse (losses) loom larger than improvements or gains.[124]

Thus, the threat of losing the auction may spur at least some bidders to increase their bids since the cost of paying slightly more for the target weighs much less heavily than the potential loss associated with a competitor winning the auction.

A recent real-world example illustrates these theoretical insights. In May and June 2014, Hillshire Brands Co. received several unsolicited takeover bids from industry rivals Tyson Foods, Inc. and Pilgrim's Pride Corp.[125] Tyson offered to purchase Hillshire for $50/share (approximately $6.2 billion);

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122. Graham et al., *Managerial Attitudes and Corporate Actions, supra* note 119, at 15.

123. *See, e.g.,* Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers,* 12 BELL J. ECON. 605, 605-17 (1981) (finding suggestive evidence that risk aversion causes managers to acquire firms outside their core industries as a method of diversifying their personal wealth); Bart Frijns et al., *Cultural Values, CEO Risk Aversion and Corporate Takeovers* 4 (Oct. 12, 2011), http://ssrn.com/abstract=1942971.

124. Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias,* 5 J. ECON. PERSP. 193, 199 (1991).

125. Dana Mattioli, *Tyson Wins Bid Against Itself,* WALL ST. J., June 9, 2014, http://online.wsj.com/articles/tyson-foods-nearing-deal-for-hillshire-brands-1402314461.

Pilgrim's Pride offered \$55/share (approximately \$6.7 billion).[126] After consulting its investment bankers, Hillshire decided to conduct a modified FPSB auction between its suitors. Each company would simultaneously submit a bid on a particular day and time, without knowing the status of the other company's bid.[127] If the bids were less than \$2.50/share apart, each bidder would have the opportunity to submit a second bid.[128] However, if either bid topped the other by \$2.50/share or more, the auction would end and the company would pursue a transaction with the winning bidder.[129] In the first round of sealed bidding, Tyson raised its offer to \$63/share, approximately \$7.7 billion.[130] Pilgrim's Pride, however, did not raise its bid at all.[131] Tyson and Hillshire thereafter entered into a definitive merger agreement at \$63/share,[132] and the merger closed on August 28, 2014.[133]

Hillshire's decision to employ a sealed bid process rather than an English auction appears to have secured several hundred million dollars of additional value for its shareholders. In an English auction, Tyson would have learned that Pilgrim's Pride had dropped out at \$55/share. Assuming a minimum bid increment of \$2.50/share, Tyson could have won the bidding for \$57.50/share. Why did Tyson increase its bid by such a large margin? It is impossible to know for certain, but the relationship between the bidders and a statement made by Donnie Smith, Tyson's CEO, hint at Tyson's risk aversion concerning the outcome of the auction. Tyson and Pilgrim's Pride (or, more precisely, the latter's parent company) are chief rivals in their industry, and according to industry commentators, Tyson's acquisition of Hillshire was a strategic move meant to "contain" its rival's expansion.[134] Moreover, shortly after the results of the auction were made public, Mr. Smith commented that the purchase price was justified because "[b]rands like Hillshire . . . don't become available very often."[135] The combination of these factors suggests that, given the sealed-bid structure, Tyson made a strategic decision to trade some of the surplus from the deal for a substantially higher likelihood of winning the auction.

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126.     Jeffrey McCracken & David Welch, *Tyson Said to Win Hillshire Bidding, Beating Pilgrim's Pride*, BLOOMBERG NEWS, June 9, 2014, http://www.bloomberg.com/news/2014-06-08/tyson-said-to-win-bidding-for-hillshire-beating-pilgrim-s-pride.html. Pilgrim's Pride had made an earlier, tentative offer of \$45 per share. Mattioli, *supra* note 125.

127.     Mattioli, *supra* note 125.

128.     *Id.*

129.     *Id.*

130.     *Id.*

131.     *Id.*

132.     Press Release, Tyson Foods, Inc., Tyson Foods and Hillshire Brands Announce Definitive Merger Agreement (July 2, 2014), http://ir.tyson.com/investor-relations/news-releases/news-releases-details/2014/Tyson-Foods-and-Hillshire-Brands-Announce-Definitive-Merger-Agreement/default.aspx.

133.     Press Release, Tyson Foods, Inc., Tyson Foods Hillshire Brands Complete Merger (Aug. 28, 2014), http://www.tysonfoods.com/Media/News-Releases/2014/08/Merger-Complete.aspx. As of this writing, no party has challenged the legality of either the auction process or the merger itself.

134.     Mattioli, *supra* note 125.

135.     *Id.*

Sellers, too, might be risk-averse. It's unclear why a target board (or a corporation's shareholders) would prefer the more variable outcomes associated with English auctions unless there is a commensurate increase in expected value. Thus, all else equal, FPSB auctions are preferable even if the other assumptions of the baseline model hold. If, however, other factors weigh in favor of an English auction, the board must carefully balance the variability of outcomes against the higher expected value. Rational diversified shareholders should prefer that the board maximize the risk-adjusted returns of any investment, including the sale of the corporation.[136]

## B. Asymmetric Bidders and Their Incentives to Bid

There is ample reason to believe that strong and weak bidders exist in many competitive bidding situations, i.e., bidders' values are often asymmetric. For example, a management-led buyout team is clearly in a strong position given its informational advantage over outside bidders.[137] Similarly, strategic buyers who see substantial private values resulting from synergies with the target may be in a stronger position than financial buyers, whose value is largely drawn from common value attributable to the target's current enterprise. A recent study supports this intuition, finding that strategic bidders have higher average valuations across all targets.[138] However, a more granular examination of the data illustrates that financial buyers may be stronger than strategic buyers in some circumstances. For example, Gorbenko and Malenko find that financial buyers are willing to offer higher bids for poorly performing target companies.[139] Martos-Vila, Rhodes-Kropf and Harford suggest that this result obtains because financial buyers are repeat players in the takeover markets and thus are more experienced at monitoring underperforming companies and better able, due to their ability to diversify capital structures across their deals, to take advantage of factors such as putatively overpriced debt.[140]

If putatively weak bidders have reputations for bidding aggressively or if putatively strong bidders have reputations for hard-nosed negotiations in which

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136.    *See* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) ("In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others."); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.").

137.    Conducting a FPSB auction in this context may also insulate the board from allegations of conflict or favoritism.

138.    Alexander S. Gorbenko & Andrey Malenko, *Strategic and Financial Bidders in Takeover Auctions*, 69 J. FIN. 2513 (2014).

139.    *Id.*

140.    Marc Martos-Vila et al., *Financial vs. Strategic Buyers* (Harv. Bus. Sch., Working Paper No. 12-098, 2014), http://www.hbs.edu/faculty/Publication%20Files/12-098_dc44025a-785b-45c5-9d31-60e02f091b7d.pdf.

they lowball targets, a FPSB auction may generate meaningfully increased returns. Thus, the board ought to inform itself about the strength and reputation of the potential acquirors.

Relatedly, and perhaps most importantly, the target board should carefully consider whether it needs to entice entrants into the process. As described above, increasing the number of bidders generally increases the seller's expected revenue, and adding a second bidder to the mix—without whom there can be no auction at all—is critical. This dynamic is especially important in the corporate takeover context. Boone and Mulherin report that, on average, targets receive fewer than two private offers when they engage in a competitive bidding process.[141] Thus, in many transactions there is ultimately only one bidder and a real risk that the target will be unable to extract much surplus from the auction. A famous case illustrates this point. In 1995, Glaxo bid £9 billion for Wellcome, a drug company, in an ascending auction.[142] While both Zeneca and Roche expressed some willingness to make higher bids, they ultimately elected not to enter the process when it became clear that Glaxo was a stronger bidder and thus would likely top any bid.[143] Wellcome's CEO later admitted that "there was money left on the table."[144]

FPSB auctions entice weaker entrants precisely because the winning bidder is less easily identifiable ex ante. As Klemperer describes, in an English auction, the strong bidder will simply top any bid made by the weaker bidder(s).[145] Given that participating in corporate takeover auctions is costly—for example, the bidders must hire financial and legal advisors and incur due diligence costs— weaker bidders will rationally refuse to participate if they fear they have no realistic chance of winning.[146] However, in a FPSB structure, an aggressive weak bidder might win the auction at a price the strong bidder *could* have beaten but failed to beat because it attempted to maximize its surplus by submitting a lowball offer.[147] Moreover, even if weaker bidders do not ultimately win the auction, they force the stronger bidder into a bidding strategy more favorable to the target. As discussed above, this effect is strongest where there is a single strong bidder.[148]

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141.    Boone & Mulherin, *supra* note 4, at 852.
142.    KLEMPERER, *supra* note 36, at 106.
143.    *Id.* at 106-08.
144.    *Id.* at 106.
145.    *Id.* at 132.
146.    *Id.; see also* Griffith, *supra* note 14, at 605-13.
147.    KLEMPERER, *supra* note 36, at 132.
148.    More speculatively, weak financial buyers might enter the bidding process as arbitrageurs. For example, if a strong strategic buyer miscalculates and loses a takeover bid, it may be willing to purchase the target in a resale transaction if the winning bid from the primary auction was sufficiently below its private value. Thus, target boards may wish to employ FPSB auctions in cases where they need to entice a second party to enter the process or in cases where a single obviously strong bidder has expressed interest.

