A Reliance Damages Approach to Corporate Lockups

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INTRODUCTION

To paraphrase a recent men's aftershave commercial, takeovers are back. Few expect the resurgence to reach 1980s levels, but merger activity clearly is on the rise again.1 The widely followed Paramount Communications, Inc. v. QVC Network, Inc.2 decision prominently reflected this recent shift. After earlier suggesting, in Paramount Communications, Inc. v. Time, Inc.,3 that directors have almost complete discretion in responding to a takeover bid, Delaware now has made clear that the directors of a corporation that is a takeover target cannot simply stonewall one suitor in favor of another, in an opinion that appears to breathe life back into the takeover-friendly Delaware decisions of the mid 1980s.5

A crucial issue in Paramount, and one that almost certainly will increase in importance if the recent propensity for negotiated mergers continues, is courts' treatment of lockup provisions granted by a target's managers to a bidder. A lockup is a provision pursuant to which a target promises to compensate the bidder if their proposed sale falls

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2 637 A.2d 34 (Del. 1994).
3 571 A.2d 1140 (Del. 1989).
4 The term "bidder" will be used throughout the Article to denote an individual or corporation seeking to acquire another corporation, which will be referred to as the "target," either through a negotiated merger, a tender offer, or by other means.
5 The effect of Paramount v. QVC itself should not be overstated. In a subsequent takeover decision, the Delaware Supreme Court upheld managerial defensive tactics. Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995). Yet Paramount made clear that there still are limits to target directors' ability to thwart a takeover. Moreover, the resurgence in takeovers that began shortly before Paramount has continued.
Traditionally, courts have been skeptical of lockups, fearing, among other things, managerial self-dealing—that the managers of a target firm will make exorbitant concessions in return for special treatment for themselves in connection with the transaction. As a result, courts have scrutinized lockups on an ad hoc basis, enforcing those that appear reasonable and striking down those that do not. While commentators have proposed various ways to simplify the scrutiny, nearly all have called for some kind of winnowing process that upholds some lockups but not others.

In a provocative and ambitious recent article, “Toward Unlocking Lockups,” Stephen Fraidin and Jon Hanson insist that the conventional approach to lockups is wholly misguided. Fraidin and Hanson contend that there is no reason to strike down a lockup arrangement unless it both provides excessive compensation to the recipient (“lockup”) bidder and forecloses other, higher valuing bidders from bidding for the target. In their view, the managers of a target have every reason to seek out the highest possible bidder. But even if they did not, and were inclined to act disloyally, the managers simply cannot prevent the highest valuing bidder from ending up with the target. A higher valuing bidder will either outbid the lockup bidder or, if the lockup is so excessive that it prevents this, will make a deal with the lockup bidder as soon as the lockup bidder has acquired the target. Based on their view that lockups will not prevent the best bidder from winning, Fraidin and Hanson conclude that courts should enforce every lockup, without exception.

As this brief description suggests, Fraidin and Hanson’s analysis can be seen as a straightforward application to corporate lockups of

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6 Throughout the Article, I use the term “lockup” broadly, intending to encompass any provision that has this effect, including stock option agreements (“stock lockups”), options to purchase specified assets (“asset lockups”), and termination or breakup fees. “Lockup” can be a misnomer, since the provision may, but also may not, make it prohibitively expensive for other parties to try to bid on the target, thus locking up the deal between the target and a bidder.

7 For descriptions of some of the Delaware lockup cases, see infra note 93.

8 See, e.g., Ian Ayres, Analyzing Stock Lockups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?, 90 COLUM. L. REV. 682 (1990) (court scrutiny of lockups that clearly “overinsure” the bidder); Stephen M. Bainbridge, Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions, 75 MICH. L. REV. 239 (1990) (favoring presumptively striking down lockups involving more than 10% of target’s stock unless they are preceded by an auction); see also Jennifer J. Johnson & Mary Siegel, Corporate Mergers: Redefining the Role of Target Directors, 136 U. PA. L. REV. 315 (1987).

9 Stephen Fraidin & Jon D. Hanson, Toward Unlocking Lockups, 103 YALE L.J. 1739 (1994).

10 Id. at 1784. I have borrowed the term “lockup bidder” from a new article by Marcel Kahan and Michael Klausner. Marcel Kahan & Michael Klausner, Lockups and the Market for Control (July 1995) (unpublished manuscript, on file with the Northwestern University Law Review).

11 Fraidin & Hanson, supra note 9, at 1788-89.
the Coase Theorem’s suggestion that private parties will always bargain to an efficient solution in the absence of transaction costs.\(^\text{12}\) Fraidin and Hanson do not deny the existence of transaction costs. On the contrary, they acknowledge that the multiple sales their analysis contemplates would entail costs, but they conclude that the costs would be quite low, and the gains from trade high. Consequently, the Coasian bargaining that they envision would routinely take place.

This Article proposes a new approach to corporate lockups, one that offers in striking respects both from Fraidin and Hanson’s analysis and from that of previous commentators. The Article begins by exploring the existing literature on corporate lockups. It focuses in particular on Fraidin and Hanson’s optimistic view of the effect of a lockup provision, both because their analysis suggests important new insights as to the nature of lockups, and because it offers a useful vehicle for assessing the benefits lockups offer and the concerns they raise.

Drawing extensively from contract theory and doctrine, the Article then sketches an alternative approach to lockups, which is referred to as a “reliance damages model.” Like the conventional view of lockups, and unlike Fraidin and Hanson’s perspective, this model relies on court scrutiny of lockups to distinguish between those that should, and those that should not, be enforced. The model diverges from previous commentary, however, in that it focuses on a bidder’s reliance interest rather than its expectancy or the general “reasonableness” of the lockup, and in the model’s contention that a bidder should be entitled to prove its actual damages if its lockup provision is struck down.

The analogy to contract law is an obvious one. As any first-year Contracts student would recognize, and as courts and commentators frequently point out,\(^\text{13}\) lockups are closely analogous to the liquidated damages provisions used in other contract settings. Yet, prior to Fraidin and Hanson, commentators had largely neglected the extensive literature and case law on liquidated damages and other contract issues once they actually began to analyze corporate lockups.\(^\text{14}\) This

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\(^{12}\) See Ronald H. Coase, The Problem of Social Cost, 3 J. L. & ECON. 1 (1960). One of the frontiers of this classic article is that Coase not only does not explicitly articulate what has come to be known as the “Coase Theorem,” but he also intended to focus more on the importance of transaction costs than on the efficacy of private ordering in their absence. For a fascinating exploration of the Coase Theorem and some of its limitations, see Robert Cooter, The Cost of Coase, 11 J. LEGAL STUD. 1 (1982); see also Russell Korobkin, Note, Policymaking and the Offer/Asking Price Gap: Toward a Theory of Efficient Entitlement Allocation, 46 STAN. L. REV. 663 (1994) (arguing that offer/asking price gaps may undermine Coase’s invariance proposition).

\(^{13}\) See, e.g., QVC Network, Inc. v. Paramount Communications, Inc., 635 A.2d 1245 (Del. Ch. 1993), aff’d, 637 A.2d 34 (Del. 1994) ($100 million termination fee is a “fair liquidated amount to cover [the bidder’s] expenses should the . . . merger not be consummated”); Bainbridge, supra note 8, at 286.

\(^{14}\) Ian Ayres’s article on lockups is both an exception to and an illustration of this point. Ayres, supra note 8. Ayres is a prominent contracts scholar in addition to his work in corporate law, and his analysis of the “insurance” effects of lockup provisions tracks an aspect of the eco-
Article takes the insights of contract theory and law in a different, and in my view compelling, direction.

Part I of the Article reviews several of the benefits that Fraiding and Hanson and other commentators attribute to lockups. The Article then shifts to the dark side of lockups and demonstrates in Part II that despite their apparent incentive to grant only appropriate lockups, even "loyal" managers of a target may nevertheless offer an excessive lockup due to mistake or collusion. Part III argues that Fraiding and Hanson's conclusion that Coasian bargaining would prevent lockups from foreclosing higher valuing bidders is mistaken and would pose serious process problems for corporate decision-making even if it were not. After briefly considering the possibility of invalidating all lockups, the final Part proposes and examines my reliance damages model.

I. THE BENEFITS OF LOCKUPS

The suggestion that lockups can serve a beneficial role in corporate acquisitions is noncontroversial—nearly all of the commentators agree that lockups may offer important benefits. This Part begins by assessing Fraiding and Hanson's account of lockup benefits because Fraiding and Hanson challenge conventional explanations as to what these arrangements can and cannot do, and because the relative importance and plausibility of the benefits will play an important role in our consideration of the very different reliance damages approach to lockups proposed in Part IV. 15

A. Traditional Justifications: Compensation for the Costs of Bidding

Commentators traditionally have justified lockups as a means of compensating a bidder for the costs it incurs in bidding. These costs can be viewed as comprising two kinds of expenses: first, the costs to the bidder of its initial investigation and the negotiations leading up to an agreement with the target and second, the costs a bidder faces after the agreement has been signed, during the inevitable delay in consummating the agreement.16 A bidder's post-bid costs include the risk...
that the target will abandon the deal in favor of a new offer that emerges after the parties reach agreement, but before the shareholders of the target have voted on the agreement. By offering a lockup, commentators have argued, a target can encourage the bidder to incur the expense of bidding and properly compensate it for its losses in the event the deal subsequently falls through.¹⁷

Fraidin and Hanson dismiss the conventional view as implausible with respect to the first type of costs—pre-bid costs—due to a logical inconsistency they detect in the explanation. However appropriate a policy it may be to encourage bidding by promising to reimburse a bidder’s costs, lockups are unlikely to serve this purpose because targets do not grant them until after a bidder already has incurred the costs.¹⁸ The argument has obvious force, but it is far from fatal to the traditional view. Lockups still may play some role, even with respect to already incurred costs, if lockups are sufficiently prevalent that a bidder can expect to receive one if it reaches agreement with the target. In such a regime, a bidder could insist on a lockup as a prerequisite to entering into any agreement. Moreover, to the extent a lockup might plausibly compensate a bidder for anticipated post-bid costs, as I argue below, a bidder is likely also to insist that the lockup cover previously incurred expenses.

Fraidin and Hanson’s dismissal of the second half of the traditional justification—that lockups compensate a bidder for the risks it faces due to post-bid delay—is even more problematic. Fraidin and Hanson allude to the costs that a bidder may incur during this period of time, but then consider only the risk that the merger may become “unattractive” to the bidder during the lagtime before its consummation.¹⁹ They ignore the more obvious risk that the bidder may face costs, such as the expenses of conducting additional investigation and devoting further executive time to the transaction, in connection with a merger that remains every bit as attractive as it was initially. Lockups serve as an excellent means of reimbursing the lockup bidder for the costs it will incur if a new bidder emerges and the lockup bidder contests (but loses to, thus triggering the lockup) the new bid because it would rather not abandon the transaction.

B. Counteracting Uncertainty: Differing Expectations and Risk Aversion

In contrast to their skepticism about the conventional justifications for lockups, Fraidin and Hanson view lockups as a desirable

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¹⁷ Bainbridge, supra note 8, at 242.
¹⁸ Fraidin & Hanson, supra note 9, at 1815.
¹⁹ Id. at 1816-17.
means of facilitating agreement when the costs of uncertainty might otherwise scuttle the deal. In particular, if a bidder and target have different expectations about the likely outcome of an auction, or if one party is risk averse, a lockup can increase the likelihood that the parties will come to terms on a mutually beneficial sale.20

To appreciate Fraidin and Hanson’s point about differing expectations, assume that a bidder is willing to pay $150 for the target, but believes that another bidder would go as high as $175 in an open auction. In contrast, the target’s managers, who would accept any offer that exceeded $100, suspect that no other bidder values it at more than $125, and that this is what an auction would bring. On these facts, both parties would benefit if the target’s managers agreed to sell the firm to the initial bidder for $150, and gave the bidder an enforceable lockup in order to protect it against the emergence of the higher bidder it fears. Absent the lockup, the deal might fall through due to the initial bidder’s unwillingness to enter a bidding contest it expects to lose.

