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Crown Jewels — Restoring the Luster to Creative Deal Lock-ups?

After a long period of dormancy, lock-ups – "crown jewel" or otherwise – have seen a recent creative rebirth with some structural twists. Even in their modern iterations, these lock-ups must be handled with care with ample discussion and documentation of the reasoning and justification for their implementation.

The "crown jewel" lock-up, a staple of high-stakes dealmaking technology in the 1980s M&A boom, has been showing some signs of life in the contemporary deal landscape, albeit often in creative new forms. As traditionally conceived, a crown jewel lock-up is an agreement entered into between the target and buyer that gives the buyer an option to acquire key assets of the target (its "crown jewels") separate and apart from the merger itself. In the event that the merger fails to close, including as a result of a topping bid, the original buyer retains the option to acquire those assets. By agreeing to sell some of the most valuable pieces of the target business to the initial buyer, the traditional crown jewel lock-up can serve as a significant deterrent to competing bidders and, in some circumstances, a poison pill of sorts.

Given the potentially preclusive nature of traditional crown jewel lock-ups, it is not surprising that they did not fare well when challenged in the Delaware courts in the late 1980s. As the Supreme Court opined in the seminal *Revlon* case, "[W]hile those lock-ups which draw bidders into a battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders detriment." Building on the holding in *Revlon*, the court in *Macmillan* said that "Even if the lockup is permissible, when it involves 'crown jewel' assets careful board scrutiny attends the decision. When the intended effect is to end an active auction, at the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession." Although crown jewel lock-ups fell out of favor following these rulings, modern and modified versions of the traditional crown jewel lock-up have been finding their way back into the dealmakers' toolkit.

During the height of the 2008 financial crisis, we saw a crown jewel lock-up in its most traditional form in the JPMorgan rescue acquisition of Bear Stearns. Driven by "life-or-death" urgency, Bear Stearns agreed to an option for JPMorgan to buy its Manhattan headquarters for approximately $1.1 billion, including in circumstances where a topping bid emerged. In the ensuing litigation, the plaintiffs argued that the option to purchase the building constituted an "effective" termination fee because the purchase price under the option was allegedly below fair value. A New York court, applying Delaware law, rejected this argument stating that the record did not substantiate the claim that the price was below fair value. The court, mindful of the extreme circumstances, also noted that the plaintiffs' criticism of the "effective" termination fee and lock-ups as being excessive or unprecedented was also misplaced because Delaware law does not "presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal."

More recently, in Apple's 2012 deal to acquire AuthenTec that grew out of initial discussions of a commercial and development arrangement, the target agreed to grant Apple an option to acquire a nonexclusive license to its sensor technology, exercisable whether or not the broader acquisition were to close, in exchange for an upfront option payment and additional future cash payments if Apple chose to license the technology. Presumably, granting one of the largest players in the electronics space a non-exclusive license to its technology could have the effect of making AuthenTec a less attractive target to potential topping bidders. Likely mindful of the close judicial scrutiny of this type of lock-up, the parties were careful to document the benefit of the option to AuthenTec as well as the fact that Apple insisted on the option as a condition to doing the acquisition. In its proxy statement, the AuthenTec board highlighted its belief that the option served an independent business purpose, and would be appealing to a potential competing bidder, because the license was non-exclusive and could bring in significant future payments from Apple as well as the reputational benefits of a relationship with Apple. Having chosen to commit to this acquisition as a means to advance its plans in this area, Apple likely justified its insistence on the option as a means of ensuring that it would have long-term access to the necessary technology in the fast-paced tech world irrespective of whether the wider deal closed.

A similar fact pattern appears to have played out in the recently announced acquisition of the NYSE by ICE. As part of the deal, the parties entered into a separate agreement whereby ICE was appointed the exclusive provider of certain clearing services for NYSE's leading European derivatives business whether or not the acquisition was completed. Notably, the clearing agreement is a standalone commercial arrangement as opposed to an option and was announced in a separate press release. Notwithstanding its potential deterrent effect on competing bidders, in their recently filed disclosure documents the parties explain the independent business purpose for the separate clearing agreement. The disclosure notes that the contemporaneous clearing services agreement addressed the risk that announcing a transaction with ICE would make it difficult for the NYSE to continue developing an internal clearing house, as customers and partners would likely be unwilling to invest the necessary funds and internal resources for a new NYSE clearing house when ICE would expect to shift clearing to its clearinghouse after closing of the merger. In post-announcement interviews, the NYSE CEO also highlighted that its prior failed merger with Deutsche Boerse had delayed NYSE's building of its own European clearinghouse, leaving residual commercial risk around NYSE's need for clearing services that had to be addressed regardless of the completion of the ICE merger.

Yet another twist on the traditional lock-up has been seen in a number of recent deals for financially strapped companies where the initial acquisition agreement is accompanied by some form of bridge loan or commitment. For example, the board of Complete Genomics believed that the company was likely headed for bankruptcy absent a sale transaction. Even with a signed merger agreement, the company may have lacked sufficient cash resources to fund its business until closing. At the signing of the merger agreement, the target also entered into a bridge loan with the buyer, BGI, that could, under certain circumstances, convert into a significant amount (22%) of Complete Genomics stock. In denying the plaintiffs' request to preliminarily enjoin the deal based in part on the alleged preclusive impact on competing bidders of this potentially large equity position for the first buyer, VC Laster noted in a bench ruling that the bridge loan "provided substantial benefit to Genomics in the form of much needed cash to get them through at least most of, and ideally all of … the transaction process and possibly a little bit beyond." (See also Sprint/Softbank transaction)

As with any other aspect of dealmaking, consideration of inclusion of a lock-up, especially of the crown jewel variety, should be with a careful eye to the specific facts on hand and overall deal dynamics. While there is little recent case law offering specific guidance, a number of general principles would seem to apply. Any lock-up mechanism is likely to be evaluated within the framework of the target's particular circumstances. What might pass muster for targets in "life-or-death" situations or in financial distress may not be advisable forms of deal protection in the ordinary course. Similarly, a contractual arrangement outside the four corners of the merger deal that may also have corollary deal-protection effects will be more defensible if the target has a demonstrable business purpose for, or benefit from, the separate arrangement. In addition, a contractual arrangement that truly stands on its own (i.e., is not merely an option triggered if a deal is topped) may be supportive evidence that the arrangement was not merely designed for its deterrent impact. While perhaps less intuitive, a lock-up also could be justified, notwithstanding its potential deterrent effect, by a particular need of the buyer – for example, if the buyer articulates a business justification for insisting on, as a condition to its willingness to do the deal, locking up a target asset or contractual arrangement (e.g., its foregoing other acquisition opportunities or business development efforts in light of pursuing the acquisition of the target).

After a long period of dormancy, lock-ups – "crown jewel" or otherwise – have seen a recent creative rebirth with some structural twists. What remains clear is that, absent extreme circumstances (such as Bear Stearns), an old-fashioned "crown jewel" asset lock-up that serves only to end an auction by virtue of its preclusive impact on other bidders will be subject to significant judicial scrutiny under basic *Revlon* and *Unocal* principles. However, a small sampling of recent case law, coupled with developing market practice, suggest that in appropriate circumstances there may be room in the dealmaking toolkit for modern and creative variations on traditional lock-up arrangements (more so where there is demonstrable business benefit to one or both parties beyond the resulting deal protection). It goes without saying that these lock-ups, even in their modern iterations, must be handled with care with ample discussion and documentation of the reasoning and justification for their implementation.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884

David B. Feirstein
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dfeirstein
+1 212-446-4861

Joshua M. Zachariah
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/jzachariah
+1 212-446-6450