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LOCKUPS AND DELAWARE VENUE IN CORPORATE LAW AND BANKRUPTCY

*David A. Skeel, Jr.**

Two of the most hotly contested corporate law issues in recent years have been the use of “lockup” provisions in takeovers and the question whether state competition to attract corporate charters is desirable, because it leads to a “race to the top,” or pernicious, because it induces a “race to the bottom.” The debate over lockups, which are provisions granted by a target that promise to compensate a bidder if their proposed sale falls through,¹ dates back to the rise of the takeover market in the mid 1980s. The charter competition debate goes back much further, although the current exchange was launched by William Cary’s 1974 article sharply criticizing Delaware’s preeminence in corporate law.² Both debates have inspired significant new contributions in the past year and neither shows any signs of subsiding.

Although each of these issues is distinctively corporate in nature, both have provoked similarly heated debate in bankruptcy. In the past decade, increasing use of lockup provisions by corporate debtors and Delaware’s new status as a favorite filing location for large corporate debtors have become two of the most controversial issues in bankruptcy practice and theory. The remarkable correlation between the concerns of corporate law and those of corporate bankruptcy is no accident. Rather than being somehow unrelated, corporate bankruptcy is an obvious extension of corporate law, and until the late 1930s, the two were treated as closely connected. Congress severed the connections by enacting sweeping reforms that ushered Wall Street bankers and lawyers out of corporate bankruptcy in 1938.³ The decades that followed can

* Professor of Law, University of Pennsylvania. I am grateful to Lynn LoPucki, Bob Rasmussen, Vice Chancellor Leo Strine and the participants in this symposium for helpful comments on an earlier draft.

1. Like other academic commentators, I use the term “lockup” broadly, to include any termination fee, stock option or option to purchase assets granted by the target firm to a bidder in connection with a proposed merger or tender offer. Courts and lawyers sometimes distinguish termination (or breakup) fees, on the one hand, from stock and asset options, on the other, and refer to only the latter as lockups.

2. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

3. Prior to the Chandler Act of 1938, the Wall Street investment bankers who had underwritten a corporate debtor’s securities, together with the bankers’ attorneys, played a central role in any large scale corporate reorganization. The Chandler Act’s new reorganization provisions, which were drafted by future Supreme Court Justice William Douglas and his staff at the Securities and Exchange Commission, dramatically altered the existing regime by mandating that the managers of a corporate debtor be replaced by an independent trustee. The Chandler Act also prohibited the debtor’s current bankers and lawyers from serving as trustee or trustee’s counsel. Because of these and other strictures, Wall Street quickly

be viewed as a slow process of restoring the prior links, and Delaware's sudden emergence as the leading bankruptcy court, together with the proliferation of lockups and other takeover devices in bankruptcy, illustrates just how far the process has come. For large firms, corporate bankruptcy now looks a great deal like corporate law.

Although the history is important, my goal in this Article is to advance the normative debate on the two issues I have mentioned—lockups and state competition for corporate charters. The first half of the Article weighs in on the role of lockup provisions. Corporate law commentators have adopted widely divergent views of the propriety of lockups, with several calling for courts to uphold all lockups and others proposing varying levels and kinds of scrutiny.⁴ To make sense of this debate, I show that the existing literature can be distilled to three central issues: 1) commentators' differing views on the larger corporate law controversy over managers' proper response to unsolicited takeover bids; 2) their views as to whether target managers can or will prove disloyal to shareholders' interests; and 3) their assumptions about the appropriate size of lockups—that is, how much compensation should be allowed. In describing the importance of these three issues, I develop and defend my own normative position. Because lockups can entice managers to accede to a change in control they might otherwise resist, I argue that courts should enforce both first and second bidder lockups. Courts should limit lockup bidders to their reliance interest, however, rather than allowing even larger lockups.⁵

Interestingly, the Delaware case law on lockups has evolved in a direction quite similar to the normative approach I defend. In an important recent case, *Brazen v. Bell Atlantic*,⁶ the Delaware Supreme Court analyzed the lockup in question in contractual terms, and outlined a reliance-like framework for scrutinizing future lockups. I argue that *Brazen* can and should serve as the touchstone for the next iteration of Delaware lockup jurisprudence.

disappeared from the corporate reorganization process. I discuss these developments at length in a book manuscript and several articles. See David A. Skeel, Jr., *The Rise and Dominion of Bankruptcy in America* (unpublished manuscript, 1999); David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075 (2000); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325 (1998).

4. Steve Fraidin and Jon Hanson have taken the position that courts should always enforce lockups. See Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1743 (1994). Their view and the debate as a whole are described in detail in Part I(A), *infra*.

5. I introduced the reliance damages perspective on lockups in David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564 (1996). Although my views have changed on some of the details, as will become clear in Part I, the lockup analysis in this Article should be seen as an extension and refinement of the earlier approach.

6. 695 A.2d 43 (Del. 1997).

I conclude the lockup analysis by considering the role of lockup provisions in bankruptcy. Although many courts and commentators have contended that bankruptcy calls for an entirely different approach to lockups, I argue that the extensive similarities between the two contexts suggest that courts should also apply a reliance-based approach in bankruptcy—though the approach should be tailored to reflect the nature of the bankruptcy decision making process.

The second half of the Article considers the longstanding state law charter competition debate. The analysis begins by describing the two traditional views: “race to the bottom” theorists insist that Delaware and other states cater to managers at the expense of shareholders, whereas “race to the top” theorists contend that market forces impel managers and states to take shareholder interests into account.⁷ Much of the most recent literature leans toward the race to the top view, but concludes that Delaware’s dominance enables it to favor local interests such as the Delaware bar. In assessing the literature, I emphasize the moral dimension in the Delaware case law, and show that many of the rules that benefit Delaware lawyers also further Delaware’s role as moral arbiter in corporate law.

Turning to corporate bankruptcy, I argue that Delaware’s increasingly prominent role in bankruptcy offers many of the same benefits as its preeminence in state corporate law. Because corporate bankruptcy is regulated by Congress rather than the states, the analogy is far from perfect. But the similarities make clear that the recent campaign to prohibit large corporate debtors from filing for bankruptcy in Delaware is misguided. Several recent commentators have challenged an earlier article of mine that defended Delaware’s popularity as a bankruptcy forum.⁸ I conclude by pointing out the problems in their critique.

I. LOCKUPS

As noted above, lockup arrangements take a variety of forms, including termination or breakup fees, stock options, and options to purchase specified assets. Lockups have long been an important feature

7. William Cary introduced the “race to the bottom” view, as noted above. Cary, *supra* note 2. Ralph Winter’s response to Cary initiated the “race to the top” literature. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). The debate is described in detail in Part II(A), *infra*.

8. See Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 972-73, 993-94, 996-97 (1999). The article Eisenberg and LoPucki respond to is David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 Del. L. Rev. 1 (1998).

of corporate acquisitions. As corporate law devices such as auctions and sales of assets have made their way into corporate bankruptcy, lockups have become increasingly important in this context as well.⁹ Although there are crucial differences, as we shall see, lockups are criticized and praised in very similar terms in the two contexts. Both in corporate law and in bankruptcy, courts and commentators worry that lockups will be used to further managers' interests at the expense of shareholders, or for other inappropriate purposes. Lockup advocates, by contrast, extol lockups as a device that helps firms to obtain higher prices for their assets in an auction or negotiated sale.

The analysis that follows explores the literature and case law on lockups in some detail. The analysis begins in corporate law, with the vibrant academic debate over the propriety of corporate lockups. After summarizing the new and previous literature and identifying the three issues that lie at the heart of the debate, I develop a reliance damages-based theory for determining whether and when lockups should be permitted. I then turn to the most recent Delaware lockup cases. Interestingly, the Delaware cases have taken an increasing interest in precisely the kinds of contractual considerations that my theory identifies.

The remainder of the part focuses on lockups in the bankruptcy context. As in the initial section, the bankruptcy analysis looks first at the existing literature, then turns to the most recent bankruptcy cases.

A. The Lockup Debate in Corporate Law Theory

The leading early articles on lockups emerged in connection with the literature on hostile takeovers, and reflected commentators' pervasive concerns about managers' resistance to takeover bids.¹⁰ The concern was (and is) quite simple. In the face of an unwanted takeover bid, the managers of the target frequently look for an alternative bidder, a "white knight" who may implicitly commit to protecting the managers' policies and jobs. Although the white knight strategy sometimes inspires a bidding contest and obtains a higher price for the target's shareholders, the target's managers can use a lockup both to chill the

9. Bankruptcy's reorganization provisions are set forth in Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-1174 (1994). Chapter 7 provides the framework for liquidating a corporation, 11 U.S.C. §§ 701-766 (1994). Provisions of the Bankruptcy Code, 11 U.S.C. §§ 101-1330 (1994) will be cited hereafter as "Bankruptcy Code § ____."

10. See Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 323-32 (1990); Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 377-78 (1987).

bidding and to assure that the white knight wins.¹¹ By agreeing to pay a large termination fee or to sell stock or important assets at a below market price if the white knight loses, the target's managers can reduce the target firm's value for an unwanted bidder. Target managers can use the same strategy even in the absence of a hostile bidder. When a target firm enters into a consensual merger agreement with a friendly bidder, its managers may grant a lockup in order to discourage any would-be hostile bidders from interfering with the friendly arrangement. Thus, target managers can use lockups to fend off both actual and hypothetical hostile bidders.

The most obvious way to prevent managers from using lockups to discourage unwanted bidders would be to prohibit them altogether. But lockup arrangements are not always pernicious. In addition to serving as a defensive mechanism, lockups also can be used for such benign purposes as enticing a bidder to increase its bid.

The initial lockup articles searched for ways to permit beneficial lockups while prohibiting the malignant ones. The most prominent suggestion came from Stephen Bainbridge, who proposed a bright line test: courts should strike down any lockup that was worth more than ten percent of the target firm's value, but uphold any lockup in a lesser amount.¹² Two other commentators argued that lockups should be subject to a vote by the target's shareholders.¹³

The second generation of lockup analysis was inspired by a simple but elegant insight by Ian Ayres. Although courts and commentators previously had assumed that lockups affected only the unfortunate, "locked out" bidder, Ayres showed that lockups have precisely the same effect on the favored, "lockup" bidder.¹⁴ Lockups reduce the amount both bidders are willing to bid, and therefore will not ordinarily affect which bidder wins a bidding contest.¹⁵

Consider a simple illustration. Assume that Friendly bidder values the Target at \$675,000, while Hostile would be willing to pay as much as \$700,000. If Target's managers gave Friendly a \$75,000 lockup in return for a bid of \$600,000, the lockup would reduce the value of Target to Hostile by \$75,000, since this amount would be paid to Friendly in the event that Hostile won the bidding. Thus, Hostile would

11. The "poster child" for these concerns was *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), a Delaware Supreme Court decision that condemned the efforts of a target's board to favor a white knight.

12. See Bainbridge, *supra* note 10, at 327-32.

13. See Johnson & Siegel, *supra* note 10, at 411-13.

14. Ian Ayres, *Analyzing Stock Lock-ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 685-94 (1990).

15. See *id.* at 695.

refuse to pay more than \$625,000 for Target.¹⁶ Yet the lockup would also lower Friendly's reservation price by \$75,000. Because the lockup assures Friendly a \$75,000 profit if another bidder wins, Friendly would rather lose the bidding than pay more than \$600,000, the bid that would assure Friendly the same \$75,000 profit. As a result, Hostile would acquire Target by bidding slightly more than \$600,000. Even with the lockup, the highest valuing bidder would still win.