In sum, there are plausible real-world situations in which conducting a FPSB auction leads to higher expected revenues for the target. A necessary requirement of a FPSB auction is that the seller credibly precommit to the rules of the game. If bidders believe that they can bid outside of the process, opportunistic acquirors will change their strategies and act as if the process was in fact an English (or SPSB) auction.[149] Yet, as described in the following Part, the legality of such precommitment devices is uncertain under Delaware law.

## III. The Fiduciary Obligations of a Selling Board

### A. Revlon's Auctioneers

In the ordinary course of business, corporate boards are granted broad deference by the courts under the business judgment rule, which presumes that the board is well-informed, independent, and acting in the best interests of the firm. In the absence of fraud, illegality, or conflicts of interest, board decisions are not subject to judicial second-guessing.[150] Irrationality is the only substantive boundary.[151] The practical consequence of this deference is that while directors as corporate fiduciaries are charged with acting in the best interests of the firm, they are afforded broad latitude to pursue that end by the means they deem appropriate.

Matters stand differently, however, when a corporation is put up for sale in a change of control transaction. First, the board now has a singular, judicially defined goal: it must secure the best value reasonably attainable for the stockholders.[152] Unpacking this statement reveals two related board obligations. All else equal,[153] the board must accept the highest price offered.[154] As such, the

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149.  *See, e.g.,* KLEMPERER, *supra* note 36, at 111; Povel & Singh, *supra* note 3, at 1415.

150.  Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) ("[I]n the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith.").

151.  *Id.* at 1052-53 ("[W]here a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty."); *In re* RJR Nabisco, Inc. S'holders Litig., C.A. No. 10389, 1989 WL 7036, at *1169 n.13 (Del. Ch. Jan. 31, 1989) ("As I conceptualize the matter, such limited substantive review as the rule contemplates (i.e., is the judgment under review 'egregious' or 'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith.").

152.  *See, e.g.,* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1994) ("In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end.").

153.  Of course, all else is not always equal. For example, the board may be required to consider the present value of different types of consideration, legal impediments to particular transactions or to transactions with particular acquirors, and any uncertainty over the acquiror's ability to obtain financing or otherwise close the transaction. *See, e.g., QVC,* 637 A.2d at 44 (listing factors a board can properly consider, such as the risk of non-consummation and questions of illegality); *In re* RJR Nabisco, 1989 WL 703614, at *1161 (Del. Ch. 1989) (discussing board valuation of non-cash consideration).

154.  *See QVC,* 637 A.2d at 44.

board can neither consider the interests of other stakeholders (such as employees or creditors) insofar as they diverge from those of stockholders[155] nor justify accepting a financially inferior proposal on the basis that it is somehow in the long-term best interests of the firm.[156] More importantly for the purposes of this Article, the board cannot remain passive and watch the sales process unfold organically; it must actively structure a process intended to elicit the best price.[157] Boards fulfill this obligation by either holding an auction or negotiating a private transaction in conjunction with a thorough market check to ensure that there is no better deal available.[158]

Second, *Revlon* imposes a more exacting standard of judicial review.[159] The board's decisions are no longer protected by the business judgment rule. Instead, the court will review the reasonableness of the board's decision-making process and the resulting substance of its sales structure.[160] In this context, reasonableness requires that the board inform itself about the prevailing circumstances and then conduct a sales process aimed at maximizing value in light of that information.[161] That said, Delaware jurisprudence emphasizes that the board retains substantial discretion concerning its preferred sales structure. As the Delaware Supreme Court recently explained, "[n]o court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control."[162] Accordingly, "there is no single blueprint that a board must follow to fulfill its

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155.     Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to stockholders. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.") (internal citation omitted).

156.     QVC, 637 A.2d at 45 (noting that when *Revlon* is triggered, "an asset belonging to public stockholders (a control premium) is being sold and may never be available again").

157.     See, e.g., Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009) (holding that "directors must engage actively in the sale process") (internal quotation omitted); QVC, 637 A.2d at 46 (holding that, when *Revlon* applies, the board is "required to pursue a transaction that is calculated to produce the best value reasonably available to the stockholders"); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989) (discussing "a board's active and direct role in the sale process"); *Revlon*, 506 A.2d at 184 n.16 ("[W]e do not embrace the 'passivity' thesis rejected in *Unocal* . . . . The directors' role remains an active one, changed only in the respect that they are charged with the duty of selling the company at the highest price attainable for the stockholders' benefit.") (internal citation omitted); *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 595 (Del. Ch. 2010) ("*Revlon* commands that directors, consistent with their traditional fiduciary duties, act reasonably, by undertaking a sound process to get the best deal available.") (internal quotation omitted).

158.     *Lyondell*, 970 A.2d at 243. Some cases contemplate a third possibility, where no active market check is required if the board can demonstrate "an impeccable knowledge of the market." *Id.*

159.     *Dollar Thrifty*, 14 A.3d at 595 ("[T]he level of judicial scrutiny under *Revlon* is more exacting than the deferential rationality standard applicable to run-of-the-mill decisions governed by the business judgment rule.").

160.     QVC, 637 A.2d at 45.

161.     Koehler v. NetSpend Holdings Inc., C.A. No. 8373-VCG, 2013 WL 2181518, at *11 (Del. Ch. 2013).

162.     *Lyondell*, 970 A.2d at 242.

duties."[163] Moreover, the board's decision need only be reasonable, not perfect;[164] courts will not second-guess the decision simply because it would have made a different decision or ex post events cast doubt on the merits of the board's determination.[165]

In sum, *Revlon* is simply a special case on the duties of care and loyalty. Delaware jurisprudence recognizes that structuring a sale of the company is a decision that requires substantial context-specific business judgment[166] and is thus a matter best decided by the board. But heightened judicial oversight is necessary to ensure that the board fulfills its obligations faithfully. In this context, the court's fundamental objective in scrutinizing a transaction is to determine whether the board was reasonably informed and appropriately motivated when deciding how to conduct the sale.[167]

But the target board's discretion in structuring a sale of the company is not as broad as it might initially seem. A separate line of cases, with its genesis in the judicial scrutiny of takeover defenses, imposes an important limitation on structured sales.

## B. Legal Limits on Structured Sales: Unocal, Omnicare and the Fiduciary Precommitment Constraint

In *Unocal Corp. v. Mesa Petroleum Co.*, a case decided the year prior to *Revlon*, the Delaware Supreme Court assessed the legality of defense mechanisms adopted by the target board in the face of a hostile attempt to acquire the company.[168] The Court announced a two-part test, in which the target board must carry the burden of demonstrating: (1) that it had reasonable grounds to fear a threat to the corporation, its shareholders, or to corporate policy and

163.　*Id.* at 242-43 (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989)).

164.　*Id.* at 243 ("Directors' decisions must be reasonable, not perfect."); *In re* Plains Exploration & Prod. Co. Stockholder Litig., C.A. No. 8090-VCN, 2013 WL 1909124, at *4 (Del. Ch. 2013) (directors "are not required to show that they made a perfect decision, only a reasonable one").