It is at least plausible that this account may accord with the dynamic of actual transactions. Target firms often negotiate privately with several possible bidders, and a bidder may well know which other firms the target has spoken to.21 If the target’s discussions persuade it that the initial bidder values it most, but this bidder’s knowledge of the other firms leads it to suspect otherwise, both parties may benefit from a negotiated merger and lockup agreement. Yet it seems questionable whether differing expectations are likely to be the sole, or even the primary, impetus for a lockup in any given case, due to the signalling problems they may create. A bidder who suspects that the target is willing to agree to a lockup due to its pessimistic view of the likely outcome of an auction may decide to lower its bid. Similarly, a target dealing with a pessimistic bidder has an incentive to conduct an

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20 Id. at 1822 (differing expectations); id. at 1823 (risk aversion).

21 The contest to acquire Grumman Industries in Spring 1994 illustrates this point. Martin Marietta entered into a merger agreement with Grumman, but subsequently dropped out when Northrop (who, as Martin Marietta well knew, had previously engaged in merger discussions with Grumman) made a higher bid. See, e.g., Jeff Cole, Northrop Seeks Grumman in Hostile $2.04 Billion Bid—Deal Set Earlier in Week with Martin Marietta Is Topped by $5 a Share, WALL ST. J., Mar. 11, 1994, at A3. If Martin Marietta (which later merged with Lockheed) was in fact the highest bidder and mistakenly thought it would lose a bidding contest to Northrop, Grumman theoretically could have granted Martin Marietta a large lockup in return for a high bid. (In actuality, Grumman granted a relatively small, $50 million termination fee.) In fact, Martin Marietta’s apparent refusal ever to engage in auctions theoretically would have made this use of a lockup valuable to any target whose managers believed that Martin Marietta was the highest valuing bidder. On the other hand, if Martin Marietta was not the highest valuing bidder and the lockup effectively precluded better bidders, the lockup would have a malignant rather than beneficial effect. Part III of this Article discusses these kinds of problems.
additional search for other, higher valuing bidders if the target is able to detect the bidder’s pessimism.22

Fraidin and Hanson also suggest that a lockup can prove beneficial if one or both of the parties is risk averse. If the bidder is risk averse, the parties can agree to a lockup that guarantees the bidder its expected profits in the event a higher bidder appears, thus shifting the uncertainty as to the existence or amount of a higher bid to the target.23 If the target rather than the bidder is risk averse, a lockup could also be calibrated to assure that the target receives a fixed return and that the bidder bears all of the risk.24 As with differing expectations, this account of lockups is subject to significant questions on inspection. Lockups seem better calibrated to address bidder risk aversion than target risk aversion, for instance, and it is not clear why a bidder would be more concerned about a merger deal that falls through than the apparently much greater uncertainties of a merger it actually consummates, as I discuss in somewhat greater detail below.25 In short, differing expectations and bidder risk aversion, while plausible, seem less compelling than the more prosaic traditional justification for lockups.

C. Encouraging Search

Lockups can be viewed as encouraging search by bidders and targets in a variety of ways. In a general sense, if a regime that enforces lockups is preferable to one that does not, lockups will encourage search by each of the interested parties by increasing the gains available from these kinds of transactions.26

In addition to noting this generally beneficial effect on search, Fraidin and Hanson also argue that lockups can give bidders a substantial, direct incentive to engage in post-bid search. If the target gives a bidder a lockup whose effect is to foreclose all other bidders, that bidder itself will benefit if it finds someone else who values the target more than it does, since the bidder could consummate its purchase of the target and then immediately resell the target at a

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22 It is also interesting to note that the differing expectations analysis arguably is in tension with the economic literature on settlements, which predicts that parties will often fail to reach agreement if they disagree about the likely outcome of litigation. See, e.g., Steven Shavell, Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Cost, 11 J. LEGAL STUD. 55 (1982). My thanks to George Cohen for bringing these issues to my attention.

23 Fraidin & Hanson, supra note 9, at 1823. For an insightful analysis of the ways in which contract damages provisions can be used to allocate risk, see A. Mitchell Polinsky, Risk Sharing Through Breach of Contract Remedies, 12 J. LEGAL STUD. 427 (1983).

24 Fraidin & Hanson, supra note 9, at 1823.

25 See infra notes 147-49 and accompanying text.

26 See supra note 17 for a closely analogous point.
In a sense, as the authors point out, the lockup gives the bidder an incentive to act as a sales agent with respect to the target firm, which may be desirable if the bidder has more information about the relevant market than the target does. On the other hand, a lockup is unnecessary for this purpose if the target is likely to be a better seller than the bidder would be, and it seems doubtful that targets would grant a lockup with the bidder’s selling expertise in mind except on rare occasions. Moreover, even the general argument that honoring lockups will encourage search is more problematic than it initially appears. While lockups will encourage search to the extent that target managers grant lockups to unsolicited bidders, a target also can use a lockup to thwart an unwanted offer by granting the lockup to a favored bidder. The possibility that lockups will be used defensively suggests that they sometimes may have a chilling effect on takeover activity and thus undermine the incentive to search.

D. Enhancing the Effectiveness of an Auction Process

One final benefit suggested by Fraidin and Hanson comes in the context of an auction. In a common values auction—that is, an auction where the target is likely to hold roughly the same value to all bidders—bidders may refrain from bidding for fear they will lose money regardless of whether they win the auction. Fraidin and Hanson suggest that, in such a context, a target can use a lockup as a promise to reimburse a bidder for its costs in the event it loses the auction, and thus as a means of encouraging an otherwise reluctant bidder to enter an auction. Despite several commentators’ suggestions to the contrary, corporate acquisitions seem unlikely ever to

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27 Fraidin & Hanson, supra note 9, at 1788-89.
28 Id. at 1827.
29 For an example of such an exceptional case, see In re KDI Corp. Shareholders Litig., No. 10,278, 1988 Del. Ch. LEXIS 143 (Del. Ch. Nov. 1, 1988). In KDI, the principal shareholders of the KDI corporation (who held 49.5% of the stock), agreed to tender their shares into a bidder’s offer, pursuant to an agreement that required the bidder to pay them 50% of any higher price the bidder received on the resale of KDI within one year. Id.
30 See Kahan & Klausner, supra note 10.
31 See Peter Cramton & Alan Schwartz, Using Auction Theory to Inform Takeover Regulation, 7 J.L. ECON. & ORG. 27, 28-30 (1991) (describing “common values” and “independent values” auctions).
32 The problem is that, once it has incurred sunk costs investigating the target and preparing its bid, a bidder knows it loses these costs if it loses the auction. The bidder therefore will bid up to the value of the target, without regard to its costs. If this bid wins, the bidder will have lost an amount equal to the amount of its costs. Id. at 33.
33 Fraidin & Hanson, supra note 9, at 1829-30; cf. Bruce A. Markell, The Case Against Breakup Fees in Bankruptcy, 66 AM. BANKR. L.J. 349 (1992) (questioning whether breakup or termination fees are necessary to induce bidding in the bankruptcy context).
truly be a common values auction. But lockups offer similar benefits in the independent values context: in particular, lockups can help to stimulate bidding.

This brief overview of the role of lockups suggests that, despite its limitations, the conventional view of lockups still seems to be the best account of their benefits. Of the additional benefits postulated by Fraidin and Hanson, the last—enhancing an auction—parallels the traditional view in many respects. While differing expectations, risk aversion, and enhancing search all hold conceptual attraction, each proves problematic on inspection, and will prove more so as we consider the dark side of lockups.

II. Excessive Damages and Other Problems with Lockups

Lockups clearly can be used for beneficial purposes. The question, then, is will they be? If the parties invariably employ lockups in an appropriate fashion, Fraidin and Hanson are justified in concluding that there is no reason for courts to scrutinize them.

Previous commentators have argued that the managers of a target firm suffer from serious conflict of interest problems, and as a result will often grant excessive lockups as a means of privileging a favored bidder. Fraidin and Hanson question whether managers' incentives

34 Cramton and Schwartz suggest that takeover contests often will be a common values auction if all bidders' principal objective is to replace the target's existing managers. Cramton & Schwartz, supra note 31, at 47. Even in this context, however, different bidders inevitably would implement different strategies and management personnel and thus are likely to value the target differently.

If an auction was in fact common values, the target would do better to negotiate a merger with a single bidder, rather than to conduct an auction, since adding bidders would increase costs without generating offsetting benefits. Delaware law limits a target's ability to take such a tack, due to its bias toward auctions. See, e.g., Jonathan R. Macey, Auction Theory, MBOs and Property Rights in Corporate Assets, 25 Wake Forest L. Rev. 85 (1990).

35 Id. Notice that this reasoning is partially undermined by the same kinds of problems Fraidin and Hanson attribute to the conventional justification for lockups: a bidder would not receive the lockup until after it had already incurred the costs of deciding whether to make a particular bid. See supra note 17 and accompanying text.

This is not surprising given that the conventional justification for lockups and the auction argument are closely related, as noted below. In a sense, the conventional justification applies when a target grants a lockup to the initial bidder, and the auction argument often relates to lockups given to second or subsequent bidders.

36 The limitations of these justifications do not undermine the general case for allowing lockups in some contexts, but they do have important implications for court treatment of lockups, as discussed in more detail in Part IV. One implication worth noting now is that, unlike previous commentators' view of lockups, these new justifications purport to even validate lockups that would give a bidder more than its "expectation" damages. To the extent the new justifications are problematic, these shortcomings therefore raise doubts about the appropriateness of supraselectivity lockups.

37 See, e.g., Bainbridge, supra note 8, at 251.
do in fact deviate from those of target shareholders, and assume that "loyal" managers will invariably grant "compensatory" lockups—lockups that obtain for the target shareholders as much in benefits, such as a higher bid or better terms, as the shareholders relinquish in potential damages should the lockup be triggered.

This Part argues, contrary to Fraiding and Hanson's assumption, that even "loyal" managers may grant excessive lockups in many contexts. First, however, I should clarify what I mean by appropriate, as opposed to excessive or malignant lockups, and define the terms I will use for the remainder of the Article.

Commentators frequently characterize appropriate lockups as those pursuant to which the bidder and target receive roughly equivalent benefits, and malignant lockups as those that appear to benefit the bidder at the expense of the target. I will adopt a similar strategy in this Part, since the Part is concerned with the question whether target managers will ever enter into bad lockups. I will refer to such a lockup, one that benefits a bidder at the expense of the target, as "malignant" or "excessive." In subsequent Parts, I also will occasionally refer to lockups as "supra-expectancy" lockups to describe a lockup that promises a bidder more than its anticipated profits from the acquisition. Other commentators have assumed, as do I, that supra-expectancy lockups are excessive because of the foreclosing effect such lockups can have on higher valuing bidders. Thus, supra-expectancy lockups can be seen as a particular kind of excessive or malignant lockup.

Although commentators often purport to consider whether a lockup gives equivalent benefits to the bidder and the target, as I will do in this Part, when it comes to their specific proposals, commentators have usually focused on the amount of compensation the bidder will receive under the lockup. This focus on bidder compensation is both unsurprising and justified, given that lockups act very much like a liquidated damages provision for the bidder. The reliance damages approach set forth in Part IV also focuses on bidder compensation, although it calls for a very different kind of inquiry.

38 See, e.g., Fraiding & Hanson, supra note 9, at 1785-87.
39 See infra note 84. Although one can imagine supra-expectancy lockups that are not malignant, several factors—the chilling effect lockups have on other bids, the problems discussed in this Part, and the fact that a supra-expectancy lockup is not necessary to achieve the primary benefits of a lockup—suggest that supra-expectancy lockups routinely will be excessive.
40 Ian Ayres suggests that any amount greater than "full insurance" is inappropriately generous, for instance, and defines "full insurance" in terms of a bidder's expectancy interest. Ayres, supra note 8, at 794-97. That is, he suggests that a lockup is appropriate so long as it does not provide to a bidder more than the profits it would have received had its deal with the target gone through—a standard similar to the traditional expectation measure of contract damages.
41 In addition to focusing on the amount of compensation a lockup gives the bidder, Delaware courts sometimes purport to consider what the target receives in exchange. See, e.g., Mills
A. Duty of Loyalty Concerns

The principal reason for courts' and commentators' longstanding hostility to lockups is their fear that managers of a target face a severe conflict of interest in the acquisition context. Under this view, lockups may exacerbate managers' inclination to focus less on shareholders' welfare than on protecting their own jobs when a target is being sold. By granting an excessively generous lockup to the bidder that seems most sensitive to their concerns, the managers of a target can ensure that the favored bidder wins out, even if another bidder would otherwise offer more.