Although lockups generally should not alter the outcome of a bidding contest, Ayres identified one important exception to this rule. A lockup that promises the lockup bidder more than its expected profit (a "foreclosing" lockup, in Ayres' terminology), can enable a lower valuing bidder to outbid a superior bidder.¹⁷ If Target's managers gave Friendly a \$125,000 lockup in return for a \$600,000 bid, for instance, the lockup would stymie Hostile. In the face of the \$125,000 obligation, Hostile would not be willing to pay more than \$575,000 for Target. Friendly would therefore win the bidding at \$600,000, even though Hostile was the higher valuing bidder. Based on this concern, Ayres concluded that courts should invalidate foreclosing lockups, but uphold lockups in every other circumstance.¹⁸

Starting from Ayres' insight that lockups are not nearly so pernicious as often thought, Fraidin and Hanson pushed this perspective to its logical conclusion. Even a so-called "foreclosing" lockup, they pointed out, might not actually prevent the superior bidder from winning.¹⁹ If Hostile valued Target at \$750,000, for instance, it would outbid Friendly even in the face of Friendly's \$600,000 bid and \$125,000 lockup by making a bid of slightly more than \$725,000. More importantly, the Coase theorem suggests that, no matter who won the initial bidding, the higher valuing bidder could eventually wind up with Target. If Friendly won the bidding, but Target was more valuable to Hostile, Hostile would strike a deal with Friendly to acquire Target through a post auction sale.²⁰ According to this reasoning, lockups will never interfere with the allocationally efficient disposition of the target's

16. A bid of \$625,000, plus the obligation to pay Friendly \$75,000 if Friendly lost the bidding, would total \$700,000, which is Hostile's "reservation price." If Hostile paid any more than this, it would lose money on the transaction.

17. See Ayres, *supra* note 14, at 699-700.

18. *Id.* at 704. Although subsequent commentators have assumed that foreclosing lockups are rare, John Coates and Guhan Subramanian point out in a new article that lockups may often prove foreclosing, due to the relatively low profits bidders receive in many transactions. John C. Coates & Guhan Subramanian, *A Buy-Side Model of Lockups: Theory and Evidence*, STAN. L. REV. (forthcoming 2000).

19. Fraidin & Hanson, *supra* note 4, at 1774-75.

20. See *id.* at 1788-94; *id.* at 1789 ("This portion of our analysis of lockups replicates the basic lesson of the Coase Theorem, which holds that so long as contracting costs are not prohibitive, parties will contract to the same allocation of resources no matter the legal rule and no matter their initial allocation.")

assets. Given that “lockups, like chicken soup, can’t hurt but may well help,” Fraidin and Hanson proclaimed that courts should uphold nearly every lockup.²¹

In response to this paean to lockups, several commentators pointed out flaws in Fraidin and Hanson’s reasoning and offered alternative approaches that comprise the third (and current) generation of lockup analysis.²² An earlier article of mine questioned Fraidin and Hanson’s Coasian assumption that the highest valuing bidder would always end up with the target. Because bargaining can break down for a variety of reasons, bidders will not always transact around an excessive lockup that gives a lower valuing bidder control of the target firm.²³ Rather than simply upholding all lockups, I argued that courts should analyze lockup arrangements in contractual terms. Although lockups resemble liquidated damages provisions in crucial respects, the contractual analysis suggests that courts should rarely if ever award expectation damages, as they do with other liquidated damages provisions. For several reasons, including the absence of specific, alternative opportunities for most bidders and risk of target manager disloyalty, courts should limit lockup bidders to their reliance damages.²⁴

Whereas my article emphasized the effects of a lockup on post-lockup events, Marcel Kahan and Michael Klausner pointed out that lockups can influence whether a higher valuing bidder enters the bidding in the first instance. If a higher valuing bidder’s costs are as high as its expected profits in a bidding contest, for instance, it will stay out of the bidding altogether unless the target managers subsidize the higher bidder’s entry by granting it a lockup.²⁵ Because lockups can influence who does or does not make a bid, an obvious concern is that target managers will use lockups to discourage unwanted bidders and dampen the market for corporate control. In order to limit the pernicious effects of lockups, Kahan and Klausner proposed to distinguish among three different types of lockup. In their view, courts should closely scrutinize both “anticipatory” lockups—lockups granted to a favored bidder in anticipation of a bid from an unwanted bidder—and “second bidder”

21. *Id.* at 1745.

22. This depends on how one counts “generations.” Although I treat the most recent contributions to the literature as part of the third generation, they could also be seen as a new, fourth wave.

23. See Skeel, *supra* note 5, at 580-84.

24. See *id.* at 595-601. I develop this analysis further in Part I(A)(3), *infra*.

25. See Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1548-49 (1996). Kahan and Klausner illustrate this point numerically. If one bidder values the target at \$780 million, a second, higher valuing bidder who expects to incur \$30 million in bidding costs will not bid unless it values the firm at more than \$810 million—enough to cover its expected costs. See *id.* at 1548.

lockups—lockups used to induce a second bidder to enter the bidding after an unwanted bidder has already commenced the bidding.²⁶ Only “nonanticipatory first bidder” lockups, which target managers give to a bidder in the absence of any evidence of a second, unwanted bidder, should be subject to more deferential review under the business judgment rule.²⁷

Two recent contributions to the lockup debate have offered additional support for the conclusions I and Kahan and Klausner reached several years ago. A new, doctrinally oriented article contends, as did my earlier analysis, that courts should give greater attention to the contractual nature of lockups and reach similar conclusions. Drawing on contract and trust law doctrines that decline to enforce contractual expectations under some circumstances, but award reliance damages to parties that had no reason to know the contract was unenforceable, the article contends that courts should adopt a similar approach to lockups—an approach that considers the lockup bidder’s contractual rights, rather than just the target manager’s fiduciary duties.²⁸ Another new article uses auction theory to defend the distinction—first emphasized by Kahan and Klausner—between first and second bidder lockups. Based on the assumption that auctions reduce the profits of an initial takeover bidder and thus undermine their incentive to search for attractive targets, this article concludes that first bidder lockups (which discourage auctions) should be permitted, but courts should prohibit second bidder lockups (which create auctions).²⁹

26. See *id.* at 1564-65 (“[S]econd-bidder and anticipatory lockups warrant close judicial scrutiny.”).

27. See *id.* at 1565.

28. Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lockups*, 21 CARDOZO L. REV. 1 (1999). Regan argues that courts should consider four factors when determining whether to enforce a lockup: 1) whether the lockup bidder knew or should have known that the target managers breached their fiduciary duty in connection with the proposed agreement; 2) whether the agreement had already been performed or was wholly executory; 3) whether any fairness concerns implicated by target managers’ breach are based on strong policy commitments; 4) whether reliance damages are available in the event the lockup bidder is an innocent party. Although his exploration of contract and trust law provides doctrinal support for a reliance-based approach, Regan’s analysis differs from my reliance theory in its greater willingness to invalidate lockups altogether—that is, to deny a lockup bidder even its reliance interest. Regan’s analysis also has several limitations as a source of doctrinal guidance. First, the fiduciary duty inquiry in the first and third factors is somewhat circular: it may not be clear whether the target board has breached its fiduciary duty or not, or how strong the fairness concern is, until the Delaware Chancery Court has assessed the board’s performance. This, of course, is precisely the assessment that the four factors are intended to inform. Second, most of the contract and trust doctrines Regan identifies, such as courts’ unwillingness to enforce contracts made with an underage or incompetent promisor, are narrow exceptions to a general policy of enforcement. The general enforceability of lockups, by contrast, is much more in question.

29. Kermit Roosevelt, *Understanding Lockups: Effects in Bankruptcy and the Market for Corporate Control*, 17 YALE J. ON REGUL. 93 (2000).

What are we to make of this burgeoning literature on lockups (not to mention the equally vibrant case law, which we will explore in a moment)? As diverse and at times complex as the literature is, the debate can be distilled to three crucial issues: 1) whether courts should focus on maximizing value from an ex ante or an ex post perspective by promoting passivity or auctions, respectively; 2) whether target managers can or will use lockups for disloyal purposes; and 3) what the appropriate measure of lockup "damages" should be. The first two issues implicate the longstanding debate about takeover defenses and the proper role of target managers, and the third focuses more narrowly on lockups. By exploring each of these issues, we can arbitrate among the existing approaches and develop a more compelling explanation of the role of lockups in corporate law.

1. Ex Ante (Passivity) vs. Ex Post (Auction) Perspectives

The first question, whether courts should focus on maximizing value ex ante or ex post, was inspired by Easterbrook and Fischel's so-called "passivity thesis" concerning target manager's appropriate response to unsolicited takeover bids.³⁰ Prior commentators had tended to assume that auctioning a target corporation to the highest bidder was the best outcome for the shareholders of target firms, since it would lead to higher bids. Easterbrook and Fischel challenged this reasoning. They pointed out that by forcing the initial bidder to pay more for the target corporation or even lose the bidding altogether, auctions reduce a bidder's expected profits. Potential bidders will therefore engage in less search in an auction regime than they would in a world that promised a greater return on their investment. Once a bid has been made—ex post—shareholders do better if the target's managers conduct an auction; but from an ex ante perspective, shareholders should prefer a regime that offers higher returns to initial bidders, since a bidder-friendly regime leads to more takeover activity (as well as a greater deterrent effect on managers). On balance, Easterbrook and Fischel argue, shareholders benefit more from a world with more takeovers at somewhat lower prices, than they would with fewer takeovers at higher prices. Rather than resisting takeovers, target managers should be

30. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). Easterbrook & Fischel elaborated on their initial analysis in Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982). Alan Schwartz subsequently seconded their view. Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229 (1986).

required to take a passive stance, and submit every bid directly to the target's shareholders.

Overlapping in many respects with the distinction between *ex ante* and *ex post* perspectives is the question whether to maximize shareholder value or social value. In some cases, a regime that maximizes shareholder value may not be optimal if we consider the effect on every affected party—that is, its overall social value. Easterbrook and Fischel contend that their passivity regime maximizes social value as well as shareholder value, since a vibrant takeover market encourages managers to run their firms efficiently and increases the likelihood that inefficient firms will be taken over.³¹

In response to Easterbrook and Fischel, several commentators insisted that takeover auctions, rather than passivity, maximize both shareholder and social wealth.³² Although auctions reduce the expected returns to initial bidders, these commentators argued that active bidding assures that the target will be sold to the highest valuing bidder. Moreover, initial bidder search may be adequate even in an auction regime, in part because bidders can assure themselves a profit by buying target stock before making a bid.³³

The two different perspectives imply differing views about whether and when lockups are appropriate. If we ignore for a moment the possibility of target manager disloyalty, Easterbrook and Fischel's passivity view suggests that courts should welcome lockups to initial bidders. First bidder lockups can encourage an initial bid, and the

31. Easterbrook & Fischel's argument that passivity maximizes shareholder value overall focuses on the shareholders as a collective—that is, all the shareholders of all firms. Once a firm has received a takeover bid (that is, *ex post*), the shareholders of that particular firm are likely to receive a higher price for their shares if managers encourage active bidding. The Delaware cases have tended to focus on this *ex post* shareholder perspective.

32. Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) [hereinafter *Facilitating Competing Tender Offers*]; Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter *A Reply and Extension*]; Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982). Bebchuk and Gilson contended that auctions maximize both shareholder and social value, much as Easterbrook and Fischel viewed passivity as superior on both counts.

33. In his contribution to the debate, Alan Schwartz emphasized that a bidder's profits (and thus the incentive to search) will always be higher if it acquires the firm, since this enables the bidder to profit from at least 50% of the firm's shares, rather than from a smaller, minority stake. Schwartz, *supra* note 30, at 237.

Roosevelt, following Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27 (1991), points out that a negotiated merger may even lead to a higher price for shareholders *ex post* if the target's assets have the same value for all potential bidders—that is, if the assets are "common value." Target firms seem more likely to have bidder-specific values, however, since bidders may have different synergies or different management plans. In the "independent values" context, auctions ordinarily obtain more value for shareholders *ex post*. See, e.g., Roosevelt, *supra* note 29, at 117-118.

lockup may under some circumstances reduce the likelihood that a second bidder will emerge and bid up the price that must be paid for the target.³⁴ Second bidder lockups, on the other hand, bring an additional bidder into the picture and should therefore be prohibited. In contrast to Easterbrook and Fischel, auction enthusiasts should be more sympathetic to second bidder lockups, since they favor a regime that encourages active bidding. First bidder lockups are problematic from this perspective if they discourage additional bidding, but desirable if they induce an initial bid.

2. Can Target Managers Use Lockups Disloyally?

In addition to the distinction between passivity and auctions, a second crucial issue is whether target managers can use lockups disloyally. As we add disloyalty to the picture, the analysis will both describe the existing literature and begin more explicitly to develop my own normative view.

Simply put, there are two camps on the disloyalty issue, those who conclude that managers cannot use lockups to further their own purposes, and those who view disloyalty as a serious concern. Fraidin and Hanson insist that target managers cannot use lockups disloyally. Not only do many managers have a significant stock interest, which encourages them to act in shareholders' interests, but they cannot successfully serve their own interests at the expense of target shareholders as a group because a bidder that protected disloyal managers would lose out to bidders who sought to run the firm in a more efficient manner.³⁵ Based on their assumption that managers act loyally, Fraidin and Hanson conclude that courts should uphold both first and second bidder lockups.

Notice that Fraidin and Hanson's support for second as well as first bidder lockups implies that they favor auctions rather than strict adherence to Easterbrook and Fischel's passivity approach.³⁶ In a full enforcement regime where managers cannot act disloyally, the

34. This reasoning lies at the heart of Roosevelt's lockup analysis. Roosevelt, *supra* note 29, at 119.

35. See Fraidin & Hanson, *supra* note 4, at 1788. Roosevelt shares Fraidin and Hanson's view that managers cannot act disloyally. See Roosevelt, *supra* note 29, at 106.

36. In other respects, Fraidin and Hanson's stance more closely accords with the passivity view. Like Easterbrook and Fischel, they contend that Coasian bargaining will assure that the highest valuing bidder ultimately acquires the target, even if a lower valuing bidder prevails in the first instance. But, as noted in the text, they defend second bidder lockups, which often lead to auctions; and much of their analysis seems to assume that shareholders have an interest in maximizing value *ex post*. For a discussion and critique of Fraidin and Hanson's support for second bidder lockups, see Kahan & Klausner, *supra* note 25, at 1551-52 n. 37.

managers may use second bidder lockups to spur additional bidding. In fact, loyal managers have an incentive, once the bidding has begun, to do precisely this in order to maximize value for shareholders *ex post*, even if auctions are suboptimal from an *ex ante* perspective. A commentator who believes both that auctions are inefficient and that managers cannot act disloyally should advise courts to permit first bidder lockups but prohibit second bidder lockups, as Roosevelt does in his recent analysis of lockups. In effect, the prohibition on second bidder lockups serves as a precommitment by managers not to create an auction.³⁷

The obvious problem with each of these views is that the claim that managers always act loyally is implausible. In some (and perhaps many) cases, target managers may grant a lockup that is large enough to enable a lower valuing bidder to acquire the target.³⁸ Alternatively, target managers sometimes can tilt the playing field enough—through differential access to information, for instance—to allow a lower valuing bidder to win.³⁹ At least as important, and of particular interest for present purposes, is managerial disloyalty that brings a higher valuing bidder into the contest.⁴⁰

Consider a simple illustration. Hostile values Target at \$675,000, and makes a hostile bid of \$600,000. Rather than accede to the bid, Target's managers look for and find an alternative bidder, Friendly, who values Target at \$700,000. In return for an implicit promise that Friendly will treat the managers well (by, for instance, preserving their jobs or offering an attractive severance package), Target's managers grant Friendly a \$20,000 lockup when Friendly bids. Although the lockup does not change the bidders' *relative* valuations, it does reduce the amount that Friendly must pay to acquire Target. Without the lockup, Friendly would win the bidding by offering (slightly more than)

37. Prohibiting second bidder lockups can thus be seen as responding to a collective action problem. Loyal managers, on this view, would prefer that all firms commit *ex ante* to forego second bidder lockups in order to maximize the benefits of takeovers. Once a target firm receives a bid, however, loyal target managers have an incentive to defect, and to generate competing bids so that they can obtain a higher price *ex post*. Prohibiting second bidder lockups would make defection somewhat more difficult.

38. This is the foreclosing lockup identified by Ayres—a lockup that exceeds the lockup bidder's expectation interest and which, as a result, may fend off even higher valuing bidders. Ayres, *supra* note 14, at 699-700. See also Coates & Subramanian, *supra* note 18 (arguing that lockups may often have a foreclosing effect).

39. For a discussion of reasons that even "loyal" target managers may grant excessive lockups, see Skeel, *supra* note 5, at 575-80 (considering mistake and bargaining power differences).

40. Fraidin and Hanson would not treat such behavior as managerial disloyalty, since its effect is to bring in a higher valuing bidder. See, e.g., Fraidin & Hanson, *supra* note 4, at 1809. Kahan and Klausner, by contrast, identify several reasons for characterizing these kinds of lockups as disloyal, as I discuss in the text below. See, e.g., Kahan & Klausner, *supra* note 25, at 1561-62.

\$675,000. With the lockup, Friendly need only bid (slightly more than) \$655,000, since Hostile will not pay more than \$675,000 (the \$655,000 bid, plus the \$20,000 lockup to Friendly). So long as the implicit side payment to Target's managers costs Friendly less than \$20,000, both Friendly and Target's managers benefit from the managers' disloyalty.

Notice that, under these conditions, Target managers' disloyalty also can be seen as benefitting Target's shareholders *ex post*. If Target's managers had simply accepted Hostile's bid, the shareholders would have received only \$600,000. The Target managers' disloyal arrangement with Friendly brought Friendly into the bidding and increased the final purchase price to \$655,000. Although an auction enthusiast might welcome this result, the outcome is troubling for a passivity theorist. To see why, we will focus on several concerns highlighted by Marcel Kahan and Michael Klausner. We then will return to the auction perspective.

Drawing on the Easterbrook and Fischel insights, Kahan and Klausner emphasize two adverse effects of disloyal lockups on the takeover market. First, disloyal lockups undermine potential bidders' incentives to search.⁴¹ Because bidders like Hostile may lose the target, as in my example, and must pay more even if they win, disloyal lockups reduce their reward for discovering suitable targets. Second, by giving Target managers a way to cut themselves a deal, these lockups impair the disciplinary effect of the takeover market on managers.⁴² Although the illustration involved a second bidder lockup, first bidder lockups can be equally pernicious. Managers who know an unwanted bid is coming can try to preempt the hostile bid by offering a first bidder lockup to a friendly bidder.

To address these concerns, Kahan and Klausner propose the three-fold typology of lockups noted earlier.⁴³ They call for searching scrutiny of second bidder lockups and preemptive first bidder lockups of the sort I have just described, which they call "anticipatory" lockups. Only the third category of lockups, "nonanticipatory first bidder" lockups, escape their condemnation.⁴⁴ Target managers who give nonanticipatory first bidder lockups are not trying to thwart an unwanted bidder. Because these lockups may encourage a bidder to bid and do not interfere with the market for corporate control, Kahan and Klausner believe that courts should generally uphold them.

41. See Kahan & Klausner, *supra* note 25, at 1552-59.

42. See *id.* at 1559-62.

43. See *supra* notes 26-27.

44. See Kahan & Klausner, *supra* note 25, at 1564-65 (close scrutiny of second bidder and anticipatory lockups but not nonanticipatory lockups).

The three-fold typology is an important advance in our understanding of lockups, but it also suffers from two significant limitations. The first is an obvious line-drawing problem. The typology assumes that courts can easily distinguish between anticipatory and nonanticipatory first bidder lockups. Yet many lockups fall in the hazy middle ground between these two categories. A lockup granted after an unwanted bidder clearly signals its intention to make a bid is anticipatory, but the issue becomes less clear if the potential bidder has simply indicated a general level of interest. Similarly, if target managers know that their firm is likely to be subject to an unwanted takeover bid, and enter into a lockup arrangement at a time when the writing is on the wall, but no specific hostile bidder has emerged, the lockup would apparently qualify as nonanticipatory.⁴⁵ Yet the prospect of such lockups may discourage search and enable target managers to insulate themselves from the disciplinary effects of a takeover, much as a truly anticipatory lockup does.

More importantly, the typology assumes that anticipatory and second bidder lockups are invariably undesirable.⁴⁶ Yet even disloyal lockups have benefits that may outweigh their undesirable effects. Under existing law, target managers have a wide variety of devices for resisting takeovers, including takeover defenses such as poison pills as well as state antitakeover laws. Although lockups can be used defensively, too, they differ in one crucial respect from other defenses. By granting a lockup, target managers relinquish their independence, since lockups are used in connection with mergers and related transactions. Rather than keeping all bidders out, as other defenses often do, lockups let one bidder in. If the ability to use a lockup encourages target managers to accede to a change in control, and if the managers might otherwise have resisted all bidders by "just saying no,"⁴⁷ even disloyal lockups may serve

45. The recent Warner Lambert takeover battle can be used to illustrate the difficulty. Negotiations between Warner Lambert and American Home Products were well underway, but the parties had not reached a final agreement, when Pfizer announced an intention to make a bid for Warner Lambert. Shortly thereafter, Warner Lambert and American Home Products signed a preliminary merger agreement that included a \$1.8 billion termination fee. See, e.g., *After P&G, What's Next in Pfizer War*, WALL ST. J., Jan. 27, 2000, at C1. Under the three-fold typology, this termination fee would presumably qualify as anticipatory, given Pfizer's intent to bid. If Pfizer had been less explicit about its intentions, however, or Pfizer were not yet prepared to make a serious bid, the distinction between anticipatory and nonanticipatory would be quite murky. Notice, too, that a potential bidder would have a strategic incentive to announce an interest in order to destabilize the target's intended agreement with another bidder.

46. Rather than calling for blanket prohibition, Kahan and Klausner provide a multifactor test for determining whether these lockups should be struck down. See Kahan & Klausner, *supra* note 25, at 1564-68. But they seem to envision that nearly all will be invalidated.