165.　*QVC*, 637 A.2d at 45 ("If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.").

166.　*See, e.g., id.* ("[A] court should not ignore the complexity of the directors' task in a sale of control. . . . The board of directors is the corporate decision making body best equipped to make these judgments."). Part II describes in more detail the range of matters over which the board must exercise its business judgment.

167.　Koehler v. NetSpend Holdings Inc., C.A. No. 8373-VCG, 2013 WL 2181518, at *11 (Del. Ch. 2013) ("*Revlon's* reasonableness test also requires the Court to scrutinize the board's true intentions to determine if the board is acting with the best interests of the stockholders in mind."); *accord* Bainbridge, *supra* note 23, at 3337 (arguing that board motive is the animating feature of *Revlon* scrutiny).

168.　Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Defensive mechanisms, in this context, are any devices that interfere with (or make more costly) a hostile (i.e., not board-approved) acquisition of the company. Such devices include defensive recapitalizations (the crux of the board's defense in *Unocal*), poison pills, and staggered boards.

effectiveness;[169] and (2) that the defensive measures employed were not "draconian"[170] but were reasonable in relationship to the threat posed.[171] In subsequent cases, the Delaware Supreme Court clarified the second prong of this analysis and explained that target boards cannot take action that is either "preclusive" or "coercive."[172] The former refers to defensive measures that fully block a hostile bidder from gaining control of the target.[173] The latter refers to defensive measures that force stockholders to accept unwillingly or involuntarily a management-sponsored alternative to the hostile bid.[174] If the defensive measure is either preclusive or coercive, it is impermissible.[175] If not, the court must still determine whether it was reasonable in relationship to the threat posed.[176]

The *Unocal* framework is animated fundamentally by the "omnipresent specter," in cases where the company is threatened by a hostile takeover, that "a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[177] Specifically, heightened scrutiny is warranted because of the positional conflict faced by the board. In defending against a takeover, the directors (and especially inside directors) might act primarily out of a selfish desire to entrench themselves in office rather than out of an honest belief that the prospective acquiror's offer was not in the best interests of the firm.[178]

The *Unocal* framework intersects with *Revlon* in a peculiar way. An early application of the *Revlon* standard is instructive and is quoted at length below. The Delaware Supreme Court explained:

> [W]hen several suitors are actively bidding for control of a corporation, the directors may not use defensive tactics that destroy the auction process. When it becomes clear that the auction will result in a change of corporate control, the board must act in a neutral manner to encourage the highest possible price for shareholders. . . . *Revlon* is merely one of an unbroken line of cases that seek to prevent conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders.

169.    *Id.* at 955.
170.    *Id.*
171.    *Id.*
172.    Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995). These categories were intended to illuminate *Unocal*'s rather abstract and unhelpful reference to "draconian" defensive measures. *Id.* at 1386.
173.    *Id.* at 1387; Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 935 (Del. 2003) ("A response is 'preclusive' if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise.").
174.    *Id.* at 935 ("A response is 'coercive' if it is aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer.").
175.    *Id.*
176.    *Unitrin*, 651 A.2d at 1387-88.
177.    Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, at 954 (Del. 1985).
178.    *Id.* at 955 (explaining that the "restriction placed upon a [takeover defense] is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office").

> When multiple bidders are competing for control, this concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another.[179]

Thus, if a plaintiff can show that the target board treated one or more bidders on unequal terms, a slightly modified version of the two-part *Unocal* test determines whether such disparate treatment is permissible.[180] Specifically, the courts carefully scrutinize whether the board "properly perceived that shareholder interests were enhanced" by the disparate treatment of bidders and then determine whether the discrimination was "reasonable in the relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests."[181]

This convergence of *Revlon* and *Unocal* occurs most prominently in cases where the target employs deal protection devices to favor a particular bidder. A deal protection device is a contractual agreement between the target and a bidder designed to increase the likelihood of consummating a transaction between the two parties.[182] Common deal protections include termination or breakup fees (paid to the bidder in the event that the transaction is not consummated between the bidder and target), lock-ups (in which the bidder has the right to obtain either stock or assets from the target at below-market prices should the deal fall apart), matching rights (which allow the bidder to match on equal terms any superior offer), and various restrictions on the target's ability to seek out other buyers after the agreement has been signed (e.g., "no-shop" provisions).[183]

While there are numerous variations, the basic principle behind all deal protections is the same: they increase the cost of a topping bid that the board would, as a matter of its fiduciary obligation, almost certainly be obliged to accept. Acquirors request deal protections because there is substantial expense associated with valuing a potential target, making a bid, and then preparing the requisite contractual agreements between the parties.[184] Absent deal protections, first-movers would bear the information costs for a free-riding third party willing to make incrementally small topping bids.[185] From the target's perspective, deal protections are offered to a potential acquiror to induce it to make an initial bid. At least in theory, targets employ deal protection devices because some potential

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179.    Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-87 (Del. 1989) (citation omitted).

180.    Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1988).

181.    *Id.*

182.    ALLEN ET AL., *supra* note 23, at 574.

183.    *Id.* at 574-76.

184.    *Id.* at 575 (noting that deal protection devices "are often justified as necessary to compensate a friendly buyer for spending the time, money, and reputation to negotiate a deal with a target when a third party ultimately wins the target").

185.    *See, e.g.*, Steven M. Davidoff & Christina A. Sautter, *Lock-up Creep*, 38 J. CORP. L. 681, 682 (2013) ("A lock-up theoretically compensates a buyer for its investment costs in making an initial bid for a target by making a second, competing bid more costly.").

acquirors will not make initial bids without a measure of protection against topping bids and/or compensation in the event that their deals are superseded.[186] Targets also employ deal protections as carrots to coax higher bids out of recalcitrant bidders in auctions in exchange for increased certainty of consummating the deal. Both of the above results are, at least arguably, value-maximizing for the shareholders.[187]

Of course, targets might employ deal protection devices to lock up deals for reasons unrelated to shareholder value. For example, the board might prefer a particular acquiror for reasons of personal gain (e.g., a promise to retain the incumbent board or management) or purely as a matter of personal animosity and ego. Indeed, *Revlon* itself seems to have involved both. Chancellor Strine remarked, "Revlon's CEO . . . appears to have preferred to continue running Revlon but when it was clear that a sale would occur, wished to avoid selling to Ron Perelman [the hostile bidder], a person the [Delaware] Supreme Court found that [the Revlon CEO] disdained."[188]

If deal protections are sufficiently onerous, they might deter otherwise available value-maximizing bids. The purpose of enhanced scrutiny in the deal protection context is thus closely related to *Revlon*'s core concern that the board act loyally to seek the best possible value available for shareholders. Put differently, we worry that the board members will protect or lock up a deal in order to satisfy their own preferences rather than to maximize shareholder value. Accordingly, enhanced scrutiny allows the court to "take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board to block a bid or to steer a deal to one bidder rather than another."[189]

Delaware's superintendence of deal protections reached its apogee in the Delaware Supreme Court's *Omnicare* decision, which formalized the fiduciary precommitment constraint described above. In that case, a target in acute financial distress sought a merger partner.[190] After a multi-year search, with the assistance of several expert advisors, the target identified only two plausible acquirors: Omnicare and Genesis.[191] Relatively early in the process, the target had invited Omnicare to discuss a potential transaction, but Omnicare initially offered only to purchase the target's assets in bankruptcy.[192] That original

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186.    *Id.* at 693 ("Without the compensation lock-ups provide, there will theoretically be fewer bids, as bidders will be hesitant to invest in making the first bid.").

187.    *Id.* at 684-93 (surveying empirical literature on deal protections and lock-ups).

188.    *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 597 n.174 (Del. Ch. 2010); *accord* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986) (noting that Revlon's CEO had a "strong personal antipathy to Mr. Perelman").

189.    *Dollar Thrifty*, 14 A.3d at 598.

190.    Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 920 (Del. 2003).

191.    *Id.* at 920-21.