Commentators have suggested various solutions to the conflict of interest problem, such as presumptively invalidating any lockup that affects more than ten percent of a target's assets unless it has first been subject to the market test of an auction. Delaware's most recent pronouncement is even stricter, suggesting an almost complete distrust of target managers' motives in the lockup context.

Fraidin and Hanson contend that the widespread concerns about managerial loyalty are misguided. Because managers frequently own substantial amounts of stock, they have a direct financial incentive to sell a target to the highest bidder. Moreover, even if managers were thoroughly disloyal and interested only in job protection, they still would seek out the highest bidder, since the highest bidder could match any side deal offered by a lesser bidder.

Fraidin and Hanson are persuasive in arguing that overt disloyalty seems less pervasive than many commentators have assumed, and that loyalty concerns do not justify a blanket judicial refusal to enforce

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Acquisition v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988) (considering whether target received a "substantial benefit"). Because it is extremely difficult to isolate the benefits a target receives in connection with a lockup, focusing on the bidder's damages is a more useful and manageable approach, as in other liquidated damages contexts.

42 The classic early statement, although it involved takeover defenses rather than lockups, was the Delaware Supreme Court's suggestion in Unocal that the "omnipresent specter that a board may be acting primarily in its own interests" necessitated special scrutiny of directors' actions in the takeover context. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).


44 Bainbridge, supra note 8, at 322-24; see also Johnson & Siegel, supra note 8 (calling for shareholder vote with respect to significant lockups).

45 Paramount Communications, Inc. v. OVC Network, Inc., 637 A.2d 34, 50-51 (Del. 1994). The court in Paramount was so hostile to the lockup arrangement Paramount and Viacom had agreed to in that case that parties have subsequently shied away from stock lockups, though bidders continue to negotiate for termination fees. See Greg Steinmetz, Stock-Option Lockups are Absent from Takeover Deals, WALL ST. J., May 24, 1994, at C1.

46 Fraidin & Hanson, supra note 9, at 1804-05.

47 Id. at 1785.
lockups. Consequently, overt disloyalty can and should be dealt with separately, as proposed in the “reliance damages” model in Part IV.

But to suggest that disloyalty never interferes with managerial decisionmaking in this context seems seriously mistaken. Moreover, even nominally “loyal” managers may be prone to granting excessive lockups. The remainder of this Part considers several reasons why excessive lockups are a very real concern. In connection with this discussion, I also note some of the perverse consequences of excessive lockups.

B. Why “Loyal” Managers May Grant Excessive Lockups

Fraidin and Hanson suggest that there is nothing to worry about once we have taken overt disloyalty problems into account. They assume that so long as it is loyal, a board will never agree to an inappropriate lockup. According to Fraidin and Hanson, their assumption “can be justified on the ground that courts are in no position . . . [to] second guess the decisions of loyal boards.” Even if Fraidin and Hanson’s dim view of judicial competence is justified, an issue explored in detail in the following Part, the question whether and how frequently “loyal” boards grant malignant lockups has critical implications for their insistence that the benefits of lockups are not offset by any conceivable harm.

The analysis below describes two contexts where even “loyal” managers may grant excessive lockups. Together with the possibility of disloyal behavior by target managers, the analysis suggests substantial grounds for concern.

1. Managerial Mistakes in the Bargaining Process.—An obvious, and potentially widespread, source of excessive lockups is that a target’s managers may simply make a mistake; that is, that the managers may miscalculate the amount that a bidder has at stake or the value of the lockup that the parties agree to. Managers can make miscalculations in any context where they stipulate damages, of course, but the risk that mistakes will lead to excessively generous damages seems particularly high with lockups.

First, stock lockups can be particularly difficult to value because the parties may have little way of knowing what the upper value may be (since this will be determined by the winning bid of a bidder who

48 Even if the deal as a whole is tainted, a lockup provision may play a valuable role in promoting bidding if it is limited to an appropriate amount. Consequently, Delaware’s tendency to void lockups altogether in such contexts, based on a conclusion that they are part of an “overall pattern” of inappropriate behavior, seems misguided. See, e.g., Revlon, 506 A.2d at 184. I offer what I view as a superior approach in Part IV.

49 Fraidin & Hanson, supra note 9, at 1745 n.16.
may not initially be known to either party). In theory, the amount of a higher bidder's final bid is related to the lockup bidder's reservation price, since the winning bid in an auction ordinarily should equal (or barely exceed) the reservation price of the second highest bidder. But it is unclear whether this in fact is true in practice in the corporate acquisition context. The new bidder's presence may alter the lockup bidder's reservation price, for example, or the new bidder may offer more than this price if the auction is not an English (that is, increasing bid) auction. Thus, even if the parties wished to correlate lockup damages in some fashion with the lockup bidder's reservation price, the higher bidder's final bid may not be an appropriate surrogate for this amount, and the problem is compounded by the fact that a lockup ordinarily cannot affect more than twenty percent of a target's stock.

The second factor indirectly returns us to the question of managerial loyalty. However loyal managers may otherwise be to target shareholders, they frequently will have an implicit preference for one bidder over another. Such preferences could play a role on the margin in any transaction a corporation enters into, but they take on particular significance in the acquisition context, since acquisitions affect the very nature of the enterprise. In Revlon, for instance, it was no secret that Michel Bergerac, Revlon's chief executive, viewed suitor Ronald Perelman with deep animosity. Similarly, in the recent contest for Paramount, newspapers widely reported that Paramount's Martin Davis enjoyed far more cordial relations with Sumner Redstone of Viacom than he did with Barry Diller, the CEO of QVC, Paramount's other suitor.

In short, managers of a target may be particularly subject to cognitive dissonance in the acquisition context, at least in some cases conflating their own preferences that the target be sold to one bidder.

50 The Delaware Supreme Court was particularly concerned about this in Paramount, stating that “[b]ecause the Stock Option Agreement was not ‘capped’ to limit its maximum dollar value, it had the potential to reach (and in this case did reach) unreasonable levels.” Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 39 (Del. 1994).

51 For a good overview of corporate auctions and the implications of different auction strategies, see Macey, supra note 35.

52 An expectancy-based lockup, for instance, would give the bidder an amount equal to the difference between its bid and its reservation price; Fraidin and Hanson's differing expectations and risk aversion rationales both appear to use expectancy as a floor.

53 If the target is listed on the New York Stock Exchange, for instance, the issuance of 20% of its stock would require a shareholder vote, thus undermining much of the purpose of the lockup.


55 See, e.g., Susan Antilla, Hard Lessons of Paramount's Saga, N.Y. TIMES, Dec. 26, 1993, at F11 (noting that it is well-known that Martin Davis "hates Barry Diller").
rather than others with the best interests of their shareholders. Managers may overestimate the attractiveness of other aspects of the bidder's offer or underestimate the likelihood or potential value of a competing offer. Together, valuation difficulties and the existence of implicit preferences create a nontrivial possibility that loyal managers will make costly mistakes in granting lockups.

2. Collusion Between Target and a Bidder.—In addition to mistake, another exception to parties' general tendency to provide for appropriate, rather than excessive liquidated damages, is collusion and related bargaining breakdowns.

The perception that target managers are unlikely to enter into an inappropriate lockup agreement implicitly assumes that the parties have equal bargaining power. Economists have shown that parties may deviate from this norm, however, if one has market power vis-à-vis the other. In this view, a monopolist may insist on excessive damages in order to exclude competitors. The promisor may agree to

56 Such dissonance seems most likely to come into play when there is only one bidder and the target's managers discount the possibility that others will emerge, or—as very frequently is the case—when it is unclear which of two or more bidders is the highest valuing bidder. Target managers cannot so easily justify a preference if the preferred bidder clearly is not the highest valuing bidder.

57 The famous Globe Woolen case may well have been an example of such a dynamic. Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. 1918). In Globe Woolen, Maynard, who was a director of both Globe Woolen and Utica Gas and Electricity, and the largest stockholder of Globe Woolen, agreed at the urging of a Utica officer to consider converting Globe Woolen's mills to electricity. But Maynard made clear that he would only be interested if Utica guaranteed that the switch would reduce Globe Woolen's energy costs. The contract that the Utica employee devised and the parties agreed to turned out to give Globe Woolen an enormous windfall, and was struck down by Judge Cardozo as violating Maynard's duty of loyalty to Utica. While no evidence suggests that Maynard was involved in drafting the proposed contract, or that the Utica employee intentionally favored Globe Woolen, one suspects that the employee's subconscious desire to make the arrangement work for Globe Woolen—due to Maynard's status as one of his employer's (Utica's) directors—increased the likelihood of a miscalculation such as the one that in fact occurred.

58 In the analogous context of liquidated damages, commentators have suggested that promises have a disincentive to seek supra-compensatory damages because they will have to pay for the extra compensation, perhaps in the form of a higher bid. Alan Schwartz, The Myth that Promissee Prefer Supra-compensatory Remedies: An Analysis of Contracting for Contract Damages, 100 YALE L.J. 369 (1990). Notice that a bidder's general disinclination to pay for excessive relief might reduce, but would not eliminate, the possibility of mistake. Moreover, any such disinclination seems likely to be particularly muted in the corporate acquisition context, especially if the target managers' preferences cause them to attach little value to the possibility of other, higher bids.

such a provision so that it will receive some of the rents obtained from a third party that attempts to enter the market.\textsuperscript{60}

Thus, in the corporate acquisition context, a bidder who has market power may demand a lockup that excludes all other bidders except those that not only can outbid the lockup bidder in absolute terms, but also can shoulder the cost of the excessive damages triggered if they win the bidding. It is not clear how frequently bidders are likely to have market power superior to that of a target. Yet many, and perhaps most, observers do not view the market for corporate control as a competitive market,\textsuperscript{61} and a bidder may often have significant leverage if the target’s managers are concerned that another, more hostile bidder could emerge.

Fraidin and Hanson acknowledge that bidders and targets may enter into collusive lockups, but characterize this as a potential benefit of lockups rather than as a problem. A simple hypothetical illustrates their reasoning. Assume that the initial bidder, $B_1$, values the target at $75; another bidder, $B_3$, values it at $100; and the target’s managers would be willing to sell it for $70 or more. Rather than auction the target, both the bidder and the target may benefit if they enter an agreement pursuant to which $B_1$ bids $85 and target agrees to a $14 lockup.\textsuperscript{63} Absent the lockup, $B_3$ would have won the auction by agreeing to pay $75 for bidder. The lockup forces $B_3$ to raise its bid to $86 (or, more precisely, to an amount greater than $85), which together with the $14 $B_3$ must pay to $B_1$ equals $B_3$’s full reservation price, and enables $B_1$ and the target to secure most or all of $B_3$’s profits for themselves.\textsuperscript{64}

This account suggests that collusive damages not only may accord with allocative efficiency (since the bidder that values the target most, $B_3$, will win the bidding), but they may also be value increasing for target’s shareholders. The problem with the account is that it seems to

\textsuperscript{60}The collusion analysis depends on an assumption that a third-party entrant is likely to have market power—that is, that there will be only one entrant, rather than, competing entrants. See, e.g., Bradley & Ma, supra note 59, at 1173. This very frequently is the case in the corporate acquisition context, as suggested by the discussion of the nature of the corporate control market below.

\textsuperscript{61}See, e.g., Edward B. Rock, Antitrust and the Market for Corporate Control, 77 CAL. L. REV. 1365, 1379 (1989). Fraidin and Hanson themselves note this in another context. Fraidin & Hanson, supra note 9, at 1813 n.284.

\textsuperscript{62}Following Fraidin and Hanson’s notation (which they in turn borrow from Ayres, supra note 8), I use $B_1$ to indicate the initial bidder (and recipient of the lockup) and $B_3$ to refer to the new, higher valuing bidder.