47. For a prominent article contending that Delaware permits managers to "just say no," see Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993). I describe the significance of this possibility in more detail below.

a beneficial function. In effect, lockups may “bribe” target managers to agree to a change in control they would otherwise resist.⁴⁸

If target managers truly had the power to “just say no” under current law, the argument for permitting (at least some) disloyal lockups to entice target managers to relinquish control would be especially strong.⁴⁹ The reality is more complex, however. Although target managers can resist nearly any bid so long as they remain in power, hostile bidders can wage a proxy fight in an effort to replace the incumbent directors. After a successful proxy fight, the hostile bidder can effect a takeover. Added to the threat of a proxy fight is the possibility that institutional shareholders may pressure the target’s managers to agree to a takeover.

The question, then, is whether the possibility of a proxy fight frees up the market for control enough to make anticipatory and second bidder lockups unnecessary. In my view, it does not. The proxy contest alternative is an expensive and time-consuming mechanism for obtaining control. Moreover, if the target firm has a staggered board whose members can only be removed for cause, it may be impossible to replace a majority of the board’s directors in a single proxy fight. The prospect of target resistance and the limitations of a hostile bidder’s alternatives suggests that even potentially disloyal lockups may play a desirable role.⁵⁰

If we shift from Kahan and Klausner—who draw most directly from the *ex ante*, passivity perspective—to the views of an auction enthusiast who concedes the possibility of managerial disloyalty, the case for permitting both anticipatory and second bidder lockups (at least in some cases) becomes still stronger. We have already seen the most important benefit of “disloyal” lockups: they require target managers to agree to a change of control transaction. Interestingly, and of particular importance for auction enthusiasts, the lockup strategy gives the

48. I discuss lockups’ role in enticing target managers to relinquish control at greater length in another article. See David A. Skeel, Jr., *Lockups, Agency Costs and Remedies in Corporate Law* (unpublished manuscript, 1996); see also Roosevelt, *supra* note 29, at 109 (noting that lockups are ineffective as an entrenchment device). See also Fraidin & Hanson, *supra* note 4, at 1827, 1831 (“[T]he board loses much of its control ... when the board agrees to sell the target.”).

49. Among lockup commentators, Fraidin and Hanson suggest that Delaware does indeed permit target managers to “just say no.” See Fraidin & Hanson, *supra* note 4, at 1827 n.344. Kahan & Klausner reject this view, largely for the reasons noted in the text that follows. See Kahan & Klausner, *supra* note 25, at 1551-52 n.37. A federal judge in Delaware has held that Delaware does recognize “just say no” as a defense, but the Delaware state courts have not explicitly addressed the issue. My own view, as suggested below, is that target managers have significant but not unlimited ability to resist takeovers.

50. Interestingly, if one were to conclude that proxy contests and other pressures do obviate the need to allow anticipatory or second bidder lockups, the most plausible solution might be to prohibit all lockups. Given the difficulty of distinguishing anticipatory from nonanticipatory lockups, there is a strong case for adopting a blanket prohibition. Alan Schwartz’s early hostility to lockups seems to reflect an analogous intuition. See Schwartz, *supra* note 30, at 238.

managers a powerful incentive to search for the highest valuing bidder. Disloyal managers may sometimes help a preferred, lower valuing bidder to acquire the target, as noted earlier. But the target managers' only sure path to success is to find a higher valuing, friendly bidder.

In the earlier illustration, for instance, Friendly won the bidding because it placed a higher value on Target (\$700,000) than Hostile did (\$675,000).⁵¹ As noted earlier, Target's managers and Friendly both benefit so long as the managerial protections are worth up to \$20,000 and Target's shareholders benefit from the higher takeover premium. In short, for an auction enthusiast, concerns about managers disloyalty are counterbalanced by the facts that lockups encourage Target's managers both to relinquish the firm's independence and to find a higher valuing bidder.

To summarize, the possibility of managerial disloyalty complicates the lockup analysis in intriguing respects. From an *ex ante*, passivity perspective, both anticipatory and second bidder lockups are problematic, since they may introduce an additional bidder and thus undermine an initial bidder's returns from search. Yet, because they force target managers to relinquish their independence, lockups also offer countervailing benefits. The question for proponents of passivity, then, is whether lockups' value as an enticement to target managers outweighs the chilling effect they have on bidder search.

For auction enthusiasts, the benefits of lockups are both straightforward and compelling. To the extent lockups promote bidding and encourage target managers to sleuth out the highest valuing bidder, they help to achieve the principal benefits of an auction regime. Lockups should thus be especially attractive to auction theorists, at least to the extent they are appropriately constrained.

In a moment, we will consider how lockup compensation, the last of the three factors, can be used to provide appropriate constraints. But first we should briefly address the most recent academic perspective on the lockup issue.

As our discussion of target manager disloyalty suggests, much of the existing commentary has focused on agency costs and other distortions facing *target* firms. In a new article, John Coates and Guhan Subramanian contend that a variety of distortions may affect *bidder* decision making. Included in their account are bidder agency costs; information effects (a lockup increases the information that a lockup bidder can derive from a second bidder's bid); switching costs; reputational effects (a lockup bidder may have a reputational stake in

51. See *supra* text following note 40.

winning the bidding); and endowment effects.⁵² In their view, lockups have an asymmetric effect because of these buy-side distortions. Whereas lockups decrease an alternative bidder's willingness to bid, buy-side distortions cause the lockup bidder to ignore the value of the lockup and to continue bidding. Coates and Subramanian thus add another set of explanations as to how lockups may tilt the deck in favor of a lockup bidder.

The extent to which these behavioral effects alter the existing accounts of lockups is unclear, however.⁵³ Two important caveats are in order. First, the buy-side distortions may cancel out if the other, "locked out" bidder is subject to some of the same distortions as the lockup bidder. In a rapidly consolidating industry, for instance, agency costs and reputational effects may significantly alter the decision making of the locked out bidder.⁵⁴ Second, Coates and Subramanian seem to focus on cases in which target managers grant a lockup to the first bidder. The recipient of a second bidder lockup seems less likely to face the kinds of distortions that Coates and Subramanian identify.

3. Lockup Damages: Reliance vs. Expectation

As with their differing views on the passivity-versus-auction debate and the likelihood of disloyal lockups, commentators also have sharply diverged in their conclusions about the appropriate size of lockups. Several commentators have argued that a bidder's lockup should be based on some component of the bidder's costs, either its total pre- and post-bid costs, or solely its post bid costs.⁵⁵ Others, notably the second generation theorists, have suggested that courts should focus on the bidder's expected profits—its expectation interest, in contract damages terms.⁵⁶ In their apologia for lockups, Fraidin and Hanson defend even supra-expectancy lockups.⁵⁷

52. See Coates & Subramanian, *supra* note 18, at 40-49.

53. Coates and Subramanian provide empirical evidence suggesting that bidders that receive lockups are much more likely to win the bidding. As they recognize, however, it is not clear whether lockups increase a bidder's likelihood of success, or whether target managers tend to give lockups to bidders who are likely to win. See *id.* at 60.

54. In the recent contest to acquire Warner Lambert, for instance, Pfizer had at least as great a reputational stake (and agency costs) in winning as did American Home Products, the bidder that received the lockup.

55. See Kahan & Klausner, *supra* note 25, at 1565 ("If the value of a lockup exceeds a reasonable estimate of the lockup bidder's costs of bidding, the lockup should be invalidated."). Kahan and Klausner apparently would permit larger lockups if the lockup is nonanticipatory. See *id.* (proposing close scrutiny and compensation limits only for second bidder and anticipatory lockups).

56. See Ayres, *supra* note 14, at 699-703.

57. See, e.g., Fraidin & Hanson, *supra* note 4, at 1782, 1827-28.

Consider first the view of passivity proponents who do not believe lockups can be used disloyally.⁵⁸ Such theorists would not impose any restrictions on the size of a first bidder lockup: the larger the better, in fact, since a large lockup might discourage additional bids and thus maximize the initial bidder's returns from search. From this perspective, large first bidder lockups are attractive because they reduce the likelihood of an auction. (Second bidder lockups, of course, should be prohibited because they have the opposite effect).⁵⁹

Once we take the possibility of disloyalty into account, however, permitting unlimited first bidder lockups proves more problematic. Because anticipatory first bidder lockups undermine bidder returns and the market for corporate control, they should be prohibited if possible. The distinction between anticipatory and nonanticipatory first bidder lockups might suggest that all nonanticipatory first bidder lockups should be enforced, no matter how large.⁶⁰ But, as we have seen, it may often be difficult to distinguish between anticipatory and nonanticipatory first bidder lockups, which suggests that courts should be hesitant about approving large lockups.

Doctrinal considerations raise additional concerns about expectation and supraexpectancy lockups. From a structural perspective, directors can propose a merger or related transaction, but shareholders are entitled to make the final decision whether or not to permit the transaction to go forward.⁶¹ An expectancy or supracompensatory lockup stands in tension with the principle of shareholder authority, since it promises to pay the lockup bidder its expectation damages if the lockup bidder is outbid by another bidder. In effect, such lockups promise to treat the lockup bidder as if the merger were approved, even if it is not.⁶² To be sure, expectancy lockups are not a precise substitute for a completed contract. Some lockup provisions only require the target to compensate the lockup bidder if the target enters into an alternative transaction before the lockup expires, for instance. But the potential for interference with shareholders' role in corporate decision

58. Roosevelt is the commentator who takes this perspective most consistently. See Roosevelt, *supra* note 29, at 106.

59. An auction theorist who believes that target managers cannot or will not act disloyally would uphold both first and second bidder lockups, since both can be used to stimulate bidding. Fraidin and Hanson adopt something like this view, though their analysis deviates from that of the auction theorists in some respects. See *supra* note 36.

60. This seems to be Kahan and Klausner's view, although they leave open the possibility that courts might sometimes strike down a nonanticipatory lockup under business judgment rule scrutiny. See Kahan & Klausner, *supra* note 25, at 1565.

61. See, e.g., DEL. CODE ANN. tit. 8, § 251 (Supp. 1998) (requiring shareholder approval of merger).

62. See Skeel, *supra* note 5, at 584-86 (discussing structural or "process" concerns).

making suggests the need for a different, lesser yardstick for measuring lockup compensation. The conflict is especially stark with supraexpectancy lockups, because they may foreclose another, higher valuing bidder.

As I have argued at length elsewhere, a reliance-based approach is the most plausible candidate for determining lockup compensation.⁶³ Limiting the lockup bidder to its reliance interest reduces the pernicious effects of disloyal lockups, by making it far more difficult to use the lockup to deter other bidders and by limiting the size of the fund that can be used for implicit side payments to the target's managers. At the same time, the reliance approach preserves the most important benefits of lockups. A reliance-based lockup should be large enough to induce bidders to make a bid, and it also encourages otherwise reluctant managers to give up the target's independence. This reasoning suggests that both first and second bidder lockups should be presumptively enforced up to the amount of a bidder's reliance interest.

Interestingly, although I have argued that lockup bidders should not receive the same entitlements as the promisee in a completed contract, analogizing lockups to liquidated damages provisions in traditional contexts reinforces the case for a reliance-based approach. The traditional view that contractual promisees should receive their expectancy interest is based in part on the assumption that the promisee gave up the opportunity to secure identical profits in connection with another contract when it entered into the contract in question.⁶⁴ In the lockup context, the lockup bidder often does not have identical, or even similar alternative opportunities. If there were no similar opportunities in prospect, the argument for compensating the lockup bidder for anticipated profits on foregone opportunities is much weaker.⁶⁵ For bidders who do have other opportunities, moreover, any expected profits should be discounted to reflect the possibility that the bidder would fail to acquire the other target.