192.    *Id.* at 921.

proposal would have partially compensated the target's debtholders without generating any value at all for the company's shareholders.[193]

The target then commenced negotiations with Genesis, which preliminarily offered a transaction that would have provided recovery for both the target's debtholders and shareholders.[194] However, Genesis had a prior history with Omnicare; the two companies were competitors, and Omnicare had recently outbid Genesis in another takeover contest.[195] Accordingly, Genesis informed the target that it would not bear the cost of further due diligence and negotiating a final deal unless the target agreed to fully lock up the transaction.[196] The target board, seeing no better deal on the horizon, agreed to exclusivity with Genesis. The lock-up combined two statutorily authorized structures: the board agreed to put the deal to a shareholder vote, regardless of whether it continued to recommend the merger (a "force-the-vote" provision), and the majority shareholders (who were also directors) agreed to vote in favor of the Genesis deal.[197] Thus, the transaction with Genesis was a *fait accompli*, even in the face of a superior offer.[198] Unsurprisingly, Omnicare subsequently offered a transaction that the board concluded was likely superior, and the target's minority shareholders sued to enjoin the target's agreement with Genesis.[199]

A majority of the Delaware Supreme Court concluded that the deal protections violated the board's fiduciary obligations. First, the majority held that the deal protections did not pass muster under *Unocal* because they were both preclusive and coercive: Omnicare was effectively precluded from making a topping bid, and the target's minority shareholders were coerced into accepting the Genesis deal insofar as they had no ability to vote down that transaction in favor of Omnicare's higher bid.[200] Second, and much more controversially,[201] the majority asserted that, regardless of the board's motivations, the absolute lock-up was a per se violation of the board's fiduciary obligations.[202] According to the majority, the board was legally obliged to include a "fiduciary out" clause

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193.    *Id.*
194.    *Id.* at 922.
195.    *Id.* at 923.
196.    *Id.*
197.    *Id.* at 925-26.
198.    *Id.* at 936.
199.    *Id.* at 927.
200.    *Id.* at 935-36. While the former is trivially true, the latter conclusion is somewhat puzzling insofar as the minority shareholders (who held only 35% of the total vote) would *never* get their way in the event that the majority shareholders preferred a different transaction. *Id.* at 944-45 (Veasey, J., dissenting). The dissent also drew a distinction between deal protections adopted unilaterally by the board to lock up a preferred deal (which could be deemed preclusive to other bidders) and those the board viewed as necessary to induce a bid from "the only game in town." *Id.* at 943-44.
201.    Indeed, *Omnicare* is one of the rare Delaware Supreme Court cases involving a dissent. *See, e.g.*, Griffith, *supra* note 14, at 570 n.7 (arguing that the existence of a dissent "alone marks *Omnicare* as an unusual and noteworthy case . . . ."); David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 129 (1997) (noting that "[e]ven on deeply controversial issues . . . Delaware's justices almost invariably speak with a single voice").
202.    *Omnicare*, 818 A.2d at 936-39.

in the Genesis agreement.[203] Such clauses state, in sum, that the target board reserves the right to cancel the agreement in the event that it subsequently receives a better offer and determines that declining the superior offer would be in violation of its fiduciary duty.[204] The Court justified this conclusion on the basis that, by pre-committing to the Genesis deal, "the [target] board disabled itself from exercising its own fiduciary obligations at a time when the board's own judgment is most important, i.e. receipt of a subsequent superior offer."[205]

Omnicare was criticized heavily by both academics and, curiously, Chancery judges.[206] While the Delaware Supreme Court has never expressly overruled Omnicare, subsequent Chancery decisions have narrowed the scope of its holding.[207] In particular, these cases are highly critical of the notion that deal protections can ever be invalid per se.[208] In the post-Omnicare era, the Chancery Court has upheld most deal protection measures in cases where the deal is not otherwise tainted by board self-interest.[209] And yet, hints of Omnicare have recently re-entered the judicial discourse in relation to a novel class of precommitment devices known as standstills.

## C. Modern Developments: Standstill Agreements and Simulated FPSB Auctions

Deal protections have long been used midstream during takeover negotiations with the intent of inducing a known counterparty to make its best

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203.    *Id.* at 938 ("We hold that the NCS board did not have authority to accede to the Genesis demand for an absolute 'lock-up.' . . . Instead of agreeing to the absolute defense of the Genesis merger from a superior offer, however, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer.").

204.    *Id.* The history and operation of fiduciary outs is described at length in Sabrina Ursaner, *Keeping 'Fiduciary Outs' Out of Shareholder-Proposed Bylaws: An Analysis of* CA, Inc. v. AFSCME, 6 N.Y.U. J. L. & BUS. 479 (2010).

205.    *Omnicare,* 818 A.2d, at 938.

206.    *See* Transcript of Oral Argument at 127, Optima Int'l of Miami v. WCI Steel, Inc., No. 3833-VCL (Del. Ch. June 13, 2008) (statement of Lamb, V.C.) ( "[I]t's really not my place to note this, but Omnicare is of questionable continued vitality."); Bainbridge, *supra* note 5, at 26 ("The court's emerging hostility to precommitment strategies is puzzling."); Griffith, *supra* note 14, at 623 ("In short, the *Omnicare* rule.is bad law, bad economics and bad policy."); Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take That Action: The Implicit Corollary to the Rule of* Schnell v. Chris-Craft, 60 BUS. LAW. 877, 902–03 (2005) (arguing that, at least in some circumstances, absolute lock-ups should be adjudged equitable). *But see* J. Travis Laster, Omnicare's *Silver Lining*, 38 J. CORP. L. 795, 796 (2013) (arguing that *Omnicare* "isn't all bad"); Brian J.M. Quinn, Omnicare: *Coercion and the New* Unocal *Standard*, 38 J. CORP. L. 835, 837-42 (2013) (offering a defense of *Omnicare*); Megan W. Shaner, *Revisiting* Omnicare: *What Does Its Status 10 Years Later Tell Us?*, 38 J. CORP. L. 865 (2013) (arguing that *Omnicare's* negative effects have been overstated).

207.    *See* Davidoff & Sautter, *supra* note 185, at 702.

208.    *See, e.g., In re* Atheros Commc'ns, Inc. S'holder Litig., C.A. No. 6124-VCN, 2011 WL 864928, at *7 n.61 (Del. Ch. Mar. 4, 2011) (noting that "Delaware courts have repeatedly recognized that [deal protection] provisions such as these . . . are not per se unreasonable, and do not alone constitute breaches of fiduciary duty."); *In re* 3Com S'holder Litig., C.A. No. 5067-CC, 2009 WL 5173804, at *7 (Del. Ch. Dec. 18, 2009); *In re* Toys "R" Us S'holder Litig., 877 A.2d 975, 1017 (Del. Ch. 2005) (holding that neither termination fees nor matching rights—an agreement that the bidder have the opportunity to match any superior bid—are invalid per se).

209.    *See* Davidoff & Sautter, *supra* note 185 (surveying the cases and describing this phenomenon as "lock-up creep").

bid upfront. More recently, transaction planners have employed contractual agreements with potential bidders in an effort to credibly commit ex ante to a structured sale of the corporation. While there are many variations, the basic pattern is as follows.

When a company is put up for sale, the target board generally retains one or more investment bankers to advise it through the sales process.[210] The board and its advisors then identify plausible buyers and contact them to gauge their interest in acquiring the target.[211] Boone and Mulherin report that, on average, companies that are interested in a competitive bidding process contact over twenty potential acquirors.[212] The target offers these potential acquirors access to confidential information (financial or otherwise) that will assist in their valuation process.[213] In exchange for the target's confidential information, bidders must execute confidentiality agreements that almost always contain a standstill provision.[214] Standstills, in this context, bar the bidder from making a public bid for the target for a set period of time after receiving the confidential information.[215] After a due diligence period, the target then requests final sealed bids from the bidders that remain in the process.[216] The winner is the highest bidder, who must pay the price bid.

Standstills are thus mechanisms by which target boards can simulate FPSB auctions.[217] By contractually foreclosing losing bidders from making topping bids, the target seeks to induce each participant to make its best offer[218] because: (i) if it is not the winning bidder, it will have no opportunity to make a subsequent bid outside of the process; and (ii) if it is the winning bidder, it need not fear a topping bid from another bidder with access to the target's confidential information.