\textsuperscript{63}Notice that, while $B_1$’s $85 bid exceeds its reservation price, $B_1$ does not expect to pay this amount because it anticipates that $B_3$ will win the bidding. Some of the problems with this analysis are discussed below.

\textsuperscript{64}Thus, the target would receive a $16 profit ($86-$70), and $B_1$ would receive the $14 value of its lockup. Absent the lockup, $B_3$ would only need to bid $75 (or slightly more) to win the bidding, thus giving the target a profit of $5 ($75-$70) and leaving $B_1$ with nothing.
assume that B1 and target have equal bargaining power and that both know exactly what B3's reservation price for target is. The parties' ability to ascertain B3's reservation price is limited if B3 has actively participated in the bidding process, and next to none if the target and B1 agree to a lockup before any other bidders have entered the bidding. Moreover, if B1 has superior bargaining power, or if the parties misgauge B3's valuation of the target, the lockup may yield far more malignant consequences. If, for instance, B1 bids $70 and is given a lockup worth $35, allocative efficiency could be thwarted, since B3 may never enter the bidding, and target's shareholders could fare worse than they would in a simple auction.65 Such a result seems at least as likely to occur as the rosy scenario Fraidin and Hanson depict.66

In sum, Fraidin and Hanson's assumption that loyal managers will never grant excessive lockups is simply an assumption. The likelihood of mistakes and collusion makes clear that malignant lockups are a very real concern. The most obvious consequence of such lockups is that they may cause a target to be sold to a lower valuing, rather than the highest valuing, bidder. Given that lockups enhance target managers' ability to control whether a particular bidder acquires the target, excessive lockups also can have perverse effects outside of the bidding process.67 Because potential bidders fear that the target will grant a lockup to a favored bidder, and thus thwart any unsolicited offer, lockups can reduce bidders' incentive to engage in a search.68 In addition, target managers' ability to use lockups as leverage in negotiating continued employment or attractive severance packages could

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65 B1's bid of $70 gives target shareholders $5 less than the $75 they would receive in a simple auction. The lockup thus acts like a specific performance provision. This presumably is at least part of what Viacom had in mind when it announced, in a much quoted statement, that only a “nuclear attack” could prevent its acquisition of Paramount from going through. Paramount Communications, Inc. v. QVC Newwork, Inc., 637 A.2d 34, 39 (Del. 1994). Notice that an asset lockup is particularly likely to entail what, in effect, is specific performance, although the parties run the risk that a lockup involving the target's key assets will be seen as a sale of most or all of its assets, thus requiring a shareholder vote. See, e.g., Del. Code. Ann. tit. 8, § 271 (Supp. 1995).

66 Fraidin and Hanson's response to this is to suggest that B1 will resell the target to B3, which would make both better off and assure that the target ultimately winds up in the hands of the highest valuing bidder, B3. I describe some of the impediments to this scenario in Part III, infra.

67 The collusion problem is particularly acute if B1 and the target do not know whether B3—that is, a higher valuing third party—exists at the time they agree to an acquisition and lockup, since uncertainty about B3 magnifies the likelihood that B1 can secure a lockup that precludes entry by another bidder. See Bradley & Ma, supra note 59.

68 The concerns discussed below can arise even with an otherwise appropriate lockup. They obviously are exacerbated if the target's managers grant an excessive lockup.

69 Marcel Kahan and Michael Klausner discuss this concern in detail in a forthcoming article. See Kahan & Klausner, supra note 10.
diminish the ex ante disciplining effect the takeover market has on managers.69

Lockups also offer significant benefits, as we have seen. But the perverse effects they can have suggest that courts have every reason to be concerned that target managers not enter into malignant lockup arrangements.

III. The Impossibility of Foreclosing Higher Bidders?

While Fraidin and Hanson might quibble with the particulars of the preceding analysis, they appear to acknowledge the possibility of excessive lockups. Their response is to suggest that there is nothing to worry about, and that the concerns noted in the preceding analysis are mistaken. In what arguably is the pivotal contention in their article, Fraidin and Hanson insist that even an excessive lockup will not foreclose a higher bidder from acquiring the target and, as a result, that it does not make a difference whether a target’s managers sometimes grant inappropriately generous damages.70

Simply put, they argue that as long as B1’s bid plus the amount of the lockup is less than B3’s reservation price, B3 will win the bidding in the first instance; moreover, even if an excessive, supra-expectancy lockup stymies B3 initially, thus enabling B1 to acquire the target, B3 will simply arrange to purchase the target from B1 at some price higher than B1’s reservation price but lower than B3’s. Thus, even if the lockup is great enough to thwart a higher valuing bidder initially, it will not prevent such a bidder from ultimately acquiring the target. In short, lockups will not interfere with allocative efficiency.

Despite its surface appeal, the suggestion that lower valuing bidders will always resell targets to higher bidders, and in doing so counteract the effects of excessive lockups, proves problematic on inspection. The subparts that follow consider the two most obvious impediments to this scenario.71

69 Id. The detrimental effect on managerial discipline should not be overstated. Even if the managers of a target are able to retain their jobs, they are likely to be subject to enhanced oversight after a takeover. Moreover, because takeover defenses already give target managers a significant say in whether the target is or is not taken over, as well as significant leverage in bargaining with a bidder, lockups may have only a marginal additional effect.

70 Fraidin & Hanson, supra note 9, at 1788-89. As the illustration below suggests, any lockup that gives a bidder more than its expectancy interest can have the foreclosing effect described in this Part. For a more detailed discussion of this point and its implications, see infra note 83.

71 In addition to the problems with resale as a means of counteracting excessive lockups that I discuss below, full enforcement of excessive lockups may diminish the parties’ incentive to renegotiate inappropriate lockup provisions. This concern is discussed in greater detail in Part IV.
A. The Costs of Resale

In the much-cited debate about managers’ response to takeover efforts, Ronald Gilson suggested that resale by an initial bidder after it acquired a target could entail substantial costs.72 Gilson’s reasoning was that once a bidder and target merge, any subsequent bidder (B3) now must value the combined entity. As a result, any previous investigation of the target is largely useless, and B3 must reinvestigate in order to account for the effects of the initial bidder-target combination. At its heart, Gilson’s analysis was an argument about the likelihood of Coasian bargaining in the corporate acquisition context. In his view, significant transaction costs would impede the multiple transactions necessary to move a target to the bidder that values it most.

Fraidin and Hanson point out in response that, by reselling the target before it and the target have merged (“preselling” the target), the initial bidder (B1) can minimize the need for the duplicative investigation that Gilson was concerned about. Yet even a presale of this sort would fall far short of eliminating the costs of an additional sale. Moreover, presales obviously would not take place on every occasion when a higher valuing bidder (B3) existed, particularly if B1 were unaware of B3’s existence. In short, resales and even presales would entail significant costs that would potentially thwart the second sale on which Fraidin and Hanson’s analysis depends in some, and perhaps many, cases.

What are these costs? First, even if B3 already had evaluated and bid on the target, and B1 and the target had not yet combined (thus obviating Gilson’s “reinventing the wheel” concern), both it and B1 still would face additional investigation and other costs in connection with the second sale. If B3 had dropped out of the original bidding

early on, the necessary investigation could be substantial.\textsuperscript{73} B3’s expenses also would include the costs of conducting potentially lengthy negotiations with B1. The second sale would involve similar costs for B1, including additional negotiation costs. Moreover, if B3 had not participated in the original bidding—as might often be the case if lockups were fully enforced, since negotiated agreements that included excessive lockups could chill any third party interest—the initial bidder’s costs also would include the expense of locating and reaching agreement with (and the risk of failing to do so) a higher valuing B3.\textsuperscript{74}

A second transaction cost of resale is the risk of impasse due to strategic bargaining frictions.\textsuperscript{75} Suppose, as suggested earlier, that the initial bidder, B1, has agreed to purchase target for $70 and has been given a $35 lockup, and that B3 values target at $100. While B1 has an incentive to sell target to B3 for some amount between $75 and $100, and B3 has an incentive to buy, as in any negotiating process, uncertainty about one another’s bargaining range or other factors may prevent them from reaching agreement.\textsuperscript{76} More than in many contexts, in corporate acquisitions, personality conflicts and target directors’ recognition that they may lose their positions as a result of the takeover magnify these frictions, and can play a large role in whether a deal actually goes through.\textsuperscript{77} If an initial contest between B1 and B3 to purchase target was acrimonious, such frictions might prevent resale negotiations from ever getting off the ground.\textsuperscript{78}

\textsuperscript{73} Notice that, if the lockup led to an early conclusion of the initial sale, any costs saved as a result of B3’s early exit would need to be subtracted from the costs incurred in the second sale in order to determine the net costs of the extra sale.

\textsuperscript{74} See, e.g., Bebchuk, \textit{Facilitating Competing Tender Offers}, supra note 72, at 1048; Bebchuk, \textit{A Reply and Extension}, supra note 72, at 41. The risk that a higher valuing bidder exists but would never be located is not a trivial one. Although the initial bidder theoretically has an incentive to search for such a bidder, as a practical matter many bidders are primarily interested in acquiring the target, as noted below. See infra note 79 and accompanying text. Unless an obviously higher valuing bidder is readily at hand, the initial bidder may not seriously look for a sale, at least in the near term.

\textsuperscript{75} I use the term “strategic bargaining frictions” in an effort to make clear that the concerns addressed in the text that follows are a specific type of “friction” or transaction cost.


\textsuperscript{77} See supra notes 54-55 and accompanying text for anecdotal examples.

\textsuperscript{78} While Fraidin and Hanson allude to such costs, they dismiss them in a footnote, based on their belief that “the transactions costs of resale and pre-sale are no higher than those between the recipient bidder and the target board.” Fraidin & Hanson, supra note 9, at 1803 n.239. But this does not follow from their analysis. The comparison is not between the strategic bargaining frictions of a target-B1 sale and those of the sale by B1 to B3. Rather than substituting one sale for the other, resale adds a second sale. Resale therefore entails two sets of bargaining frictions rather than just one. Moreover, even if Fraidin and Hanson were correct to compare the two
A consideration of the reasons the managers of bidders engage in takeovers underscores the obstacles to resale. Observers have long suggested, and recent studies confirm, that hubris is often an important motivating factor in a bidder's decision to engage in acquisition activity.\textsuperscript{79} Even in the absence of an "empire building" motivation, bidders who have strategic reasons for acquiring a target often have not pursued the acquisition with resale in mind. In both instances, a successful initial bidder may have little interest in considering a resale to B3. Moreover, the literature on the gaps between offer and asking prices suggests that the price at which B1 would consider a resale may rise considerably once it has acquired the target.\textsuperscript{80}

Tax effects are still another source of potential impediments. In an auction regime, B3 could structure its acquisition of the target as a tax-free reorganization in many cases.\textsuperscript{81} By contrast, the resale mechanism could undermine B3's ability to structure the acquisition as tax-free. If the initial sale of the target to B1 were taxable, for instance, this sale might preclude B3 from characterizing its subsequent purchase of the target from B1 as tax-free, thus adding a potentially huge transaction cost—an expense that could scotch the deal from B3's perspective and, as a result, prevent the highest bidder from acquiring the target.\textsuperscript{82}

sets of costs, the second (B1-B3) sale might often involve more significant strategic bargaining frictions than a sale of target to B1 or an auction involving B1 and B3. Not only does target managers' willingness to grant a lockup to B1 suggest that target-B1 strategic bargaining frictions may be comparatively low, but B1 and B3 will often be competitors, thus magnifying the likelihood of such frictions. If such frictions are absent, on the other hand, and the resale process between B1 and B3 is too smooth (and even if it is not), it might even raise antitrust concerns. For an argument that bidders who decide to negotiate jointly should be subject to antitrust scrutiny, see Rock, supra note 61.

\textsuperscript{79} See, e.g., Mathew L.A. Hayward & Donald C. Hambrick, Explaining Premiums Paid for Large Acquisitions: Evidence of CEO Hubris (July 1995) (unpublished manuscript, on file with the Northwestern University Law Review) (four key characteristics of managers most likely to engage in short-term acquisition activity were inexperience in the industry, good performance in recent months, self-esteem, and recent, glowing press coverage); see also Richard Roll, The Hubris Hypothesis of Corporate Takeovers, 59 J. Bus. 197 (1986).