Although reliance should appeal both to proponents of passivity and to auction proponents, I should acknowledge that it fits less naturally into the passivity approach. Because passivity theorists wish to maximize the likelihood that an initial, outside bidder will win the contest,

63. See *id.* at 595-601.

64. See, e.g., Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1284, 1287-88 (1980) (arguing that the reliance measure would be superior to expectation if courts' awards took all of a promisee's foregone opportunities into account).

65. See Skeel, *supra* note 5, at 596. I do not mean to suggest that lockup bidders should be limited to their out-of-pocket costs. The bidder's reliance interest also could include compensation for factors such as the managerial time devoted to the acquisition effort. My point is simply that a bidder's alternative prospects usually are much less certain than those of other contractual promisees.

they would prefer lockups that favored only this bidder. I have argued that the difficulty of distinguishing anticipatory and nonanticipatory bids, together with the need under current law to encourage managers to accede to changes of control, justify enforcement of bidders' reliance interest under second as well as first bidder lockups. For a passivity theorist, the reliance approach is therefore a "second best" solution—an implicit "bribe" to managers that would not be necessary if managers were prohibited from defending against takeovers.

For auction enthusiasts, by contrast, the reliance-based approach should have a far more direct appeal.⁶⁶ Auction enthusiasts favor devices that induce an additional bidder to enter, thus stimulating an auction, and reliance-based lockups have precisely this effect. By paying a bidder's costs, target managers can persuade an otherwise reluctant bidder to make a bid. The managers' motivations may be suspect, but they have a strong interest in finding the highest valuing bidder and their actions have the consequence of spurring bidding.

The analysis thus makes clear that courts should enforce both first and second bidder lockups. Yet the reliance approach also leaves flexibility for courts to adjust their scrutiny in light of the nature of the lockup in question. Perhaps most importantly, courts should construe reliance especially strictly with second bidder lockups.⁶⁷ The costs of bidding are often lower for a second bidder (in part, because they can free ride on the search efforts of the initial bidder), and the lost opportunity costs for second bidders are likely to be lower.⁶⁸ Courts should take each of these considerations into account in determining the lockup bidder's reliance interest. The same reasoning suggests that courts should construe reliance more restrictively with a lockup that is clearly anticipatory, since such bids may free ride on an expected bid. Courts should not deny compensation altogether, however. Because anticipatory lockups may entice target managers to relinquish control, they too should be enforced up to the amount of the bidder's reliance interest. Courts also should distinguish among the different kinds of lockups. Interestingly, despite the judicial hostility to stock lockups, stock lockups arguably should be encouraged because they give the

66. From the perspective of Delaware law, the auction perspective is the more relevant approach, since it accords more closely with the Delaware courts' emphasis on maximizing value for shareholders in a takeover auction.

67. See Skeel, *supra* note 5, at 600-01.

68. Second bidders also may not have as great a reputational stake as the first bidder. A first bidder that enters into a proposed merger with the target but then loses a bidding contest to a subsequent bidder may, as a result, become viewed a takeover target itself.

lockup bidder a monetary stake that increases as the winning bid of another bidder increases.⁶⁹

B. Convergence of Theory and Practice? Lockups in the Delaware Courts

As in the academic literature, lockups have played an increasingly prominent role in the Delaware takeover jurisprudence since the earliest important cases in the 1980s. At times, the academic literature and the Delaware cases have seemed to have little in common. In its most recent case, however, the Delaware Supreme Court has offered its subtlest analysis of lockup issues to date, and has suggested an approach that accords with the reliance approach I have defended above. The analysis that follows briefly describes the earlier Delaware case law, then turns to the supreme court's most recent pronouncement, *Brazen v. Bell Atlantic Corp.*⁷⁰

In most of the pre-*Brazen* cases, Delaware courts have tended to treat lockups as part of the larger question of whether target managers fulfilled their fiduciary duties. In several cases where target managers entered into merger agreements with one bidder and no competing bidder emerged, or where the lockup came at the end of an auction, the courts scrutinized both the overall transaction and the lockup arrangement under the business judgment rule. In these cases, Delaware upheld even large lockups—lockups that affected as much as 20% of the target's stock.⁷¹ Delaware courts take a much closer look both at target managers' overall performance and at the lockup, however, when an additional bidder emerges either before or after the managers grant a lockup to a favored bidder. The seminal cases are *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁷² and *Paramount Communications Inc. v. QVC Network Inc.*⁷³

In *Revlon*, Revlon granted a lockup to Forstmann, Little in the midst of a bidding contest between Forstmann, the "white knight," and Pantry Pride, an unwanted hostile bidder. In addition to articulating its famous *Revlon* duties, which require managers to obtain the best reasonably obtainable value for shareholders once a sale of the target becomes inevitable, the Delaware Supreme Court also applied searching scrutiny

69. See Coates and Subramanian, *supra* note 18, at 67-68.

70. 695 A.2d 43 (Del. 1997).

71. See, e.g., *Yanow v. Scientific Leasing, Inc.*, No. CIV.A. 9536, 1988 WL 8772 (Del. Ch. Feb. 8, 1988) (16.6%, together with bidding expenses); *Hecco Ventures v. Sea-Land Corp.*, No. CIV.A. 8486, 1986 WL 3840 (Del. Ch. May 19, 1986) (21.7%).

72. 506 A.2d 173 (Del. 1986).

73. 637 A.2d 34 (Del. 1994).

to the \$125 million lockup. Because it was not persuaded that the Revlon board reasonably believed that the lockup would benefit shareholders and that Revlon's shareholders were assured an adequate benefit, the supreme court refused to enforce the lockup.

In *QVC*, the Delaware Supreme Court once again applied its enhanced fiduciary duty and lockup standards. Because Paramount, the target, failed to adequately consider an unwanted bidder, *QVC*, the Delaware Supreme Court held that its agreement with the favored bidder, Viacom, violated the directors' *Revlon* duties. Included within the overall agreement was a stock lockup that permitted Viacom to purchase 19.9% of Paramount's stock if another bidder acquired Paramount. Because the option could prove unreasonably generous, the supreme court concluded that it too must be struck down.⁷⁴

The cases discussed thus far can be described as taking a pure fiduciary duty approach to lockup arrangements. Focusing solely on fiduciary duty has several related limitations. One limitation is that the lockup and fiduciary duty inquiries blur together if courts apply the same analysis in both contexts. Courts tend to strike down a lockup if they disapprove of the managers' overall performance, and uphold lockups when the managers have satisfied their fiduciary duties. Yet lockups can perform a valuable function (recall that they serve as an implicit "bribe") even if the directors have otherwise breached their duties. A more distinct lockup standard would help to distinguish the lockup and overall duty inquiries. A second, quite similar issue is that the fiduciary duty analysis can obscure the crucial issue of lockup compensation—whether the lockup is properly calibrated or excessive.

In *Brazen*, its most recent lockup case, the Delaware Supreme Court appears to address precisely these concerns. *Brazen* arose as a class action filed by shareholders of Bell Atlantic asking the Delaware courts to invalidate a \$550 million termination fee Bell Atlantic granted to NYNEX in connection with their proposed merger. In upholding the termination fee, Chief Justice Veasey explicitly eschewed the fiduciary duty approach in favor of a contractual analysis. Because the merger agreement characterized the termination fee as liquidated damages, he held that a liquidated damages analysis should apply. Under Delaware law, such a provision is enforceable if "the damages are uncertain and the amount agreed upon is reasonable."⁷⁵ Applying this standard, the

74. See *id.* at 50-51. The court questioned the terms of the lockup and emphasized that the stock option "had the potential to reach (and in this case did reach) unreasonable levels." *Id.* at 39.

75. *Id.* at 48 (quoting *Lee Builders v. Wells*, 103 A.2d 918, 919 (Del. Ch. 1954)). To determine reasonableness, Delaware courts focus on 1) "the anticipated loss by either party should the merger not occur;" and 2) "the difficulty of calculating that loss." *Id.*

Supreme Court concluded that the \$550 million fee properly took account of NYNEX's out-of-pocket and related costs, and that its value, "2% of Bell Atlantic's market capitalization of \$28 billion . . . falls well within the range of termination fees upheld as reasonable by the courts of this State."⁷⁶

Brazen does not abandon the earlier Delaware cases,⁷⁷ and the liquidated damages inquiry overlaps in important respects with standard fiduciary duty analysis. Yet the case marks an important development in Delaware's lockup jurisprudence. By focusing explicitly on the compensation issue, the court has laid the groundwork for more complete appreciation of the effects of lockup arrangements.

Not least of the attractions of the case for this author, of course, is that *Brazen* fits so neatly with the reliance damages approach to lockups. The connection between the two suggests three important issues to watch for as future Delaware cases develop the insights of *Brazen*. The first is the question whether courts will uphold future lockups under the *Brazen* analysis even in cases where target directors violate their *Revlon* or *Unocal* duties.⁷⁸ In nearly every earlier case, courts have reached the same conclusion—either to uphold or invalidate—on both directors' duties and on the lockup.⁷⁹ As we have seen, the reliance damages approach suggests that lockups may be valuable even if the directors have otherwise breached their duties, and *Brazen* could easily lend itself to a similar conclusion.⁸⁰

76. *Id.* at 49.

77. Had *Brazen* overturned prior law, the Delaware Supreme Court would have been required to decide the case en banc, rather than in a three judge panel. See David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 136 n.31 (1997). The fact that *Brazen* was decided by a three judge panel underscores that the justices viewed the case as consistent with the existing supreme court case law.

78. Given that *Brazen* involved a merger of equals, it is also possible that Delaware will limit its application to this context. The analysis of this Article suggests that the approach should also be applied in cases that implicate target managers' *Revlon* or *Unocal* duties.

79. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), can be seen as an exception, since the Delaware Supreme Court left the stock option lockup in place but held that the target directors had breached their duty of care. But the *Van Gorkom* decision did not expressly address the validity of the lockup.

80. A good illustration of this point, and an additional basis for optimism about the trend of the Delaware case law, is the stock lockup and termination fee in *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994). The lockup with Viacom arguably was anticipatory in nature, and the stock option and termination fee as a whole exceeded any reasonable reliance interest of Viacom. See Kahan & Klausner, *supra* note 25, at 1568. Yet the \$100 million termination fee, by itself, was a plausible estimate of Viacom's reliance interest. The analysis of this Article thus suggests that the chancery court in *QVC* was correct in striking down the stock option but upholding the termination fee. See Skeel, *supra* note 5, at 602 (discussing *QVC Network, Inc. v. Paramount Communications, Inc.*, 635 A.2d 1245 (1993)). Because the chancery court's termination fee ruling was not appealed, the Delaware Supreme Court did not address the issue. See *Paramount*, 637 A.2d at 50 n.22. *Brazen* cites the chancery court analysis on this issue with apparent approval, however, which suggests that the Delaware Supreme Court may apply similar reasoning

Second, Chief Justice Veasey rejected Brazen's contention that, because the lockup would be triggered if shareholders rejected the NYNEX merger, it coerced shareholders to approve the merger.⁸¹ Although the Chief Justice's conclusion that the lockup should be upheld even if it affected the shareholders' vote seems correct,⁸² it could be (mis)construed as permitting courts to enforce expectation-based and supraexpectancy lockups. As we have seen, structural factors—most importantly, the implicit nullification of shareholders' right to determine whether a merger is approved—counsel against such a sweeping reading.⁸³ Perhaps more importantly, such a reading would conflict with the focus of *Brazen* and the reliance damages approach on awarding a lockup bidder its out-of-pocket and related costs, rather than full expectation damages.