One particularly intricate form of standstill—termed the "Don't Ask, Don't Waive" (DADW) standstill—not only bars losing bidders from making subsequent topping bids, but also prevents them from asking the target board to

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210.    Boone & Mulherin, *supra* note 4, at 849.

211.    *Id.*

212.    *Id.* at 852.

213.    *Id.* at 849; Christina M. Sautter, *Promises Made to Be Broken? Standstill Agreements in Change of Control Transactions*, 37 DEL. J. CORP. L. 929, 931 (2013).

214.    *See, e.g.*, S. Union Co. v. Sw. Gas Corp., 180 F. Supp. 2d 1021, 1034 (D. Ariz. 2002) ("'[I]n deals for public companies, it would be extraordinary for there not to be' a confidentiality and standstill agreement.") (citation omitted).

215.    *See* Sautter, *supra* note 213, at 932 (noting that standstills typically run for one to two years from the date of signing). On average, approximately seven potential acquirors execute a standstill in any given auction. *See* Boone & Mulherin, *supra* note 4, at 852.

216.    Some sale structures contemplate a single round of bids; others involve multiple rounds. *See, e.g.*, Sautter, *supra* note 213, at 988.

217.    The standstill structure only simulates a FPSB auction because third parties outside the process, i.e., those that did not sign the standstill, can always make topping bids, but must do so without the benefit of the target's confidential information.

218.    *See, e.g.*, Telephonic Oral Argument and the Court's Ruling at 9, *In re* Complete Genomics, Inc. S'holder Litig.,C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012).

waive that restriction.[219] The rationale for the second constraint is that a losing bidder could, instead of making a public bid outside of the process, hint to the target board that it might be willing to make a topping bid. In the face of such a request, the board's fiduciary obligations might require re-opening negotiations with that losing bidder, which would destroy the integrity of (and any financial benefits flowing from) the FPSB auction process. As previously noted, if the target cannot credibly commit to the rules of the game, the bidders will treat the process as an English auction.

While the Delaware Supreme Court has not yet opined on this matter, several recent Chancery decisions provide conflicting guidance on the legality of standstills and especially DADW standstills. In two early cases, neither of which squarely confronted the question, the Chancery Court expressed deeply divided views on DADW standstills. For his part, Chancellor (and now Chief Justice) Strine was open to the possibility that such devices might pass muster in the appropriate circumstances:

> Contemplate, for example, a final round auction involving three credible, but now tired bidders, who emerged from a broad market canvass. One can easily imagine how a board striving in good faith to extract the last dollar they could for their stockholders might promise the three remaining bidders that the top bidder at 8:00 p.m. on the next Friday will get very strong deal protections including a promise from the target not to waive the Standstill as to the losers.[220]

On the other hand, in dicta during the approval of a settlement, Vice-Chancellor Laster ventured that DADW standstills might be per se illegal. He opined that "it is weird that people persist in the 'agree not to ask' in the standstill," and he queried, "When is that ever going to hold up if it's actually litigated . . . ?"[221]

The Delaware Chancery Court addressed the legality of DADW standstills more directly in two subsequent cases, which illustrate similar fault-lines among the judges. In *In re Complete Genomics, Inc.*, the target contacted over forty potential buyers, of whom nine signed confidentiality agreements.[222] Four of those agreements contained standstill agreements, one of which—the contract with "Party J"—included a DADW clause.[223] Shortly after signing its agreement,

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219.     *See* Davidoff & Sautter, *supra* note 185, at 682 (describing DADW standstills).

220.     *In re* Topps Co. S'holders Litig., 926 A.2d 58, 91 n.28 (Del. Ch. 2007).

221.     *In re* RehabCare Grp., Inc. S'holders Litig., C.A. No. 6197-VCL, tr. at 46 (Del. Ch. Sept. 8, 2011). Vice Chancellor Parsons, too, expressed concerns. While he declined to adopt or suggest a per se rule of invalidity, he highlighted the potential "informational vacuum" created by DADW agreements (especially when combined with other provisions that restricted the board's ability to inquire about further interest from potential buyers). *See In re* Celera Corp. S'holders Litig, C.A. No. 6304-VCP, 2012 WL 1020471, at *21-22 (Del. Ch. Mar. 23, 2012).

222.     Telephonic Ruling of the Court at 7, *In re* Complete Genomics, Inc. S'holder Litig.,C.A. No. 7888-VCL (Nov. 9, 2012) [hereinafter *Complete Genomics* Ruling].

223.     *Complete Genomics* Ruling at 8; Telephonic Oral Argument and the Court's Ruling at 12, *In re* Complete Genomics, Inc. S'holder Litig.,C.A. No. 7888-VCL (Nov. 27, 2012) [hereinafter *Complete Genomics* Oral Argument].

Party J indicated that it had no intention of pursuing a transaction with the target and ended communications with the target's board.[224] The target received six proposals and narrowed the field down to two bidders, who were asked to provide their best and final bids.[225] The target ultimately pursued a transaction with BGI-Shenzen, which—among other things—agreed to let the CEO of the target remain with the company and run it as an independent entity under BGI's ownership.[226]

Plaintiff shareholders challenged the validity of the DADW agreement relying explicitly on the notion that it was barred by the fiduciary precommitment constraint.[227] In a bench ruling, Vice Chancellor Laster enjoined the provision without explicitly invoking *Omnicare* but instead relying on the key rationale underlying that decision: board disablement as a result of a precommitment strategy verged on per se illegality regardless of whether the sales process was otherwise reasonable and well-motivated. Specifically, the Vice Chancellor held that "the target board's agreement to disable itself from engaging in dialogue with a potential acquiror under any circumstances whatsoever was the legal equivalent of willful blindness."[228] Accordingly, the "DADW [standstill] represents a promise by a fiduciary to violate its fiduciary duty, or represents a promise that tends to induce such a violation."[229]

In *In re Ancestry.com Shareholders Litigation*, then-Chancellor Strine issued a bench ruling that adopted a cautious, but more accommodating, view of DADW standstills. The Chancellor disclaimed that such provisions were per se illegal,[230] but he advised that they were potent devices, and thus needed to be used with extreme caution.[231] He then opined that DADW standstills might be used appropriately to create a structured auction process with a definite end-period:

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224.    *Complete Genomics* Oral Argument at 12.

225.    *Complete Genomics* Ruling at 8.

226.    *Id.* at 8-9.

227.    *Complete Genomics* Oral Argument at 8 ("It is our view that under *Omnicare*, that that is an improper impediment, an unreasonable impediment, on a potential bid for the company. *Omnicare* says that it is unreasonable if it presents anyone from making a bid for the company. And that's exactly what it does here.").

228.    *Id.* at 15. Laster analogized the DADW agreement to the bidder-specific no-talk clause that had been enjoined in Phelps Dodge Corp. v. Cyprus Amax Minerals Co., C.A. Nos. 17398, 17383, 17427, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999).

229.    *Complete Genomics* Oral Argument at 18.

230.    Plaintiff's Motion for Preliminary Injunction and the Court's Ruling at 21, *In re* Ancestry.com S'holder Litig., C.A. No. 7988-CS ("I know of no statute, I know of nothing, that says that these provisions are per se invalid. And I don't think there has been a prior ruling of the Court to that effect. I know people have read a bench opinion that way.").

231.    *Id.* at 22 ("I think what *Genomics* and *Celera* both say, though, is Woah, this is a pretty potent provision. And precisely because of this *Schnell* overlay, the equitable overlay of the law, directors need to use these things consistently with their fiduciary duties, and they better be darn careful about them.").

[T]he value-maximizing purpose has to be to allow the seller as a well-motivated seller to use it as a gavel, to impress upon the people that it has brought into the process the fact that the process is meaningful; that if you're creating an auction, there is really an end to the auction for those who participate. And therefore, you should bid your fullest because if you win, you have the confidence of knowing you actually won that auction at least against the other people in the process.[232]

In other words, DADW agreements might be legal if used to create FPSB auctions.