\textsuperscript{80} The offer/asking price gap refers to the tendency of current owners of property to place a higher value on the property than do potential buyers. The existence of such a gap is an important impediment to Coasian bargaining. See, e.g., Korobkin, supra note 12.

\textsuperscript{81} A bidder generally can treat an acquisition as tax-free if a significant portion of the purchase price consists of the bidder's stock. See generally 26 U.S.C. § 368(a) (1988) (defining "reorganization"); id. §§ 354-68 (providing for tax-free treatment of reorganizations where there is a continuity of interest of the new and old security holders).

\textsuperscript{82} The problem is that the initial taxable purchase could be seen as eliminating the continuity of interest between B3 and the holders of the target's stock. In the recent, widely followed decision in J.E. Seagram Corp. v. Comm'r, 104 T.C. 75 (1995), which involved the competing tender offers by Seagram and DuPont for Conoco, the Tax Court held that Seagram's purchase of a substantial minority of Conoco's shares through its unsuccessful tender offer did not destroy the tax-free nature of DuPont's successful cash-and-stock tender. Had Seagram actually acquired Conoco, then sold its shares to DuPont in a sale-resale transaction, DuPont would have
This is not to say that the resales envisioned by Fraidin and Hanson would never occur in a full enforcement regime. At least sometimes, they would. But Fraidin and Hanson suggest that the resale would regularly take place—that a higher valuing bidder would always end up acquiring the target.\footnote{See Fraidin & Hanson, supra note 9, at 1804 (“foreclosure is unlikely ever to occur”).} As suggested by our discussion of the direct and indirect costs of an additional transaction, however, their belief in flawless private ordering is implausible. Lockups could and would prevent the target from winding up in the hands of the highest valuing bidder in some cases. Moreover, even if transaction costs do not interfere with a desirable second sale, the expense of resale is likely to be substantial, which reintroduces the question of whether depending on a series of sales to counteract the perverse effects of an excessive lockup really is the best way to transfer ownership of a target.

### B. Process Concerns with a Full Enforcement Regime

In addition to serving as liquidated damages, lockup provisions can (as noted earlier) act very much like a specific performance provision. Once the managers of a target grant an excessive lockup to an initial bidder, they may effectively preclude the target from selling itself to any other bidder. Notice that resale or presale by the initial bidder to a higher valuing bidder does not change this. While a second sale may transfer the target to a higher valuing bidder, the target has already been sold to the initial bidder when this occurs.

Even if one is not concerned about lockups that are both excessive and foreclosing from the perspective of allocative efficiency, these lockups are deeply problematic from a corporate decision-making perspective.\footnote{Any lockup that assures a bidder more than its expectancy interest can foreclose higher bidders, as Ayres (speaking in terms of “full insurance”) pointed out. Ayres, supra note 8. Although Fraidin and Hanson argue that the parties might appropriately enter into supra-expectancy lockups in some circumstances, the need for such relief is questionable, as discussed earlier in subpart I.B (differing expectations and risk aversion), and elaborated on below in arguing for a reliance-based standard. See Part IV. Supra-expectancy lockups therefore seem much more likely to reflect mistake or collusion than more benign origins, and I will assume that this is the case in the discussion that follows. Moreover, the process problems I describe raise questions even about an otherwise benign, supra-expectancy lockup.}

In the corporate acquisition context, the role of a tar-
target's managers is to propose a merger or other transaction to target shareholders, and to put the final decision to a shareholder vote. The problem with a foreclosing, supra-expectancy lockup is that it makes the target's directors, rather than its shareholders, the final decisionmaker as to the sale to the initial bidder. Once the sale has been "locked up" with such a lockup, it is effectively a done deal, long before shareholders have the opportunity to respond.

Fraidin and Hanson do not address this concern, but related questions have surfaced in several important non-Delaware decisions that purport to apply Delaware law. The most prominent of these cases have focused on agreements by a target board not to entertain any bids other than that of the initial bidder—so-called "exclusivity" provisions. Courts generally have been hostile to these provisions. While the Ninth Circuit indicated a willingness to enforce an exclusivity provision, two state supreme courts have refused to hold directors to "best efforts" clauses after changed circumstances made the merger in question less attractive.

These exclusivity provisions arguably do not really interfere with intracorporate decisionmaking, at least in the absence of duty of loyalty problems. This is because, from an ex ante perspective, directors may be acting wholly consistently with their fiduciary duties when they agree to a best efforts provision—only when circumstances change does 20/20 hindsight cast doubt on the decision. Similarly, the provisions affect, but arguably do not seriously undermine, shareholder voting: shareholders can reject the proposal if a new suitor emerges, and thus pave the way for a subsequent tender offer or merger proposal from the new suitor.

_Quence, this seems less problematic. Any residual concern would almost completely disappear under the reliance model proposed in the next Part._
The same cannot be said of a supra-expectancy lockup, however. Far more than exclusivity provisions, such a lockup may effectively foreclose all other options. In theory, shareholders still can vote down the initial proposal, but any new suitor would be forced to make good on the stock lockup, an added expense that may eliminate its ability to top the initial bidder’s bid. Thus, if a target’s board grants a supra-expectancy lockup, it may leave target shareholders with little choice but to forego any takeover premium or to approve the initial proposal.

At the least, this suggests that lawmakers should sharply curtail the allowable duration of such lockups. If the lockup were strictly limited in duration, shareholders’ ability to reject the existing proposal in the hope of a subsequent, better offer would not be nearly as seriously undermined. From the initial bidder’s perspective, of course, this would take away much of an otherwise foreclosing lockup’s attractiveness. Nevertheless, it seems clear that some degree of judicial scrutiny of lockups is both necessary and inevitable, contrary to Fraido and Hanson’s call for universal enforcement.

IV. ALTERNATIVE APPROACHES TO CORPORATE LOCKUPS

In assessing the existing literature on lockups, Fraido and Hanson contend that a lockup should never be invalidated unless it both is excessive and forecloses other possible bidders. In their view, no lockup will meet this standard of malignancy. The authors therefore conclude, paraphrasing Delaware’s Chancellor Allen, that since “lockups, like chicken soup, can’t hurt but may well help,” courts should always enforce them.

The problem with their otherwise well-reasoned analysis is that lockups clearly can “hurt.” As we have seen, even loyal boards will sometimes grant excessive lockups, and such lockups may thwart sales to higher valuing bidders. Because full enforcement falls far short of the perfection that Fraido and Hanson attribute to it, we must compare it to other plausible approaches. I take up this task in the subparts that follow and, in doing so, propose a reliance damages approach to judicial scrutiny of lockups.

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91 See Buxbaum, supra note 89, at 1706. For a similar point about fiduciary duties in the takeover context, see Marcel Kahan, Paramount or Paradox: The Delaware Supreme Court’s Takeover Jurisprudence, 19 J. Corp. L. 583, 596-97 (1994). Kahan argues that the inability of Revlon’s shareholders to reverse the merger agreement between Forstmann and Revlon if they wished to do so, due to defensive measures such as the lockup used in that case, was an important factor in the Delaware’s Supreme Court’s decision to apply enhanced scrutiny in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

92 Fraido & Hanson, supra note 9, at 1745.
A. Invalidating All Lockups

Given the shortcomings of a blanket enforcement regime, one alternative would be to move in precisely the opposite direction—to invalidate all lockup arrangements. Like full enforcement, universal invalidation would obviate the need for judicial assessment of which lockups are and are not appropriate. This approach also would eliminate the risk of malignant lockups and other problems.

The obvious downside to invalidation is that it sacrifices all of the benefits of lockups—their usefulness in compensating a bidder for its costs, for instance, and for enticing a reluctant bidder to participate in an auction. In light of these benefits, blanket invalidation seems relatively unattractive unless we conclude that lockup arrangements are routinely malignant. Nevertheless, this clearly is a plausible approach. It also avoids the kinds of process problems posed by a full enforcement regime.

B. A Reliance Damages Model of Judicial Scrutiny

The more obvious choice is a model between the extremes of invalidating all lockups and Fraidin and Hanson's full enforcement regime. This subpart describes a model for court differentiation and argues that, while it too has shortcomings, the model is at least as attractive normatively and is far more plausible positively than blanket enforcement. While previous commentators also have called for varying kinds of judicial scrutiny, this model, my reliance damages model, differs in several crucial respects. Most importantly, based on the analogy between lockup provisions and contract damages generally, I question the frequent use of expectancy-based assumptions about lockups, after first making a case that courts should scrutinize lockups at least to the extent of striking down those that promise a bidder more than its expectancy interest.

1. Lockups as Liquidated Damages Provisions.—In American contracts law, judicial scrutiny rather than universal enforcement of liquidated damages provisions has long been the norm. In assessing a provision that stipulates damages, courts consider whether it appropri-

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93 Despite the hostility towards lockups shown by the Delaware Supreme Court in Paramount, the court has always insisted that lockups are not per se invalid. Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994); Revlon, 506 A.2d at 183.

94 See supra note 8.
ately compensates a nonbreaching party for her expectation damages, striking down the provision if it operates as a penalty—i.e., if it gives the nonbreaching party a greater profit than she would have received if the contract had been performed.\textsuperscript{95} Courts do not require that a liquidated damages provision correlate perfectly with actual expectation damages. Instead, they tend to focus on whether the provision was a reasonable prediction of a promisee’s likely damages in the event of a breach, and whether the actual amount of damages was uncertain.\textsuperscript{96}

Although some contracts commentators have insisted that courts should routinely enforce all liquidated damages clauses,\textsuperscript{97} much as Fraidin and Hanson argue for blanket enforcement of lockups, courts’ hostility to supra-expectancy damages provisions can be persuasively justified on efficiency grounds. By invalidating supra-expectancy liquidated damages provisions, courts can minimize the incentive promisees otherwise would have to strategically induce a breach to take advantage of an excessive damages provision.\textsuperscript{98} An excessive damages provision may also be evidence of mistake or implicit collusion between the parties.\textsuperscript{99} Given that lockups are closely analogous to liquidated damages provisions, this reasoning also serves as a powerful argument for judicial scrutiny of lockup arrangements.\textsuperscript{100}


\textsuperscript{96} Rea, supra note 95, at 147-48. The Uniform Commercial Code and the Second Restatement adopt essentially this standard. U.C.C. § 2-718(1); Restatement (Second) of Contracts § 356 (1981). However, neither expressly limits a court’s focus to the time of the contract, and some courts have required that liquidated damages be reasonable not only then but also at the time of the breach. See, e.g., Vines v. Orchard Hills, Inc., 435 A.2d 1022 (Conn. 1981) (focusing on reasonableness at breach). At least one commentator detects an increasing tendency by courts to invalidate liquidated damages provisions that are unreasonable at the time of breach, even if they were reasonable initially. Note, \textit{Contract Renegotiation}, supra note 95, at 1202-03.

\textsuperscript{97} Schwartz, supra note 58.

\textsuperscript{98} See Clarkson et al., supra note 95, at 366.

\textsuperscript{99} See Rea, supra note 95, at 160-63. Rea points out that nonenforcement in the event of a mistake “forces the party best able to acquire information on losses, the buyer, to acquire more information.” \textit{Id.} at 162.

\textsuperscript{100} Eric Talley has recently suggested, as an additional reason for judicial scrutiny of excessive liquidated damages provisions, that scrutiny may reduce the costs of ex post renegotiation of inappropriate provisions, even if uncertainty undermines the courts’ ability to accurately determine the nonbreaching party’s actual damages. Note, \textit{Contract Renegotiation}, supra note 95, at 1240-41. For further discussion of this insight and its applicability to corporate lockups, see infra notes 106 & 127 and accompanying text.
To be sure, not all of the justifications for striking down supra-expectancy liquidated damages provisions translate into the corporate lockup context. The inducement issue is one example. The concern in the context of an ordinary contract is that a promisee who is protected by an overly generous damages provision will attempt to claim breach if the promisor deviates from the contract in even trivial ways.101 Lockups, on the other hand, ordinarily are triggered by dramatic, easily ascertainable events most of which are entirely within the promisor’s (target’s) control, such as a target’s decision to accept a second offer.