The final issue to watch for is whether the Delaware courts will adjust their interpretation of appropriate lockup damages as they apply it to different bidding contests—most importantly, whether Delaware construes the lockup bidders' costs more narrowly in the second bidder context than with first bidders. Once again, *Brazen*'s focus on reliance-based costs lends itself easily to just these kinds of distinctions.

C. Lockups in Bankruptcy

As in corporate law, breakup fees and other lockup arrangements play a prominent role in many corporate bankruptcy cases. The question that courts and commentators have asked, and rightly so, is whether lockups offer the same benefits in bankruptcy as they do in corporate law. To answer this question and to determine how bankruptcy lockups should be treated, let us briefly consider the three factors we used to explore lockups in the corporate context.

On the first factor, the choice between passivity and auctions, the consensus view seems to be that courts should adopt an auction perspective and focus on maximizing value *ex post*. Even Kim Roosevelt, a relentless advocate of passivity outside of bankruptcy, believes that there is no reason to worry about *ex ante* considerations such as bidder search once a bankruptcy petition has been filed.⁸⁴

in future cases. See *Brazen v. Bell Atlantic Corp*, 695 A.2d 43, 49 n.20 (Del. 1997).

81. See *Brazen*, 695 A.2d at 50.

82. For a similar view, see Bainbridge, *supra* note 10, at 285 (Termination fees that "involve only a [relatively] small percentage of the value of the transaction ... [are] unlikely to coerce shareholders.").

83. See *supra* notes 55-56 and accompanying text.

84. See Roosevelt, *supra* note 29, at 125. Although Roosevelt suggests that managers can sometimes maximize value through a negotiated sale rather than an auction, he contends that courts should assess

Roosevelt suggests that all bankrupt firms are targets—presumably because financial distress signals that the firm's assets can or should be redeployed. Thus, bankruptcy itself serves to identify the firm as a target. Yet bankruptcy is an extraordinarily noisy signal. Many bankrupt firms would make poor acquisitions, for instance, and even viable bankruptcy debtors may be more valuable under their existing managers than under a third party. Bidder search—the effort to identify targets—is therefore just as important in bankruptcy as under corporate law. As a result, the debate as to whether courts should favor passivity (to encourage search) or conduct auctions is relevant in bankruptcy, as in corporate law, and one's views on the debate will influence their view of bankruptcy lockups.

If we shift to the second factor, managerial disloyalty, bankruptcy lockups once again raise concerns analogous to those we saw in the corporate context. Bankruptcy assures that the debtor's managers control the reorganization process, at least at the outset,⁸⁵ and managers have many of the same incentives to further their own interests in bankruptcy as they do when the firm is healthy. Likewise with the final factor: lockup compensation raises the same kinds of issues in bankruptcy as it does in corporate law.

I do not mean to suggest that bankruptcy simply mirrors corporate law in all relevant respects. It obviously does not. In an influential article, Bruce Markell explores several of the most significant differences between bankruptcy and nonbankruptcy sales.⁸⁶ In Markell's view, these distinctions, together with managers' ability (which they also have outside of bankruptcy) to reduce bidders' due diligence costs by giving them additional information, diminish the need to use lockups to induce bids.⁸⁷ None of these considerations is a substitute for lockups, however. Although bankruptcy may reduce bidders' costs and uncertainty to some

these transactions from an ex post wealth maximization perspective. Roosevelt, *supra* note 29, at 44. The other important bankruptcy lockup articles, each of which adopts an auction perspective, are Mark F. Hebbeln, Comment, *The Economic Case for Judicial Deference to Break-up Fee Agreements in Bankruptcy*, 13 BANKR. DEV. J. 475 (1997); Paul B. Lackey, Note, *An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 COLUM. L. REV. 720 (1993); Bruce A. Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 AM. BANKR. L.J. 349 (1992).

85. The Bankruptcy Code permits the debtor's managers to continue running the business in bankruptcy, *see, e.g.*, Bankruptcy Code § 1107 (establishing powers of "debtor in possession"), and the so-called "exclusivity period" assures that the debtor's managers are the only ones who can propose a reorganization plan for at least the first 120 days of the case. Bankruptcy Code § 1121.

86. Among other things, Markell emphasizes that bankruptcy sales guarantee clear title to acquirors, whereas nonbankruptcy sales do not. *See* Markell, *supra* note 84, at 374.

87. *See id.* at 369-70.

extent, significant costs and risk remain, which suggests that lockups can play a valuable role in bankruptcy, as in corporate law.⁸⁸

The most recent bankruptcy lockup cases are characterized by a remarkable degree of confusion as to the effects of lockups.⁸⁹ Although much more thoughtful than most of the lockup cases, and probably correct on the facts, the Third Circuit's important new decision in *Calpine Corp. v. O'Brien Environmental Energy, Inc.*⁹⁰ illustrates some of the problems with the case law. In *O'Brien*, the debtor initiated an auction by contacting over 300 potential bidders, winnowing the list to five, and then signing an agreement with Calpine that included \$4 million in breakup fees. The bankruptcy court postponed its decision whether to approve the lockup, then refused to enforce it after another bidder outbid Calpine. In upholding the bankruptcy court decision, the Third Circuit took a troublingly hostile stance toward bankruptcy lockups.⁹¹ The *O'Brien* opinion emphasizes, for instance, that Calpine continued to bid, even though it knew that its breakup fee might be denied.⁹² Yet Calpine's continued bidding was entirely rational—*more* so, rather than less so if the validity of its lockup was in doubt⁹³—and tells us nothing about the question whether its lockup was desirable or pernicious.

What might a better approach look like? Given the benefits of lockups, courts should use the same reliance-based framework I defended earlier as their starting point, with appropriate modifications for bankruptcy. Perhaps the most important bankruptcy-specific factor is the nature of the bankruptcy court process with respect to the

88. A final point reinforces this conclusion: Markell's skeptical account of bankruptcy lockups seems to focus on managers who have already decided to seek a sale and bidders who are committed to making a bid. As we saw in the corporate context, lockups may entice managers to agree to a sale in the first instance, and they can be used to induce a bid from a bidder who might otherwise hesitate. For a similar point, see Hebbeln, *supra* note 84, at 497 (criticizing existing analysis because "it places too much emphasis on the role of break-up fees in encouraging (or discouraging) further bids ... and too little emphasis on the role break-up fees play in encouraging the initial bid").

89. Borrowing from Delaware corporate law, several earlier cases applied a business judgment rule analysis and upheld bankruptcy lockups. See, e.g., *In re 995 Fifth Avenue Associates, L.P.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989); *Official Committee of Subordinated Bondholders v. Integrated Resources, Inc.* (In re Integrated Resources, Inc.), 147 B.R. 650, 659-660 (S.D.N.Y. 1992). These cases are closer to the mark but pre-date important developments such as Delaware's decision in *Brazen*.

90. 181 F.3d 527 (3d Cir. 1999).

91. Like several of the other cases, *O'Brien* was influenced by the insights offered by Bruce Markell. 181 F.3d at 535 (citing Markell, *supra* note 84); see also *In re America West Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) ("[T]his Court's opinion herein adopts and approves of the reasoning enumerated in the [Markell] law review article.").

92. *O'Brien*, 181 F.3d at 537.

93. Even if the lockup were enforceable, Calpine would have an incentive to keep bidding so long as its expected profits exceeded the value of the lockup. If validity of the lockup were in doubt, Calpine would discount its value and continue bidding so long as its expected profits exceeded the reduced value of the lockup.

transaction in question. Sales of assets that do not involve the entire firm can be approved at a so-called section 363 hearing,⁹⁴ whereas transactions that affect the reorganization as a whole must be put to a vote of all classes of creditors and shareholders.⁹⁵ Because the section 363 approach entails substantially less delay than the firm-wide reorganization vote, courts should be more restrictive in the reliance costs they allow in that context. Courts also should be somewhat stingier about reliance costs in cases like *O'Brien*, where the debtor initiated the auction and provided extensive information to the bidders.

It is worth emphasizing that even if the bidder's reliance interest is relatively limited, this does not mean that the lockup in question should be prohibited. As in corporate law, the best approach is to limit, but generally permit, lockup arrangements (and to permit them for both first and second bidders).

II. DELAWARE IN CORPORATE LAW AND BANKRUPTCY: CHARTER COMPETITION AND VENUE

Part I explored a particular issue, the role of lockups in change of control transactions. Given Delaware's preeminence in corporate law, the analysis drew largely from Delaware cases. In this part, we shift from specific doctrinal issues to Delaware itself. Delaware's success in attracting corporations has long been controversial, and has prompted periodic calls for reform.

The first section of this part describes the corporate law debate, which pits defenders of Delaware against those who view Delaware's dominance in corporate law as pernicious. Although defenders of Delaware appear to have the upper hand, as we shall see, commentators also have identified areas where Delaware lawmaking may further interests other than efficiency.

The second section turns to bankruptcy. After decades in the shadows, Delaware has now become by far the most popular venue for large corporations that file for bankruptcy. Delaware's sudden bankruptcy dominance has proven at least as controversial as the state's role in corporate law; the debate over proposals to limit Delaware venue is now the single hottest issue in corporate bankruptcy. In an earlier article, I explained why the increasing number of Delaware filings is a

94. Bankruptcy Code § 363(b) requires court approval, after notice and a hearing, of any sale that is outside the ordinary course of business.

95. See Bankruptcy Code § 1129 (vote to confirm a reorganization plan). Both section 363 sales and the reorganization vote introduce delay somewhat analogous to the delay required for a shareholder vote outside of bankruptcy. Section 363 entails less delay, whereas the reorganization vote may involve more.

cause more for celebration than for concern.⁹⁶ In this article, I respond to several subsequent commentators who have challenged my analysis,⁹⁷ and I expand and defend my earlier conclusions.

Notice that my confidence about Delaware's role in corporate law and bankruptcy has obvious implications for its treatment of particular issues such as lockups. The same forces that explain Delaware's dominance in corporate law and bankruptcy suggest that Delaware will develop a generally efficient response to the lockup issue—precisely what we see in cases such as *Brazen*.

A. Charter Competition and Delaware Corporate Law

Although Delaware's status as home base for most of the nation's largest corporations dates back to the early decades of the twentieth century, Delaware was not first. Before Delaware, New Jersey attracted numerous prominent corporations and drew the ire of reformers.⁹⁸ It was the reformers' ire, in a sense, that led to New Jersey's demise. After New Jersey had long given large corporations significant flexibility to engage in mergers and acquisitions, Woodrow Wilson, as governor, championed legislation that would subject these activities to searching antitrust review. Rather than submit to the new regime, many of the nation's largest corporations simply picked up shop and moved down the coast to Delaware. Delaware has been the leading state of incorporation, and an ongoing target of critics, ever since.