The foregoing illustrates the deep divide within the Chancery Court concerning the propriety of DADW standstills. Given this uncertainty, prominent practitioners have cautioned against the use of DADW provisions.[233] Moreover, the shadow of *Omnicare* looms large.[234] The Delaware Supreme Court has not yet confronted this issue, but plaintiffs have already drawn analogies to the absolute lock-up deemed per se illegal in that case.[235]

## IV. A Principled Framework For The Judicial Oversight of Structured Corporate Auctions

The preceding Parts demonstrate that: (i) FPSB auctions may, in the right circumstances, generate higher revenues for the seller; (ii) determining whether those circumstances exist requires the target board, along with its expert advisors, to exercise substantial business judgment; and (iii) FPSB auctions require the target board to credibly commit to the integrity of the process. If we assume a

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232.    *Id.* at 23.

233.    *See, e.g.*, Alan J. Stone & David Schwartz, *NetSpend Board in Breach of* Revlon *Duties as Sale Process Is Determined Not to Be Designed to Produce Best Price*, MILBANK, TWEED & HADLEY LLP (May 30, 2013), http://www.lexology.com/library/detail.aspx?g=1983a812-6802-421d-9c75-e33fc20714ea ("*NetSpend* . . . also reiterates the disdain Delaware courts have had for 'don't ask, don't waive' clauses in standstill agreements, especially when such clauses are combined with restrictive provisions in an acquisition agreement that reinforce their application. While the *NetSpend* decision should not be read as a per se prohibition against the use of [DADW] clauses, practitioners should be very wary of utilizing these provisions in the context of a sale process in which a board could be viewed as willfully blinding itself to information."); *Delaware Court of Chancery Holds That So-Called "Don't Ask, Don't Waive" Standstills Are Per Se Impermissible Under Delaware Law*, LATHAM & WATKINS, LLP (Dec. 2013), http://www.lw.com/thoughtLeadership/RecentCourtofChanceryDecisionEnjoinsDontAsk DontWaiveStandstills. ("We continue to believe that under appropriate facts and circumstances, a board, acting through a majority of disinterested directors, in good faith and on an informed basis, can properly determine that requiring potential bidders to acquiesce to a 'don't ask, don't waive' provision is in the best interests of the company and its shareholders. We anticipate that the tension between that analytical framework and a per se rule invalidating such provisions will be explored further through discussion among M&A practitioners, including the Delaware bar, and through subsequent litigation testing the limitations imposed by the *Complete Genomics* court on the use of such provisions."); *Delaware Enjoins "Don't Ask/Don't Waive" Standstill Provision*, WINSTON & STRAWN LLP (Dec. 2012), http://d4qxztsgsn706.cloudfront.net/images/content/1/3/v2/1340.pdf ("Overall, the court's decision [in *Complete Genomics*], if widely followed, will probably spell the end of Don't Ask/Don't Waive provisions at least as to private communications between prospective bidders and targets.").

234.    *See, e.g.*, Sean J. Griffith, *The Omnipresent Specter of* Omnicare, 38 J. CORP. L. 753, 768 (2013) ("Evidence of the continued vitality of Omnicare has recently arisen in the context of standstill provisions.").

235.    *See supra* note 227 and accompanying text.

well-motivated target board, the use of standstills to simulate a FPSB auction is thus well within the boundaries of *Revlon*'s mandate.

But, of course, not all boards are properly motivated. This Part turns to the question of the appropriate standard for judicial review and argues that Delaware courts' skepticism about ex ante precommitment strategies is largely misplaced. A per se rule of invalidity is entirely inappropriate, and the *Unocal/Unitrin* standard is the wrong analytical tool by which to evaluate the target's chosen auction structure. Instead, courts should assess the propriety of these devices on a case-by-case basis, employing the traditional *Revlon* framework to ensure that the board is adequately informed about how to structure the sale of the company, properly motivated concerning the maximization of shareholder value, and employs reasonable means to that end.

### A. A Per Se Rule Barring the Precommitments Necessary for Structured Sales Would Inappropriately Undermine Revlon's Foundational Policy

Outside of the few mandatory provisions set forth in the governing statute, Delaware's model of corporate law eschews per se rules.[236] Instead, transactions are judged on a case-by-case basis to determine whether the board adhered to its core duties of care and loyalty.[237] Accordingly, even in the context of takeover defenses and deal protection devices, the Delaware courts have repeatedly advised that there are virtually no per se illegal structures.[238]

One important reason for this flexible, enabling approach is that per se rules create the risk that a court will invalidate the actions of a well-informed board, which acts honestly in furtherance of the shareholders' best interests.[239] As Chief Justice Veasey lamented in *Omnicare*, such rules give rise to "a judicially-created 'third rail'" that unjustly limits the discretion of loyal fiduciaries.[240] This is dangerous not just in the abstract, but also because such limitations undermine other well-established corporate law policies.

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236.    *See* Plaintiff's Motion for Preliminary Injunction and the Court's Ruling at 20-21, *In re* Ancestry.com S'holder Litig., C.A. No. 7988-CS ("Per se rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be. It's inconsistent with the model of our law.").

237.    *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (Del. 2003) ("The beauty of the Delaware corporation law, and the reason it has worked so well for stockholders, directors and officers, is that the framework is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis.") (Veasey, J., dissenting).

238.    *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986) ("A lock-up is not per se illegal under Delaware law."); *In re* Toys "R" Us S'holder Litig., 877 A.2d 975, 1017 (Del. Ch. 2005) (holding that neither termination fees nor matching rights are per se illegal).

239.    *See Omnicare*, 818 A.2d at 948 ("[T]he majority finds no breach of loyalty or care but nonetheless sanctions these directors for their failure to insist upon a fiduciary out as if those directors had no regard for the effect of their otherwise disinterested, careful decision on others.") (Steele, J., dissenting).

240.    *Omnicare*, 818 A.2d at 943 (Veasey, J., dissenting).

A per se rule invalidating DADW standstills or other mechanisms aimed at fostering FPSB auctions would frustrate *Revlon*'s core mandate: that the board actively seek the best possible deal for shareholders. Consider a competitive bidding situation with two bidders—a strong bidder that values the target at $s$ and a weak bidder with value $w$. The difference between these two values ($s - w$) is the surplus up for grabs between the board and the strong bidder. If the target board takes its *Revlon* obligations seriously, its role is not just to induce the higher value bidder to make a topping bid (i.e., greater than $w$), but rather to extract as much of the acquiror's surplus as possible.

Auction theory teaches that, in the right circumstances, FPSB sales can be used to extract some of that surplus. As described above, a FPSB structure requires the target to credibly commit to the rules of the game. Thus, a well-informed, well-motivated board might reasonably conclude that it must employ a contractual device—such as the standstill agreements discussed herein—to make such a commitment. Such a board would not only have satisfied its duties of care and loyalty, but may also have achieved *Revlon*'s aspirational goal of obtaining the best price for its shareholders. This goal is indeed aspirational because there is no way to know with certainty whether, given some other structure, a better deal might have been struck.[241] For this very reason, *Revlon* requires only a reasonable, not a perfect, decision.[242]

But a per se rule invalidating the precommitment devices necessary for structuring a FPSB auction turns every competitive bidding process into a standard English auction. Leaving aside that this, in itself, may deter some bidders from participating in the process (and thus deprive the target of the benefits of a competitive bidding situation),[243] a mandatory English auction rule constrains the board in large part to seeking a topping bid rather than competing for the high bidder's surplus. The very notion of matching rights—a legal deal protection device in which the then-winning bidder is contractually entitled to match any future topping bid—is strong evidence of this point. Matching rights are a signal from the winning bidder that money was left on the table, and that they, at least plausibly, have ample surplus available to increase their bid but will

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241.    *See In re* Fort Howard Corp. S'holder Litig., C.A. No. 9991, 1988 WL 83147, at *722 (Del. Ch. Aug. 8, 1988) ("*Revlon* explicitly recognized that a disinterested board may enter into lock-up agreements if the effect was to promote, not to impede, shareholder interests. (That can only mean if the *intended* effect is such, for the validity of the agreement itself cannot be made to turn upon how accurately the board did foresee the future)."); *accord In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 617 (Del. Ch. 2010) ("I tend toward the *Fort Howard* view of directors' ability to predict the future . . . .").