The lockup agreement Paramount gave to Viacom, and which was eventually struck down by the Delaware Supreme Court, illustrates this point. All four of the events that would trigger Viacom’s lockup rights turned on Paramount’s entering into a Business Combination or Competing Transaction (as defined in the merger agreement) with another bidder.102 Because each of these factors is in the target’s (here, Paramount’s) control, a lockup bidder such as Viacom could not easily induce breach. Moreover, “breach” is less pernicious with lockups since it ordinarily benefits both parties—the lockup bidder receives the value of the lockup and the target sells to a higher valuing bidder—rather than only the promisee (bidder); and the possibility that a higher bidder will emerge arguably is contemplated by the parties and courts.103

Despite such distinctions, the case for scrutinizing lockups is at least as compelling as it is for other liquidated damages provisions. As we have seen, and as happens with liquidated damages provisions, mistake, collusion, or other problems may cause the parties to agree to an excessive lockup. While Fraidin and Hanson contend that there is no reason to worry about even those lockups that foreclose other, higher valuing bidders, since a lockup bidder can simply resell to a higher valuing bidder and thus ensure allocative efficiency, judicial scrutiny offers several advantages over their sale-resale scenario.

101 See, e.g., Clarkson et al., supra note 95, at 366; see also Lake River Corp. v. Carborundum Co., 769 F.2d 1284 (7th Cir. 1985) (dicta noting the inducement concern).
102 See Stock Option Agreement Between Viacom, Inc. and Paramount Communications, Inc. § 1.02(b) (Sept. 12, 1993) (defining “exercise event” as any of the events described in § 8.05(b) of the merger agreement) (on file with the Northwestern University Law Review); Amended and Restated Agreement and Plan of Merger Between Viacom, Inc. and Paramount Communications, Inc. § 8.05(b)(i)-(iv) (October 24, 1993) (on file with the Northwestern University Law Review).
103 Moreover, “breach” of a merger agreement entered into by a bidder and the target’s board in one sense is not really a breach (of the agreement as a whole, at least; it is a breach of the lockup arrangement), since the merger agreement does not become fully enforceable until the target’s shareholders approve it. Notice, however, that preliminary status does not always preclude a conclusion that jilting a would-be contract partner constitutes breach. For a dramatic recent example, see Texaco, Inc. v. Pennzoll Co., 729 S.W.2d 768 (Tex. App. 1987), cert. denied, 485 U.S. 994 (1988).
First, court scrutiny avoids the need for two separate sales. If the costs of a second sale are greater than those of judicial scrutiny, this alone would justify limiting the scope of permissible lockup damages, an issue explored in more detail below.\(^\text{104}\) Moreover, the prospect of court scrutiny may both reduce the likelihood of mistake or collusion in the first instance\(^\text{105}\) and increase the parties' incentive to renegotiate those lockups that nevertheless do turn out to be excessive.\(^\text{106}\)

Second, Fraidin and Hanson's resale contemplates the lockup bidder making the ultimate sale of the target, whereas the target's managers would ordinarily sell it to the higher valuing bidder after court scrutiny of a lockup. Because the target's managers are likely to have more information about the target and its existing prospects than the lockup bidder, and at least as much information about other potential buyers, the target will often be the better seller. In theory, a full enforcement regime might offer the best of both worlds, since the parties could provide for a supra-expectancy, foreclosing lockup if the bidder is the better seller, but forego such a lockup if the target appears to have a comparative advantage. Yet the possibility of disloyalty, mistake, or collusion suggests that this often will not be the real reason for the parties' agreement to a foreclosing lockup,\(^\text{107}\) and as noted earlier, lockup bidders often have little interest in reselling to another bidder.\(^\text{108}\)

Finally—and from a descriptive perspective, crucially—limiting lockup damages avoids the corporate law process problems that undermine Fraidin and Hanson's universal enforcement proposal. As noted above, invalidating supra-expectancy lockups addresses both the foreclosure problem and the risk that target shareholders will be forced to accede to an inferior acquisition offer.\(^\text{109}\)

Before we consider the principal concerns about judicial scrutiny, it is useful to mention two additional insights that the case law and literature on liquidated damages suggest for a judicial scrutiny regime.

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\(^{104}\) Notice that, whereas we considered in subpart III.A the possibility that the second sale might never take place, the question here is whether, even if a resale would occur, judicial scrutiny might be a less costly means of achieving the same result.

\(^{105}\) See, e.g., Rea, supra note 95, at 162 (nonenforcement of excessive liquidated damages provision gives buyer incentive to acquire more information).

\(^{106}\) See, e.g., Note, Contract Renegotiation, supra note 95.

\(^{107}\) Moreover, the initial bidder still can locate and resell to a higher valuing bidder if the target fails to do so after court scrutiny, whereas the target loses its incentive to look for better bidders if it has granted a lockup that effectively excludes such bidders.

\(^{108}\) See supra note 79 and accompanying text.

\(^{109}\) See subpart III.B. The adverse effect that enforcement of a supra-expectancy lockup would have on the shareholders' right to make the final decision on an acquisition offer could make the comparison between full enforcement and judicial scrutiny moot as a practical matter. Because judicial scrutiny of some sort is inevitable, the real question may be what form it should take. Nevertheless, the comparison between full enforcement and judicial scrutiny is useful because it serves to illuminate the advantages of the reliance damages approach set forth below.
One concerns the issue of ex ante, as opposed to ex post reasonableness. As noted above, a court will sometimes uphold a liquidated damages provision that is reasonable as of the time of the contract, even if changed circumstances make it inaccurate by the time the promisor breaches.\(^{110}\) Shifting to the lockup context raises the question of whether the emergence of a new higher valuing bidder, whose bid dramatically increases the value of a lockup, should be treated analogously, as a changed circumstance that does not affect enforcement of the lockup.\(^{111}\) Much of the contracts literature suggests it should be.\(^{112}\) The reliance damages approach described below would frequently lead to a different conclusion, however. This is in part because a reliance approach would focus initially on the lockup bidder’s other opportunities at the time of the agreement, rather than simply on the emergence of a new bidder.\(^{113}\)

The analogy to liquidated damages also raises questions about what courts should do when they conclude that a lockup is excessive. In the liquidated damages context, invalidation is not a complete loss for the promisee. Although she loses the windfall of an excessive damages provision, the promisee ordinarily can still recover any proven actual damages.\(^{114}\) Courts that strike down a lockup arrangement, by contrast, ordinarily deny any recovery to the bidder in question.\(^{115}\)

Why deny any recovery? Courts typically have refused recovery based on the conclusion that excessive lockups are part of an overall tainted process and must therefore be voided altogether.\(^{116}\) The problem with this reasoning is that lockups may play a valuable role in an auction even if the target’s managers have otherwise acted improp-

\(^{110}\) See supra note 96 and accompanying text.

\(^{111}\) The Paramount court was particularly troubled by the ex post effects of the Paramount-Viacom stock lockup, as evidenced by its statement that “[b]ecause the Stock Option Agreement was not ‘capped’ to limit its maximum dollar value, it had the potential to reach (and in this case did reach) unreasonable levels.” Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 39 (Del. 1994).

\(^{112}\) On one view, the emergence of a new bidder does not constitute a changed circumstance at all. The initial bidder’s expectancy interest can be seen as including the possibility of resale to another bidder, which suggests that the lockup continues to be reasonable ex post, despite the sudden increase in value. See, e.g., Polinsky, supra note 23, at 434 (relevance to expectancy interest of nonbreaching party’s ability to sell to a third party). As described below, my reliance approach leads to a very different focus.

\(^{113}\) See section III.C.

\(^{114}\) See, e.g., Lake River Corp. v. Carbournum Co., 769 F.2d 1284, 1290-92 (7th Cir. 1985) (invalidating liquidated damages (by classifying them as a penalty) and remanding for determination of actual damages).


\(^{116}\) See, e.g., id. at 184.
In addition, courts' all-or-nothing approach substantially diminishes the value of a lockup to the parties, since a bidder can never be entirely sure that it will receive any protection at all.

To better appreciate this point, consider the analogy between lockups and fraudulent conveyance law. Fraudulent conveyance statutes strike down any transaction by an insolvent debtor that does not give the debtor "reasonably equivalent value" in return. The per se nature of these provisions suggests an assumption that disproportionate exchanges by insolvent debtors invariably reflect collusion between the debtor and the recipient of the transfer to thwart the debtor's creditors. Courts that void a lockup altogether appear to do so based on similar assumptions. Yet, questionable lockups differ from classic fraudulent conveyances in several important respects. First, it often is quite unclear whether target managers' granting of a malignant lockup does in fact reflect collusion with the recipient bidder. Second, unlike fraudulent conveyances, which represent an unmitigated loss for creditors, questionable lockups often may benefit target shareholders—as suggested above—by causing a bidder to raise its bid, for instance. Both of these distinctions reinforce the conclusion that reducing problematic lockups makes far more sense than voiding them altogether.

What this suggests is that courts should separate the duty of loyalty issue from the damages question—on this issue Fraidin and Hanson seem very much on target in arguing that lockups should be completely voided only if side payments or other overt duty of loyalty violations are involved—and courts should more closely track ordinary contract law with respect to damages. I will return to this issue below, but for now the important point is that a strong case can be made for a regime in which courts scrutinize lockups, much as they scrutinize stipulated damages in other contract settings.

2. Judicial Competence and the Cost of Court Scrutiny.—As with Fraidin and Hanson's universal enforcement model, judicial scrutiny is not a perfect approach to lockup arrangements. To begin, judicial scrutiny entails costs, such as attorneys' fees and the costs of engaging other professionals in connection with litigation about the propriety of a lockup. Yet, direct costs of this sort are not likely to be overwhelm-

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117 As Fraidin and Hanson suggest in a somewhat different context, Revlon appears to be a classic case in point. However problematic Revlon's treatment of its two bidders may have been, granting a lockup to Forstmann Little & Co. induced Forstmann to increase its bid by a full dollar per share after several previous rounds of bidding. Revlon, 506 A.2d at 178-79; Fraidin & Hanson, supra note 9, at 1754.

ing, and may well be less than the direct costs of the multiple sales required in a full enforcement regime.  

Fraidin and Hanson do not compare the costs of the two regimes, due to their view that courts would be so ineffective in distinguishing appropriate lockups from excessive ones as to eliminate any virtues that a judicial scrutiny regime might otherwise have. A court would need to determine a bidder’s reservation price under an expectancy-based scrutiny of lockups for instance, since the bidder’s expectation interest equals the difference between its reservation price and the amount it actually bids. Yet, courts are particularly ill-suited to select this number, which in essence reflects the value of the target as a whole.

In other contexts, Delaware courts avoid the need to make substantive determinations of this sort by focusing on process issues such as whether the parties have engaged in vigorous, arms-length bargaining over terms. Yet even malignant lockups are likely to be preceded by hard bargaining, given that the interests of the target’s directors and the lockup bidder will often diverge not only from those of the target’s shareholders, but also from those of one another. As a result, the courts necessarily must make a substantive assessment as to whether the value of the lockup is excessive.

Fraidin and Hanson clearly are correct about the difficulty of judicially making such valuations, but this does not mean that such an assessment cannot be made. Investment bankers routinely issue public predictions as to the likely outcomes—and expected purchase price—of corporate acquisitions. In a well-publicized control contest,

119 Notice that some of these litigation costs also would be incurred in a full enforcement regime, since lockup issues usually are litigated as part of a general attack on target directors’ exercise of their fiduciary duties. While full enforcement of lockups might reduce the number of fiduciary duty challenges somewhat, it would not eliminate them altogether.

120 Fraidin & Hanson, supra note 9, at 1775-78. Fraidin and Hanson’s skepticism of judicial scrutiny closely parallels Alan Schwartz’s doubts about court evaluation of liquidated damages provisions. See supra note 58.

121 This is true at least in a “common values” context, where the value of the target is the same for each bidder. If, as is likely, the target is worth more to some than to others, bidders would have bidder-specific reservation prices. A court would therefore need to assess the lockup bidder’s particular valuation.