In its modern incarnation, the debate over Delaware's role in corporate law dates back to an important 1974 article by William Cary (who not coincidentally, had previously chaired the Securities and Exchange Commission, which oversees the principal *federal* legislation governing corporate and securities law).⁹⁹ Cary assumed that, although the decision whether to reincorporate in Delaware is subject to a shareholder vote, the shareholders of large corporations are too widely scattered to make an informed decision. A state that wishes to attract corporations must therefore cater to managers rather than shareholders. As a result, states engage in a "race to the bottom," as their efforts to entice corporations lead to more and more manager friendly laws. As

96. See Skeel, *supra* note 8, at 24-33 (arguing that corporate law charter competition and Delaware's corporate culture exert beneficial influence on Delaware bankruptcy practice).

97. See Eisenberg & LoPucki, *supra* note 8, at 972-73 (attributing Delaware popularity to undesirable "judge shopping").

98. See, e.g., Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677 (1989).

99. See Cary, *supra* note 2.

the leader in this competition, Delaware is more beholden to managers than any other state. The only solution, Cary believed, is to enact federal legislation that minimizes the pernicious effects of state charter competition.¹⁰⁰

Several years later, Ralph Winter responded to Cary in an article that has inspired the “race to the top” view of state charter competition.¹⁰¹ Even if managers rather than shareholders are the real decision makers, Winter argued, they will be penalized by the market(s) if they incorporate in a state whose laws are inefficiently lax and manager friendly. The managers of such firms will suffer in the product markets (inefficient firms cannot produce their products as cheaply as efficient ones), the managerial labor markets (sloppy managers are less attractive to other firms), and the capital markets (investors will pay less for the stock or debt of an inefficient firm). Most important of all, because their stock price will be lower than that of firms in other states, firms that incorporate in inefficient states will be much more vulnerable to takeover bids. In view of these market pressures, Winter concluded that managers have a powerful incentive to seek, and states to provide, efficient rather than inefficient laws. Charter competition thus produces a race toward the “top,” not the “bottom.”

Winter’s principal successor in the literature, Roberta Romano, has developed and defended the race to the top view in a series of important articles.¹⁰² Romano emphasizes that Delaware’s dependence on corporate law revenues acts as a commitment device. Because nearly 20% of the state’s income comes from franchise taxes and other corporate law fees, Delaware lawmakers cannot afford to suddenly turn their backs on the interests of Delaware corporations.¹⁰³ When important new corporate law innovations emerge, Delaware is always one of the first states to enact them.

Along with its legislative responsiveness, Delaware also offers important benefits in the judicial sphere. Delaware’s judiciary is the most sophisticated in the nation on corporate law issues, both because of Delaware’s preeminence in corporate law and because Delaware channels corporate law issues to a specialized chancery court with direct appeal to the Delaware Supreme Court.¹⁰⁴ Complementing this

100. See *id.* at 700-703 (proposing minimum federal standards in corporate law).

101. Winter, *supra* note 7.

102. See, e.g., Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) [hereinafter Romano, *Law as Product*]. These articles subsequently led to an influential book. See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

103. See ROMANO, *supra* note 102, at 38.

104. See *id.* at 39-40 (Delaware judiciary).

expertise is an extensive and well-developed case law on corporate law issues. Delaware also provides speed: its judges routinely resolve sensitive issues in a matter of days, rather than months.¹⁰⁵

Other scholars have continued to criticize charter competition from Cary's "race to the bottom" perspective. Although Lucian Bebchuk acknowledges many of the virtues of Delaware lawmaking, such as Delaware's expert judiciary, he argues that market forces do not eliminate states' incentive to favor managers rather than shareholders. Markets are a limited corrective, in his view, and do not prevent states from enacting provisions that, for example, provide significant benefits to managers but do not undermine firm value enough to trigger a market response.¹⁰⁶

One of the most striking attributes of the current charter competition debate is the broad range of agreement. All of the participants acknowledge that Delaware offers important benefits, and most (though not all, as the previous paragraph suggests) incline more toward the race to the top than the race to the bottom view,¹⁰⁷ and new empirical evidence lends additional support to this view.¹⁰⁸

Much of the current literature focuses on the possibility that, even if charter competition is generally effective, Delaware's lead is so commanding that it can afford to divert (at least some) value from shareholders to other beneficiaries. Although managers are one possible beneficiary, several commentators have pointed out that Delaware law benefits the local bar.¹⁰⁹ Delaware has enacted a variety of rules that make it easy for the parties to bring litigation in Delaware, for instance, and its courts have been sympathetic to plaintiffs attorneys' requests for

105. In her contribution to this symposium, Jill Fisch explores the role of the Delaware judiciary in still greater detail, and points out that Delaware's courts function much more like a legislature than do most courts. See Jill E. Fisch, *The Peculiar Role of the Delaware Courts In the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000).

106. Bebchuk has argued that markets will not correct inefficiencies with respect to issues that: 1) involve significant redistribution to managers but a more attenuated effect on shareholders; 2) directly affect the effectiveness of market discipline; or 3) have effects on third parties. Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); see also Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1172-73 (1999).

Melvin Eisenberg also has defended the race to the bottom view. Eisenberg analogizes states' solicitude for managers' interests to side payments made by a seller to an agent. WILLIAM L. CARY & MELVIN A. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* (7th ed. 1995).

107. See generally Bebchuk & Ferrell, *supra* note 106, at 1169 ("Cary's skeptical view of state competition has not been widely accepted by corporate law scholars.").

108. See Robert Daines, *Does Delaware Law Improve Firm Value?* (unpublished draft, 1999) (finding that Delaware firms are generally worth more than non-Delaware corporations).

109. This view is generally attributed to an important article by Jon Macey and Geoff Miller. See Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

compensation.¹¹⁰ In an earlier article, I suggested that the surprising amount of uncertainty in the Delaware case law could be viewed in similar terms: uncertainty breeds litigation and thus the need for lawyers.¹¹¹ Interestingly, uncertainty benefits Delaware's lawyers in another way as well. Because the courts have developed vague, fact specific standards on important issues, Delaware lawyers can represent clients on either side of the issue rather than specializing in a particular perspective.

The benefits to local lawyers reflect, it should be emphasized, at most a minor inefficiency of Delaware law. Moreover, many of the rules in question can be seen as central to Delaware's role in corporate law. The Delaware judiciary views itself as a moral arbiter on corporate law issues.¹¹² It is for this reason that so many Delaware cases include both a careful, fact intensive assessment of the directors' performance, and general moral guidance for other boards of directors. In addition to calling for nuance rather than simple rules, the moral dimension of Delaware judging also explains the courts' need for a steady supply of cases—new cases provide additional opportunities for instruction.¹¹³

Closely linked to Delaware judges' role as moral arbiter is another factor that the charter competition literature sometimes neglects: Delaware's corporate culture. Although Delaware's judges are elected, they serve lengthy terms.¹¹⁴ As a result, Delaware's judges are less subject to political pressures, such as the state's dependence on charter revenues, than lawmakers are. In theory, Delaware judges could rebel against the state's traditional role in corporate law and chart a different course. Yet Delaware's judges are steeped in local corporate culture. The frequent, ongoing, informal contact between the Delaware bar (from which most of the judges come) and the judiciary serves as a powerful constraint on defection from Delaware's traditional mission in

110. See *id.* at 494-97.

111. See Skeel, *supra* note 77, at 155-162. See also Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990). Ehud Kamar has pointed out that uncertainty can actually increase Delaware's advantage by making it more difficult for other states to replicate Delaware's case law. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

112. See Skeel, *supra* note 77, at 163-72 (describing "moral dimension" of Delaware takeover cases). Ed Rock was one of the first to emphasize this aspect of Delaware decision making, and has characterized Delaware's fiduciary duty cases as "sermons" to the business community. See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); Edward B. Rock, *Preaching to Managers*, 17 J. CORP. L. 605 (1992) (reviewing LOUIS LOWENSTEIN, *SENSE AND NONSENSE IN CORPORATE FINANCE* (1991)).

113. See, e.g., Rock, *Saints and Sinners*, *supra* note 112, at 1097-99.

114. I do not mean to suggest that Delaware judges are immune from political pressures. Judges that offend Delaware norms are sometimes not reappointed, as Andrew Moore discovered to his chagrin. See generally ROMANO, *supra* note 102, at 40 (discussing political accountability of Delaware judges).

corporate law. The constraining, and shaping, effect of Delaware corporate culture will prove especially important as this article crosses the line from corporate law back into bankruptcy.

B. Venue and Forum Shopping in Bankruptcy

Until the late 1980s, Delaware played no meaningful role in large scale corporate reorganization. Because bankruptcy's venue provision permits corporate debtors to file for bankruptcy in their state of incorporation, most large corporate debtors could have taken their bankruptcy to Delaware.¹¹⁵ Yet few firms took advantage of this option. Then everything changed. In the absence of a more attractive venue option, Continental Airlines filed for bankruptcy in Delaware in 1990. The Delaware bankruptcy court's successful handling of Continental put Delaware on the bankruptcy map, and Delaware quickly displaced New York as the venue of choice for large scale reorganization.¹¹⁶

Delaware's rapid ascent prompted a sharp backlash from bankruptcy professionals. Critics grumbled that the Delaware bankruptcy judges had cultivated too cozy a relationship with debtors and the local bankruptcy bar, and insisted that Delaware's location was inconvenient for many creditors. In 1997, these critics persuaded the National Bankruptcy Review Commission to adopt a provision proposing to remove state of incorporation, and thus Delaware, from a corporate debtor's choice of filing locations.¹¹⁷ A similar prohibition has made its way into proposed bankruptcy legislation, but it was subsequently removed.

In an earlier article, I argued that the assault on Delaware is almost entirely misplaced.¹¹⁸ Not only does much of the criticism stem from

115. Under bankruptcy's venue provision, a corporate debtor can file for bankruptcy in the district of its "domicile"—which has been construed to be its state of incorporation; its principal place of business; the location of its principal assets; or the location of a pending bankruptcy case involving an affiliate of the firm. 28 U.S.C. § 1408 (1994).

From 1938 until the early 1970s, corporate debtors were not permitted to use state of incorporation as a basis for bankruptcy venue. The drafters of the Bankruptcy Rules reintroduced state of incorporation as a venue option in 1973. For a discussion of the history and its implications, see Skeel, *supra* note 8, at 8-16.

116. For a good discussion, see Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, NW U.L. REV. (forthcoming, 2000); see also Mark D. Collins, *Why Delaware?*, 15 DEL. LAW. 38 (1997).

117. For a more detailed overview of these events, see Skeel, *supra* note 8, at 2 n.2, 21, 33-35.

118. I say "almost" because at least one criticism, the complaints about ex parte contacts between a Delaware judge and local attorneys, was well-founded. In the face of widespread criticism of Delaware's bankruptcy court (although ostensibly for other reasons), the chief judge of the District Court, Judge Joseph Farnan, intervened in the assignment of Delaware bankruptcy cases. See *id.* at 2 n.2 (describing Farnan's "withdrawal of reference" of bankruptcy cases to the bankruptcy court).

bankruptcy professionals' own interests, but permitting firms to file in Delaware promises to translate many of the benefits of state corporate law charter competition into the bankruptcy context. In fact, one could argue that firms should be *forced* to bring any bankruptcy petition in their state of incorporation.¹¹⁹ If bankruptcy and state of incorporation went together, states would treat corporate bankruptcy as an extension of corporate law (as they should), and they would compete by offering increasingly *efficient* bankruptcy rules.¹²⁰

Existing law obscures the link between bankruptcy and corporate law in several important respects. First and most importantly, Congress rather than the states regulates bankruptcy law, so state lawmakers have much less influence on corporate bankruptcy than on general corporate law. Second, bankruptcy's venue provision gives most large firms a series of venue options at the time they file for bankruptcy.¹²¹ Because they have complete control of the decision and can make their choice after the firm fails, corporate managers can shop for the most attractive courthouse at the time of bankruptcy.