242.    *See, e.g., In re* Netsmart Tech., Inc. S'holders Litig. 924 A.2d 171, 192 (Del. Ch. 2007) ("Our case law recognizes that [there] are a variety of sales approaches that might be reasonable, given the circumstances facing particular corporations.").

243.    *See Revlon*, 506 A.2d at 183 ("In this regard, we are especially mindful that some lock-up options may be beneficial to the shareholders, such as those that induce a bidder to compete for control of a corporation, while others may be harmful, such as those that effectively preclude bidders from competing with the optionee bidder.") (citing Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 274 (2d Cir. 1986)).

do so only if a topping bidder emerges.[244] Put differently, the target board is required to employ a structure that it may honestly believe is *not* likely to generate the best deal for shareholders. Framed as such, it is hard to conclude that the board has in all cases disabled itself in breach of its fiduciary obligations by pre-committing.

Finally, the strongest economic argument in support of *Omnicare*'s per se rule is inapplicable to precommitments. Several commentators challenge whether the "deal certainty" afforded by strong lock-ups truly creates value for target shareholders.[245] Briefly, they argue that if a board could in any circumstance fully lock up a deal, bidders would regularly demand bulletproof deal protection devices.[246] Given the typical bargaining power in the takeover market (recall that, on average, target corporations receive fewer than two public bids and often engage in strategic transactions while in financial distress) and the difficulty of determining whether a bidder will, in fact, walk away from a deal, sellers are unlikely to be able to credibly resist these demands.[247] Accordingly, often these negotiations are structurally biased towards bidders, and in particular the initial bidder, who has very little incentive to disclose much information about its private valuation of the target.[248] Put differently, sellers typically have no way to determine *how much* deal certainty is actually worth to the bidder and thus may systematically receive too little in exchange for foreclosing the possibility of competitive bids.[249] By taking fully locked-up deals off the table as a matter of law, *Omnicare*'s per se rule protects target shareholders by setting an important and credible limit on the deal protections that are up for negotiation.[250]

This rationale, however, lacks force with respect to the precommitments necessary to structure FPSB auctions for three reasons. First, ex ante rules-of-the-game precommitments do not create value by offering deal certainty. To the contrary, they create value precisely by introducing an element of *uncertainty* into the sales process and requiring bidders to make strategic decisions about their bid strategy. Second, while lock-ups are intended to reduce the level of competition, FPSB auctions can, in the right circumstances, increase the number of entrants into the bidding process, which is a critical determinant of the seller's revenue.[251] Third, *Omnicare*'s defenders argue that allowing the possibility of a full lock-up tilts the bargaining landscape too far in favor of bidders and

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244.    Of course, the winning bidder hopes the match-rights themselves are a sufficient deterrence such that they need not be exercised. But the effectiveness of the deal protection device is substantially diminished if the rights-holder cannot credibly signal its ability to exercise.

245.    *See, e.g.*, Quinn, *supra* note 206, at 839-42; Laster, *supra* note 206, at 827-32.

246.    Laster, *supra* note 206, at 832.

247.    Quinn, *supra* note 206, at 839-40.

248.    *Id.* at 840.

249.    *Id.*

250.    *Id.* at 841-42; Laster, *supra* note 206.

251.    KLEMPERER, *supra* note 36, at 131 (noting that attractiveness of entry is one of the few factors that "really matters in practical auction design").

especially in favor of strong bidders that might try to obtain the target at a bargain price by threatening to walk away from the deal. By contrast, strong bidders would rarely, if ever, prefer a FPSB auction structure to an English auction due to all of the incentive effects described in Part II above. Thus, the economic rationale supporting *Omnicare*'s per se rule fails to justify its application to the precommitment devices necessary for structured auctions.

## B. Revlon Alone Should Govern Neutral Ex Ante Structured Sales

Midstream deal protection devices are ordinarily governed by the *Unocal* standard described in Part III. *Unocal* requires the target board to demonstrate a cognizable threat to the corporation and only permits deal protections that are neither preclusive nor coercive but are reasonable in relation to the threat posed. Superficially, the precommitment devices necessary for structured sales seem analogous to deal protections; the target has agreed to "lock-up" a deal with the winning bidder. The rules of the game may also include actual lock-ups, such as promises to include termination fees or no-shops in the winning bidder's merger agreement. Yet, there are two key differences between ex ante structured sales and midstream deal protection devices that weigh strongly against employing the same analytical framework to test their respective legality.

First, ex ante commitment devices, such as DADW standstills, are in most cases facially neutral and thus do not create the positional conflict at the heart of *Unocal*'s enhanced scrutiny. Recall that *Unocal* is premised on the "omnipresent specter" that the target board will deploy deal protection devices (or takeover defenses) for self-interested reasons.[252] For example, the target board may prefer a deal with a counterparty that promises to let board members remain in office, offers lucrative side deals, or, as in *Revlon* itself, appeals to a constituency other than the shareholders in an effort to shield the incumbent board from impending litigation.[253]

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252.    Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 943 n.102 (Del. 2003) ("The basis for the *Unocal* doctrine is the "omnipresent specter" of the board's self-interest to entrench itself in office.") (Veasey, J., dissenting); Griffith, *supra* note 14, at 619 ("What else is the 'omnipresent specter' other than an increased risk that the board is putting another interest (its own) ahead of the interests of its shareholders?").

253.    *In re* Topps Co. S'holder Litig., 926 A.2d 58, 64 (Del. Ch. 2007) ("When directors bias the process against one bidder and toward another not in a reasoned effort to maximize advantage for the stockholders, but to tilt the process toward the bidder more likely to continue current management, they commit a breach of fiduciary duty."); *In re* Toys "R" Us S'holder Litig., 877 A.2d 975, 1000-01 (Del. Ch. 2005) ("Nor does a board's decision to sell a company prevent it from offering bidders deal protections, so long as its decision to do so was reasonably directed to the objective of getting the highest price, and not by a selfish or idiosyncratic desire by the board to tilt the playing field towards a particular bidder for reasons unrelated to the stockholders' ability to get top dollar."); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (finding that "[t]he principal benefit [of the lock-up] went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstance . . ."); *cf.* Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 118 (1965) ("When we find incumbents recommending a control change, it is generally safe to assume that some side payment is occurring.").

By contrast, a credible ex ante commitment to conduct a structured sale does not conjure the same omnipresent specter. True, the target has "locked-up" a deal with the winner, but that winner is unknown to the board at the time of the lock-up. Operating behind a veil of ignorance, there is substantially less chance that the board has forgone a better deal for the shareholders as a result of its own self-interest.[254] This neutrality is precisely what *Revlon* and its progeny command:

> [W]hen several suitors are actively bidding for control of a corporation, the directors may not use defensive tactics that destroy the auction process . . . When it becomes clear that the auction will result in a change of corporate control, *the board must act in a neutral manner to encourage the highest possible price for shareholders.*[255]

By way of comparison, consider the Povel and Singh proposal described in Part I. They suggest that the optimal sales structure involves a take it or lose it proposition to a strong bidder, where the threat is that if the strong bidder does not offer enough, she will either have to compete in a FPSB auction with a minimum bid, or the target will be sold to a weak bidder at a lower price.[256] This mechanism may indeed be optimal, either as a mathematical construct or in real-life circumstances. However, even leaving aside the risks associated with the board improvidently (but accidentally) selecting an inappropriate "strong bidder," the potential for agency costs is enormous. Because the board knows in advance to which bidder they will offer a lock-up, there is a real risk that the board members will make that choice to advance their own personal interests. Such a structure thus implicates the positional conflict animating *Unocal*; neutral ex ante structured sales do not.