122 See Edward B. Rock, Controlling the Dark Side of Relational Investing, 15 CARDOZO L. REV. 987, 1010-12, 1014 (1994) (questioning the efficacy of such scrutiny in distinguishing good and bad relational investing).

123 Id. (concluding similarly about arrangements between a corporation and a relational investor).

124 Observers have long been skeptical of judicial valuation of a firm. Two obvious examples are corporate law appraisal rights and the valuation a court must make to determine whether the absolute priority rule has been satisfied in bankruptcy. See, e.g., Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. REV. 738, 779 (1988); Elmer J. Schaefer, The Fallacy of Weighting Asset Value and Earnings Value in the Appraisal of Corporate Stock, 55 S. CAL. L. REV. 1031 (1982).
a court might use these ongoing predictions to supplement the parties' partisan assessments. Rather than focus on likely reservation prices, a court might also consider the profits a given bidder has historically made on acquisitions, or the price other bidders expect from similar transactions.125

Moreover, it is important to keep in mind that courts need only achieve rough accuracy. The difficulty of calculating actual damages is precisely why parties liquidate damages in many contractual settings, and as noted earlier, courts view uncertainty as weighing in favor of enforcement. This same reasoning suggests that courts should presumptively uphold any lockup that provides a plausible surrogate for actual damages.126

Finally, the prospect of judicial scrutiny, even if it is relatively inaccurate, can increase the parties' incentive to renegotiate an inappropriate lockup.127 The prospect of judicial scrutiny gives a lockup bidder much more reason to consider renegotiating a malignant lockup than it has if it knows the lockup will be enforced.

In short, while judicial competence would be an issue in a judicial scrutiny regime, valuation difficulties do not clearly overwhelm the advantages this approach offers in comparison to full enforcement. Moreover, much of the difficulty disappears if we reconsider what the appropriate perspective on damages should be.

125 This approach suggests intriguing parallels to the "new business" rule in general contract law. Under the new business rule, courts traditionally have refused to award lost profit damages to a nonbreaching party whose business does not predate the contract, due to the difficulty of projecting what its profits would have been absent the breach. See, e.g., Evergreen Amusement Corp. v. Milstead, 112 A.2d 901, 904-05 (Md. Ct. App. 1955). Courts increasingly have permitted a nonbreaching party to attempt to prove likely lost profits in order to give these damages in an appropriate case. See Fera v. Village Plaza, Inc., 242 N.W.2d 372, 373-74 (Mich. 1976).

It is also interesting to note that bidders appear not to have made large profits in connection with corporate acquisitions in the 1980s, thus suggesting that their actual expectancy interest may not be great. See, e.g., Michael Bradley et al., Synergistic Gains from Corporate Acquisitions and their Division between the Stockholders of Target and Acquiring Firms, 21 J. Fin. Econ. 3 (1988) (finding statistically significant negative returns to bidders); Roberta Romano, A Guide to Takeovers: Theory, Evidence, and Regulation, 9 Yale J. on Reg. 119 (1992) (describing empirical studies and suggesting possible explanations). The existing legal regime is no doubt at least partially responsible for bidders' low profits. This is because the existing regime gives targets substantial lee-way against takeovers and encourages auctions when a control contest does develop.

126 Thus, while my analysis deviates from Ayres's in many respects, I generally agree with his suggestion that courts should focus on whether a lockup is beyond the range of reasonableness. Ayres, supra note 9, at 704-05. Fraidin and Hanson may be right that Ayres's emphasis on unmistakably excessive lockups overly relaxes the reasonableness inquiry, Fraidin & Hanson, supra note 9, at 1778-79, but their doubts as to the courts' capacity to engage in meaningful reasonableness scrutiny seem overstated.

127 For a detailed discussion and game theoretic demonstration of this argument in the liquidated damages context, see Note, Contract Renegotiation, supra note 95.
C. A Reliance Approach to Lockups?

The analysis thus far has assumed that a well-defined lockup would give the bidder the profits it stands to lose if the target's managers sell the target to another bidder—that is, a lockup should protect a jilted bidder's "expectancy" interest by putting the bidder where it "would have been" if the deal had gone through. At least one previous commentator makes a similar assumption. In a sense, the assumption is not surprising. Courts and commentators have long viewed expectation as the standard measure of damages for breach of contract generally, and by extension for a liquidated damages provision. Yet a closer look at the contract analysis raises serious questions as to whether expectation is in fact the proper remedy in the lockup context.

Consider first the status of expectation damages in contract law. While expectation is seen as the baseline measure, courts in many cases have long looked to reliance, restitution, and related measures. In fact, a strong case can be made that reliance—that is, restoring an innocent party's pre-contract status—would actually be a superior damages measure if courts awarded all of a promisee's reliance losses, including the value of her foregone opportunities. In many cases, including many liquidated damages situations, expectation damages serve as a surrogate for a true reliance measure. The assumption is that, in order to enter into the contract in question, the promisee bypassed other, equivalent contracting opportunities. In consequence, she should be awarded the net value of such an opportunity—in other words, lost profit.

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128 Ayres, supra note 8, at 704-07 ("fully insuring" lockups).
130 As noted earlier, an alternative approach, which Delaware has purported to use in some cases, would be to focus not only on bidder damages, but also on whether the target receives an adequate quid pro quo for the lockup. See supra note 41. Focusing on bidder compensation can be seen as a proxy for such an inquiry and is a much more plausible approach due to the difficulty in many cases of evaluating the benefits to the target, and to the incentive effects discussed in this subpart.
132 Charles J. Goetz & Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 YALE L.J. 1261, 1284, 1287-88 (1980). Goetz and Scott argue that contract law should seek to maximize the difference between beneficial reliance—the benefits to a promisee when a contract is performed—and detrimental reliance—the costs to her of breach. This suggests that the optimal damages measure would focus on a promisee's reliance interest, including any lost opportunities.
133 This is consistent with Fuller and Perdue's view that expectation damages are most defensible in the market setting. Fuller & Perdue, supra note 131, at 65-66.
Perhaps the most striking effect of shifting from general contract law to the lockup context is the realization that much of the analysis above simply does not hold true for lockup arrangements. While a manufacturer who enters into a contract with Supplier A often forgoes the opportunity to make similar arrangements with Supplier B or Supplier C, bidders often do not have other, similar acquisition opportunities during the same time frame as their discussions with the target. The market for similar target corporations is not nearly so extensive, or "thick," as the markets that commentators tend to assume in their discussions of contract damages. To be sure, some bidders may have multiple acquisition possibilities within a particular time frame. But even these firms may not have an alternative prospect at the same time; and those prospects they do have are likely to differ in significant respects from the target in question. Because bidders often do not have foregone opportunities, reliance rather than expectation more accurately compensates a bidder for the costs to it of losing an acquisition.

On this view courts should focus on costs—such as the expense of hiring investment bankers and other experts—that a bidder incurs. Other costs, such as the cost of executive time spent on the takeover bid rather than on other firm business, also entail reliance costs.

The analysis above suggests that reliance may be the best standard from the perspective of compensation—that is, it better approximates the real consequences of breach to an initial bidder than an expectation measure would. Compensation is not the only relevant factor, however. Contracts scholars have often noted that, in addition to compensation, the incentive effects of a particular damages measure also must be taken into account. As the analysis below suggests, reliance also is the best measure from the perspective of bidder and target incentives.

The principal advantage of a reliance measure, as compared to expectation, is its effect on promisee (bidder, in the lockup context)

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134 Firms such as Kohlberg Kravis Roberts & Co., whose principal business is engaging in acquisition activity, come somewhat closer to the manufacturer-supplier illustration, as do industries that are undergoing rapid consolidation, such as the defense contracting and information technology industries in recent years. Yet, both fall well short of being truly thick markets.

135 As the analysis below will show, focusing on a bidder's reliance damages would not eliminate altogether the possibility of including lost profits in the damages calculation. Instead, rather than simply assuming lost profits, as the expectation measure does, reliance shifts the burden of demonstrating this measure to the nonbreaching party (here, the bidder).

136 Goetz and Scott refer to this aspect of reliance, which reflects a change in the bidder's pattern of consumption, as "consequential" reliance. Goetz & Scott, supra note 132, at 1297.

137 See, e.g., Rea, supra note 95, at 152 (stating that damage measure must achieve a compromise between optimal insurance and optimal precautions); see also Robert Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Cal. L. Rev. 1 (1985) (noting that compensation can conflict with giving both parties appropriate incentives to take precaution).
incentives. Because it assures a bidder the benefit of the agreement at hand, expectation gives the bidder inadequate incentives to mitigate the consequences of breach by continuing to look for other opportunities.\textsuperscript{138} By contrast, a reliance measure would limit recovery to actual losses, and thus discourage a bidder from overcommitting to any particular acquisition.

In contrast to its beneficial effect on promisee incentives, the reliance measure does not always give equally appropriate incentives to a promisor. Efficient breach theorists have long argued, for instance, that because it does not assure the promisee the full benefit of its bargain, reliance gives a promisor too great an incentive to breach. On this view, expectation offers the advantage of deterring a promisor from breaching its contract in order to take advantage of an alternative contract unless the new contract is truly superior.\textsuperscript{139}

Even in the contracts context, this analysis is subject to significant caveats. While reliance may give a promisor too great an incentive to breach, for instance, it often gives the promisor superior incentives with respect to other aspects of the contracting process.\textsuperscript{140}

More importantly for present purposes, however, there is little reason to be concerned about "excessive" promisor breach in the lockup context. The agreement between an initial bidder and a target is preliminary by its very nature. If a higher valuing bidder emerges, the parties arguably contemplate—and efficient breach theory would encourage—the target's sale to the higher bidder. While a reliance-based measure might appear to give target managers an incentive to shift to another bidder even in circumstances where the new bidder does not value the target more highly, this possibility is far less problematic with respect to corporate control contests than elsewhere. In contrast to other promises, the lockup bidder does not simply disappear if another bidder emerges. The lockup bidder still can attempt to outbid the new bidder, and it is likely to succeed unless the new bid-

\textsuperscript{138} For an important discussion of this point, and an elaborate criticism of contract theorists' traditional assumption that contract doctrine does and should provide for strict liability and expectation damages for all breaches, see George M. Cohen, The Fault Lines in Contract Damages, 80 VA. L. REV. 1225 (1994).

\textsuperscript{139} This is because expectation damages force a promisor to fully internalize the costs of a breach—a promisor will not breach unless the promisor can pay the promisee the benefit of its bargain in damages and still profit from entering into an alternative contract. See, e.g., A. Mitchell Polinsky, An Introduction to Law and Economics 33 (2d ed. 1989); Richard A. Posner, Economic Analysis of Law 108 (3d ed. 1986). The whole notion of efficient breach has itself been subject to extensive criticism. See, e.g., Ian R. Macneil, Efficient Breach of Contract: Circles in the Sky, 68 VA. L. REV. 947 (1982).

\textsuperscript{140} See, e.g., David D. Friedman, An Economic Analysis of Alternative Damage Rules for Breach of Contract, 32 J.L. & ECON. 231 (1989) (concluding that reliance leads to more efficient decisions regarding whether and to what extent to enter into a contract).
der places a higher value on the target—precisely the context where “breach” would be appropriate.\textsuperscript{141}

Focusing on a bidder’s reliance damages thus can be seen as providing appropriate incentives to both the bidder and the target in the lockup context. Not only does the reliance measure give the bidder an incentive to anticipate and mitigate any losses should the deal with the target fall through, but the incentive that reliance gives a target to shift to another, higher valuing bidder, should one emerge, arguably can also be seen as desirable rather than problematic.\textsuperscript{142}

The discussion thus far has addressed the appropriate damages measure mostly in general terms, without focusing on the particular benefits that lockups may offer in the corporate acquisition context. Yet, the argument for a reliance approach remains equally powerful once these benefits are taken into account. In the conventional view, lockups serve to encourage a bidder to participate in bidding by assuring the bidder that its costs will be compensated. At least if construed to include both pre-bid and subsequent expenses, as it should be, this is exactly what a reliance measure is designed to do.\textsuperscript{143} The reliance measure also should counteract the problems of parties’ differing expectations, or of a bidder’s hesitancy to enter an auction, since repayment of costs should be sufficient to entice a reluctant bidder to bid for the target. To be sure, a bidder might be concerned about truly receiving all of its costs in either of these situations. But so long as

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\textsuperscript{141} Another concern about the reliance standard is that it may cause a bidder to overrem—
that is, to invest too many resources in the contract—because all such expenditures can be recovered in the event of a breach. Steven Shavell, \textit{Damage Measures for Breach of Contract}, \textit{11 Bell. J. Econ.} 466, 472 (1980); see also Cooter, \textit{supra} note 138, at 20-31 (arguing that liquidated damages provisions limit overreliance by making damages invariant to the amount of reliance). But courts can and do counteract such incentives by using the mitigation, foreseeability, and certainty doctrines to disallow excessive or inappropriate expenditures. Cohen, \textit{supra} note 138, at 1249; W. David Shawson, \textit{The Role of Reliance in Contract Damages}, 76 CORNELL L. REV. 197, 230-31 (1991). It is also interesting to note that these same limitations frequently lead courts to award what is in effect reliance damages even when they purport to apply an expectation measure. That is, the mitigation, foreseeability, and certainty limitations tend to move the recovery away from expectation and toward reliance. Cohen, \textit{supra} note 138, at 1249.