These factors clearly weaken the ties to corporate charter competition, but important benefits remain. While bankruptcy law is federal, it defers to state law in numerous particulars, and even the federal framework can be applied differently in different locales. It is precisely this flexibility that has enabled the Delaware judges to develop a distinctive approach to large cases. With respect to a manager's multiple venue options, it is important to recognize that the choices are not unlimited. More importantly, the best solution would be to eliminate some or all of the other venue options.¹²² This is the intuition behind Bob Rasmussen and Randall Thomas's proposal to permit firms to select a bankruptcy venue by contract,¹²³ and it also might justify limiting bankruptcy venue to a firm's state of incorporation.¹²⁴

119. See *id.* at 37-38.

120. I have argued elsewhere that Congress ideally would shift control of corporate bankruptcy back to the states, thus truly consolidating corporate law and corporate bankruptcy. See David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994). Although such a move is politically unlikely, Delaware venue can be seen as achieving a portion of its benefits.

121. See *supra* note 115 (listing the venue options).

122. The most likely candidate for removal (or at the least, amendment) is the option to file in a district where one of a firm's subsidiaries have filed for bankruptcy. See Skeel, *supra* note 8, at 40 n.121. Firms can and do manipulate this option by filing for bankruptcy in a district where a minor subsidiary has its headquarters or principal assets, and using this filing as the basis for venue for the rest of the firm. Many of the firms that filed for bankruptcy in New York in the 1980s used this basis for venue. See, e.g., Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 22, 27.

123. See Rasmussen & Thomas, *supra* note 116, at 51-59.

124. My own suspicion is that basing bankruptcy venue on a firm's ex ante contractual choice, as Rasmussen and Thomas propose, generally would produce the same choices as a domicile-based approach.

Prohibiting firms from filing in their state of incorporation is precisely the wrong solution.

Delaware's success as a bankruptcy forum strongly reinforces the theoretical attractions of basing venue on a debtor's state of incorporation. Almost as soon as large firms started taking their cases to Delaware, Delaware developed a reputation for fast and efficient case administration. Large firms that wish to propose prepackaged bankruptcies—reorganizations that are negotiated and voted on before the debtor files—almost always look to Delaware, and Delaware also is the forum of choice for traditional reorganizations.¹²⁵ Not surprisingly, the characteristics that distinguish Delaware bankruptcy cases—speed and administrative efficiency, as well as sophistication—are quite similar to the reputation of Delaware's state court judges in high profile corporate law cases. The same business culture that has long distinguished Delaware in corporate law now encompasses both corporate law and bankruptcy.

A new article by Ted Eisenberg and Lynn LoPucki challenges many of my conclusions about Delaware and bankruptcy venue. Three contentions lie at the heart of their critique. First, Eisenberg and LoPucki question my contention that “bankruptcy law permits local variation.” Because “every significant aspect of Chapter 11 reorganization is” subject to a uniform federal law, they believe that “[s]ignificant, persistent differences among bankruptcy courts . . . should be impossible,” and that bankruptcy debtors therefore shop only for judges, not for bankruptcy courts.¹²⁶ Second, Eisenberg and LoPucki present empirical evidence on venue choice that seems to them to cast doubt on Delaware's reputation for quick and efficient bankruptcy administration.¹²⁷ Third, they suggest that speed and efficiency cannot be the reason for Delaware's prominence, because New York was corporate debtors' forum of choice before Delaware and New York does not process cases more promptly than other courts.¹²⁸ Let me describe the problems with each of these arguments in turn.¹²⁹

Nearly all small and medium-sized firms incorporate in the state where they are located, and these firms would choose the same state as their venue selection. Large corporations usually incorporate either in their principal place of business or in Delaware, and most would probably adopt a similar strategy for bankruptcy venue.

125. See generally Eisenberg & LoPucki, *supra* note 8, at 979 (venue study finding that 82.5% of large firms that “forum shopped” in bankruptcy between 1994 and 1997 filed their cases in Delaware).

126. Eisenberg & LoPucki, *supra* note 8, at 972.

127. See *id.* at 987-92.

128. See *id.* at 996-97.

129. Another problem with the Eisenberg and LoPucki analysis, as Rasmussen and Thomas point out, is that it contains an internal tension. Eisenberg and LoPucki question whether Delaware truly acts more quickly than other jurisdictions, yet at the same time suggest that Delaware processes cases so fast that

The argument that a federal framework cannot be subject to local variation is in some respects the most puzzling, as it seems to assume a hyper-formalist definition of law. Suffice it to say that even if the Bankruptcy Code's rule-based sections are interpreted precisely the same in every district, numerous bankruptcy provisions invite flexible application and can be interpreted differently by different courts.¹³⁰ In addition, the Bankruptcy Code incorporates state law on many issues. Of particular note in this context, bankruptcy courts often defer to the law of the state of incorporation on issues (such as fiduciary duty) that involve the internal affairs of a corporate debtor.¹³¹

Despite their insistence that bankruptcy law is federal and therefore uniform, Eisenberg and LoPucki seem to assume the possibility of variation, since they argue that corporate debtors shop for particular judges.¹³² This shopping would not make sense, of course, unless different judges could interpret or apply the bankruptcy laws differently. The real question is whether the differences among districts are likely to be desirable or malignant.

Second, Eisenberg and LoPucki question Delaware's reputation for speed and efficiency based on their findings that the differences between Delaware and other districts are not statistically significant. Yet Eisenberg and LoPucki's skepticism does not follow very smoothly from their evidence. In fact, their evidence shows that Delaware does process both prepackaged and traditional cases more quickly than other districts,¹³³ and they concede in a footnote that the difference might well be statistically significant if the number of cases were not so small.¹³⁴ Moreover, it would be quite possible for Delaware to maintain a

it may trammel on creditors' rights. See Rasmussen & Thomas, *supra* note 116, at 44.

130. In response to my suggestion that courts might develop different approaches to issues such as postpetition financing and extensions of a debtor's exclusivity period, Eisenberg and LoPucki assert that the "Delaware bankruptcy court would be required to follow federal law on these matters." *Id.* at 972 n.18. Concerning postpetition credit, 11 U.S.C. § 364 states the bankruptcy court "may" approve credit in various contexts, and 11 U.S.C. § 1121(d) gives the bankruptcy court discretion "for cause [to] reduce or increase" the exclusivity period. By their own terms, these provisions obviously give courts a great deal of discretion in determining what it means to "follow federal law on these matters."

131. See, e.g., Skeel, *supra* note 8, at 29-31 (speculating about future Delaware treatment of these issues).

132. See Eisenberg & LoPucki, *supra* note 8, at 972-73. My own view is that the earlier popularity of New York may have reflected efforts to obtain a single judge, Bankruptcy Judge Burton Lifland, but that Delaware's prominence is broader, as I suggest below.

133. See *id.* at 989 (mean duration of traditional cases in Delaware was 510 days, as compared to 535 days elsewhere; mean for Delaware prepackaged bankruptcies was 52 days, as compared to 59 days elsewhere).

134. See *id.* at 991 n.78 ("Having a high probability of detecting a statistically significant difference of this size between Delaware and other states . . . requires a much larger population of cases than is available. Thus, one should not take a failure to detect a significant difference as firm evidence that no such difference exists.")

reputation for speed and efficiency even if other districts also processed cases quickly. Delaware's success in the 1990s might have prompted other districts to improve their case administration, for instance, or corporate debtors may just have more confidence in Delaware due to its longstanding prominence in corporate law.

Third, Eisenberg and LoPucki's comparison of New York and Delaware's popularity misunderstands my analysis in a subtle but crucial respect. I do not contend that venue shopping is always efficient, regardless of its basis.¹³⁵ My argument, instead, is that basing the venue choice on a firm's state of incorporation offers some of the same benefits for bankruptcy that it does for corporate law. The firms that filed for bankruptcy in New York in the 1980s were not incorporated in New York, and it is quite possible that this earlier venue shopping was pernicious. (It is also possible that firms filed in New York because of the New York judges' sophistication, and that Delaware displaced New York because it offers *both* sophistication and speed).

It is interesting to note that Delaware's continued prominence raises questions about Eisenberg and LoPucki's suggestion that debtors invariably shop for judges rather than districts. Eisenberg and LoPucki speculate that debtors sought out Judge Lifland in New York, then shifted to Judge Balick in Delaware after New York adopted a truly random assignment system.¹³⁶ If this were strictly accurate, one would not expect to find corporate debtors filing in Delaware now, since Judge Balick retired several years ago and Delaware cases are currently handled by two bankruptcy judges and several district court judges.¹³⁷ The fact that Delaware remains firms' venue of choice is a tribute to the Delaware corporate culture, rather than simply a single judge. Nor is this confidence misplaced. Delaware's current bankruptcy judges have maintained the same reputation for speed and administrative efficiency as Judge Balick.

The current venue system is far from ideal. A better approach would limit firm's venue options from the outset, rather than giving them a

135. Thus, when Eisenberg & LoPucki suggest that my "underlying premise—that fast is efficient—would suggest that New York's case processing was inefficient during the period when New York was the venue of choice," *id.* at 996-97, I would agree that New York might have been inefficient rather than concluding, as they do, that *neither* New York or Delaware tends toward efficiency.

136. *See id.* at 972-73 ("[T]he principal purpose of forum shopping is to obtain or avoid the assignment of particular judges."); *id.* at 997 (suggesting that Delaware replaced New York as forum of choice because "[o]ne no longer could be so confident in the chances of assignment to Judge Lifland in New York, but one could be sure of assignment to Judge Balick in Delaware").

137. Although Eisenberg & LoPucki's study suggests that the rate of venue shopping decreased in 1997, they point out that it "remains at historically high levels" and that "Delaware currently dominates forum shopping to a degree that New York never has." *Id.* at 978-79.

choice at the time of bankruptcy, as both I and Rasmussen and Thomas have proposed. But so long as the current approach remains, it is crucial that lawmakers include corporate domicile as a venue option.

III. CONCLUSION

This Article has focused on several of the most pressing issues in corporate law and bankruptcy, issues that have both theoretical and practical significance. With lockups, I have argued that courts should enforce both first and second bidder lockups, but should limit lockup bidders to their reliance interest. This approach enables target managers to use lockups to induce bids and encourages them to accede to a change in control, but limits the lockup's chilling effect on other bidders. I have argued that courts should also apply a reliance-based approach in bankruptcy, rather than casting a cold eye on lockups as recent bankruptcy cases have done.

From lockups, the Article turned to the role of charter competition in corporate law and bankruptcy. The analysis illustrated the limitations of charter competition, its overall benefits, and the unique role that Delaware and its culture play in corporate law. The Article suggested that Delaware offers similar benefits in bankruptcy, and argued that the recent calls to bar corporate debtors from filing in Delaware are misguided.

In an ideal world, corporate law and corporate bankruptcy would be connected. Although the two areas remain separate, our discussion of lockups and charter competition illustrates just how much the distance between them has closed in recent years.