Second, *Unocal* relies on two concepts—preclusion and coercion—as a screen for impermissible board action. But those concepts fit awkwardly with ex ante contractually structured sales. Preclusion refers to the situation where a bidder is wholly barred from making a superior proposal. But, in the context of standstills, any such preclusive effect is entirely voluntary. If the bidder does not wish to be bound by the standstill, it need not sign it. Moreover, it is only limited from making topping bids if it operates outside of the structured sales process. It can unilaterally avoid this restriction by making its best offer pursuant to the

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254. For a similar reason, Chief Justice Veasey argued that it was debatable that *Unocal* even applied to the fact pattern presented by *Omnicare*. *See Omnicare*, 818 A.2d at 943 n.102 (arguing that "[t]he *Unocal* doctrine applies to unilateral board actions that are defensive and reactive in nature.") (Veasey, C.J., dissenting); *accord id.* at 948 ("The contract terms that NCS' board agreed to included no insidious, camouflaged side deals for the directors or the majority stockholders nor transparent provisions for entrenchment or control premiums.") (Steele, J., dissenting).

255. Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1287 (Del. 1989) (emphasis added).

256. *See supra* notes 114-15 and accompanying text.

rules of the game. In sum, if used appropriately, DADW standstills preclude only opportunistic behavior that deprives the target of the benefits of a structured sale.

Coercion, too, is an ungainly construct with which to measure board conduct vis-à-vis structured sales. In this context, coercion refers to management's efforts to force a particular transaction upon shareholders in the face of a hostile alternative. Within the structured sale process, however, there can be no hostile alternative unless the losing bidders breach their own contractual obligations.[257] Moreover, if the process is ex ante neutral, management is not forcing any particular transaction upon shareholders; it is simply setting the rules of the game that determine which proposal the shareholders will ultimately vote upon. All that is forced on shareholders is the structure of the process itself, but that decision is squarely within the board's authority under Delaware law.[258] In sum, *Unocal* is an inapt framework for the judicial review of facially neutral ex ante commitment devices used to enforce the rules of the game in a structured sale.

## C. Applying Revlon to Simulated FPSB Auctions

None of the foregoing suggests that standstills or other methods of simulating FPSB auctions are beyond judicial review or even subject only to the business judgment rule. I am only arguing that *Revlon* alone—as a special case of the board's duties of care and loyalty—should govern.

*Revlon* requires the court to engage in enhanced scrutiny to determine whether the board was adequately informed concerning its chosen sales process and whether the board was properly motivated in designing a process aimed at achieving the best price for shareholders.[259] It is impossible to cover the field with respect to how any given transaction might run afoul of those precepts. However, there are several threshold issues of general applicability that are worth highlighting.

First, the board should be fully informed about its own structured process. In particular, the directors should understand exactly how the standstill (with or without a DADW provision) contributes to that process and the limitations those agreements place on participants. Potent precommitments should not be adopted pro forma. For example, Vice Chancellor Glasscock appropriately chastised a

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257.    Of course, if a party outside the structured sale wishes to make a proposal without access to the confidential material, it is free to do so. The standstills and DADW agreements only restrict parties who voluntarily signed them. Target boards would be well-advised to ensure that they can feasibly consider the merits of any such outside offers.

258.    *See, e.g.*, Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("The board of directors is the corporate decision making body best equipped to make these judgments."). In any event, particularly cautious boards could submit their proposed auction structure to the shareholders for pre-approval. I thank Frank Gervurtz for this suggestion.

259.    *See, e.g.*, Koehler v. NetSpend Holdings Inc., C.A. No. 8373-VCG, 2013 WL 2181518, at *11 (Del. Ch. 2013) ("*Revlon* requires the Court to look to the directors' true intentions to determine if the directors have been motivated by the appropriate desires: i.e., to achieve the highest price reasonably available to the stockholders.").

target board where "the Board did not consider, or did not understand, the import of the DADW clauses and of their importation into the Merger Agreement."[260] He found the target's process unreasonable:

> In order to fulfill its fiduciary duty to construct a sales process reasonably designed to maximize value, the action of the Board must be informed, and "logical and reasoned." Nothing in the record indicates that the retention by the Board of the DADW provisions, or in the Board's importation of the provisions in the Merger Agreement, was informed, logical and reasoned.[261]

Similarly, targets that engage in lengthy sales processes should ensure that legacy confidentiality agreements do not interfere with or improperly restrict any subsequent auctions. If an earlier, but aborted, sales process involved standstills, the target should carefully consider whether those agreements should either be waived and/or whether the restricted parties should be re-invited to submit bids in connection with the re-convened auction.[262]

Second, DADW standstills or any other form of particularly restrictive standstill should only be employed if the target actually intends to simulate a FPSB auction. Given the potency of these clauses, there is a real danger that a poorly motivated board may bind plausible bidders to a DADW standstill and then shut them out of the process entirely by pursuing a negotiated deal with a preferred acquiror.[263] In other words, targets should not use standstills discriminatorily.

Third, the court must assess whether the rules of the auction are in fact neutral, in the sense that they do not improperly favor a particular bidder. For example, a precommitment device that required the target board to take the highest bid offered by any private equity firm may well create a positional conflict if the board knows that only one such entity is a plausible bidder. Courts should be wary of collusive dealings masquerading as neutral precommitments. Additionally, courts must be sensitive to non-financial criteria, such as regulatory constraints, feasibility of financing, structure of consideration, and the like, that a target might use to limit the pool of potential bidders.

Finally, the target should ensure that its potential bidder pool is sufficiently deep. If the board is going to commit to do a deal with the winner of the auction, then the participants should reflect the board's reasonable good faith judgment about the most plausible acquirors. This is especially true if the winning bidder

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260.   *Id.* at *19.

261.   *Id.*

262.   *Id.* at *19 n.235 ("Given that the clauses here are merely an artifact from an earlier Board strategy (to remain an independent entity), and given that they are here employed to lock up a single bidder sale, none of that utility can apply here.").

263.   Somewhat speculatively, this dynamic may well have been the cause of Vice Chancellor Laster's concerns in *Complete Genomics*, insofar as it narrowed the field down to two bidders, one of whom—indeed, the ultimate counterparty—promised to let the target's CEO keep his job. *See supra* notes 225-26 and accompanying text.

is promised additional deal protections over and above the DADW standstill restrictions on the losing bidders. Of course, a well-motivated board has a built-in incentive to get this aspect of the transaction right; in order to credibly commit to the auction process, the board must assure potential bidders that there is not likely to be a topping bid made by an unrestricted thirdparty. Accordingly, the court should carefully scrutinize the pre-auction market solicitation process if a target employs a DADW standstill coupled with back-end deal protections.[264]

Conclusion

Auction theory teaches that certain precommitments are necessary for conducting value-maximizing sales. This lesson should inform Delaware takeover jurisprudence, which mandates that the board act to maximize shareholder value when a corporation is put up for sale. Yet, Delaware law continues to exhibit unwarranted hostility to precommitments, and, in doing so, it undermines its own foundational principles of fiduciary duty.

Building on modern advances in auction theory, this Article proposes a principled framework for adjudicating precommitments in the takeover context. Delaware courts should distinguish between two categories of precommitment devices: (i) ex ante precommitments, such as rules-of-the-game precommitments in the course of a corporate auction where the target is legitimately ambivalent about the identity of its ultimate transaction partner; and (ii) midstream or ex post precommitments such as deal protection devices, in which the target locks up a transaction with a known counterparty.

Adopting the framework set forth herein would harmonize the two presently paradoxical policy considerations that underlie Delaware's takeover jurisprudence: value maximization and fiduciary loyalty. Neutral ex ante precommitments allow boards to conduct value-maximizing sales while at the same time avoiding the positional conflict that animates Delaware's current antipathy towards precommitments. These devices should not be governed by the unduly restrictive standards set forth in *Unocal* and *Omnicare*, but instead subjected to the enhanced scrutiny contemplated in *Revlon*. Thus, courts need not, and should not, defer entirely to the board's business judgment. Instead, enhanced scrutiny of precommitments, by assessing both the reasonableness of the board's chosen sales structure and the directors' good faith, would allow the courts to ensure that the board has satisfied its duties of care and loyalty.

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264.     Of course, modest back-end deal protections—such as termination fees—can serve a salutary function in structured sales. If a bidder concludes that it can make an informed valuation of the target without signing the standstill, it may voluntarily stay out of the target's chosen sales process in an attempt to avoid the incentive effects that accompany that process. If enough bidders are able to do so, the auction itself collapses. By offering the winner of the target's chosen process appropriate deal protections, potential bidders are encouraged to participate in the structured process.