\textsuperscript{142} A recent article by George Cohen parallels the analysis above in many respects. Cohen suggests that reliance is attractive where promise incentives are a greater concern than opportunistic breach by the promisor. Cohen, \textit{supra} note 138, at 1209-10. This seems true of corporate lockups. In the particular context of “superior alternatives,” Cohen argues that reliance damages are appropriate if the promisor is better situated to take advantage of a superior alternative, whereas expectation or higher damages are appropriate (since they chill the promisor’s incentive to breach) if the promise can better make the alternative sale. Cohen, \textit{supra} note 138, at 1297-302. In the lockup context, the target arguably is the more appropriate seller due to the problems with bidder resale discussed in Part III.

\textsuperscript{143} In other contracts contexts, the question whether courts should award pre-contract reliance is a matter of dispute. As the text suggests, the normative case for including pre-contract reliance is particularly strong in the lockup context, given that compensating a bidder for its costs is an important goal of lockups.

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Courts are generous in upholding lockups that provide a plausible estimation of costs, this concern is easily addressed.

While several of the benefits Fraidin and Hanson attribute to lockups might seem more difficult to achieve under a reliance-based framework, the real value of each of the benefits is highly questionable, as discussed earlier. For instance, a reliance-based lockup arguably would not encourage as much search by a potential bidder as one that guaranteed the bidder its expectancy interest in the event that a higher valuing bidder emerged, since the benefit to the bidder would be substantially lower. Yet this adverse impact on a bidder's incentive to act as a "sales agent" does not seem particularly problematic, given that the target will often be at least as effective a seller as the bidder, and the bidder still has an incentive to seek out other bidders after it has acquired the target. Moreover, lockups can undermine as well as enhance search, since target managers can attempt to use them to thwart an undesired bidder. Similarly, a reliance-based approach would preclude the bidder and the target from using a lockup collusively, in order to divert some of a higher valuing bidder's profits, but the risk that such a lockup would have malignant, rather than beneficial, effects raises doubts as to whether this is a desirable lockup goal in any event.

A final possible concern is the effect that a reliance measure would have on the parties' use of a lockup to counter risk aversion. Recall that a lockup can be used to allocate risk in the event that either the lockup bidder or the target is, or both are, risk averse. Even here, it is questionable whether greater than reliance damages are likely to be necessary. First, the principal role for a risk aversion-based lockup would be to address the bidder's risk aversion, and it is not clear how serious a concern bidder risk aversion is or should be. Given the amounts at stake, a bidder may have concerns as to whether the acquisition of the target will prove profitable, as Fraidin and Hanson suggest. But these concerns seem most significant after the ac-

144 See subpart I.C (lockups as encouraging search).
145 See supra notes 107-08 and accompanying text.
146 See subpart II.B (effects of collusion).
147 See subpart I.B.
148 While a lockup also could be used to respond to target risk aversion, see Fraidin & Hanson, supra note 9, at 1823, a simpler and more direct response to target risk aversion would be to include a liquidated damages provision giving the target a specified amount of damages in the event the bidder breaches the parties' agreement. Moreover, because target shareholders usually can diversify their portfolio, they should not be risk averse. To the extent that the target's managers are risk averse due to their concentrated investment in the target, limiting lockups to the bidder's reliance interest may help curb the managers' tendency to act on their risk aversion to the detriment of shareholders.
149 Fraidin & Hanson, supra note 9, at 1823 (citing R. Preston McAfee & John McMillan, Auctions and Bidding, 25 J. Econ. Lit. 699, 726 (1987)) (suggesting that parties are more risk averse when they have substantial percentage of their assets at stake).
quisition has taken place, when the bidder has actually incurred the cost of purchasing the target. The risk that lockups insure against, by contrast, is the risk that the transaction will fall through, which seems less likely to be a source of risk aversion on the part of bidders. Second, it is important to keep in mind that any benefit that an expectancy-based (or higher) lockup offers must be weighed against its adverse effects on the parties’ incentives.

The discussion thus suggests that lockups should be treated both like and unlike liquidated damages in other contract settings. As with other liquidated damages provisions, courts should subject lockups to scrutiny and strike down those that are excessive. Because a jilted bidder often has not foregone any similar opportunities; because breach is less problematic in this context; and in order to create appropriate incentives, however, courts should use reliance rather than expectation as the basic yardstick in measuring appropriate damages.150

D. Distinctions Between Initial and Subsequent Bidder Lockups

The analysis thus far has considered lockups in general terms, without focusing on when in the acquisition process, and to whom, the target grants a lockup. Broadly speaking, one can distinguish at least two kinds of lockups. Targets grant some lockups to the first bidder, often in connection with an agreement reached in the absence of any other bidder. Other lockups can be described as second or subsequent bidder lockups. These lockups often are granted in response to a hostile bid by an initial bidder, and the managers of a target may use such a lockup to entice another bidder into the bidding.

Subsequent bidder lockups arguably are more likely to be malignant than initial bidder lockups.151 Because an initial bidder’s costs may exceed those of subsequent bidders, an initial bidder arguably has more need for lockup protection.152 By contrast, target managers can use subsequent bidder lockups to subsidize a challenge by a friendly bidder, and thus to thwart a hostile initial bidder.153

One possible question these observations raise is whether the distinctions among lockups undermine the attractiveness of applying a

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150 Notice that this analysis also raises interesting questions as to whether expectation damages are an appropriate yardstick in other liquidated damages contexts. Because the promisee often will have foregone similar opportunities when it entered into the contract, expectation damages frequently will be appropriate. But this may not always be the case, as the lockup context makes clear.

151 See Kahan & Klausner, supra note 10 (reaching a similar conclusion about subsequent and initial bidder lockups).

152 Other bidders may free-ride on the initial bidder’s efforts to identify the target as a good candidate for takeover, for instance. The initial bidder may therefore have sunk costs that a subsequent bidder would not need to incur.

153 Notice that such lockups have the chilling effect on incentives to search that were discussed in Part I.
Corporate Lockups

Reliance damages approach all lockups. For at least two reasons, they do not. First, not all initial bidder lockups are benign, since target managers can use an initial bidder lockup not only to encourage an initial bidder but also to preempt any subsequent, potentially hostile bid. Similarly, because subsequent bidder lockups can be used to encourage competitive bidding, they are not always malignant from target shareholders' perspective. An important attraction of the reliance damages approach is that it mediates among the benefits and potential problems with lockups. The reliance damages measure is restrictive enough to impose significant limits on the parties' ability to use lockups in an inappropriate fashion, yet it does not undermine the beneficial use of lockups.

Second, the reliance damages measure could easily be used to account for the general differences between initial and subsequent bidder lockups. Courts could apply the standard more flexibly in the initial bidder context than with subsequent bidders, for instance, by applying a more stringent presumption against recovery of opportunity costs in the subsequent bidder context, or even by limiting subsequent bidders to reimbursement costs. One suspects that courts would make at least some adjustments of this sort, much as they do in applying the reliance measure in contract law generally. It is important not to overstate the usefulness of this flexibility, however. A major difficulty in scrutinizing corporate lockups is that courts often cannot easily determine whether a particular lockup (or category of lockups) is malignant, and even problematic lockups may offer appreciable benefits. One of the most important advantages of the reliance damages approach, and of assessing all lockups in reliance terms, is that it minimizes the need for courts to make difficult determinations as to the nature of the parties' motives in any given case.

E. Summary and an Application: the Proposed Scheme

The foregoing analysis suggests a simple reliance damages model of judicial scrutiny, comprised of two distinct steps. When a lockup arrangement is challenged, a court should begin with the duty of loyalty issue. If the lockup can be traced directly to a side deal or other

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154 Paramount may well have been an example of this, given Paramount's directors' apparent desire to thwart QVC. See Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 39 (Del. 1994) (discussing efforts by Paramount to discourage QVC from making a bid).

155 See, e.g., Cohen, supra note 138, at 1249-51 (discussing devices that can be used to limit reliance, such as denial of lost opportunities and use of reasonableness, foreseeability, certainty, and mitigation limitations).

Similarly, one can imagine courts applying a measure other than reliance in a truly exceptional case. Yet, the particular dynamics of lockups and the corporate acquisition context so regularly will call for a reliance standard that a strong presumption in favor of reliance is warranted. The number of cases where another standard would be appropriate would, in my opinion, be extremely small.
In the absence of an overt violation, however, courts should shift from loyalty to the second reliance damages step, a determination whether the lockup reflects a reasonable stipulation of the bidder's likely reliance losses should the deal fall through. If courts do award more than an initial bidder's out-of-pocket and related costs, they should do so only if the bidder can demonstrate an actual or highly probable opportunity loss. Given the uncertainty as to actual damages, courts should uphold any lockup that reflects a credible estimation of damages as of the time of the parties' agreement, as they do in other liquidated damages settings.

Other than the shift in damages measure, the most significant change suggested by the reliance approach arises when the target's managers have not overtly violated their duty of loyalty (i.e., the lockup passes the initial scrutiny), but a court invalidates the lockup as excessive at the reliance damages stage. Courts and commentators currently hold that a bidder is not entitled to any compensation whatsoever if its lockup is struck down. As noted above, this all-or-nothing approach seriously undermines the benefit to a lockup bidder. A better approach would permit the bidder to demonstrate its actual, provable damages if the lockup is disallowed, just as promisees with liquidated damages provisions may do in other contractual settings.

Because lockups typically are challenged at the preliminary injunction stage, giving a bidder its actual damages when a lockup is struck down raises a question as to whether a court should calculate these damages at the time of the initial challenge, or thereafter. The simplest answer is that a court need only decide whether or not to uphold the lockup (and what kinds of damages it intends to allow) at the preliminary injunction stage. Actual damages can be determined after the sale of the target is final. To be sure, postponing the determination would create uncertainty for other bidders as to how much the lockup bidder must be paid. But there would be no need ever to make the determination if the lockup bidder eventually won out, and the uncertainty would not be great.

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156 See supra note 48 and accompanying text.

157 Many of the costs that a bidder already has incurred are relatively certain; however the parties ordinarily will not know what additional expenses to expect, because they cannot predict with accuracy what additional costs the initial bidder will incur if a new bidder emerges.

158 The Paramount takeover contest is an obvious example of how this could happen. See Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); see also QVC Network, Inc. v. Paramount Communications, Inc. 635 A.2d 1245 (Del. Ch. 1993). Although Viacom's initial merger agreement (including its lockup provisions) was struck down, Viacom still eventually won the auction. Had the Delaware Supreme Court adopted the approach in the text, there would have been no need to determine Viacom's actual compensation. The facts of the Paramount contest are explored in greater detail at the end of this section.
Two final questions also warrant brief discussion. The first is how courts should treat lockup arrangements that include multiple parts—for instance, one designed to insure some or all of the bidder's profits, and another that covers the bidder's out-of-pocket costs. Delaware has tended to strike all of the provisions if the court concludes that the arrangement as a whole is excessive. However, it appears more sensible to uphold a reasonable termination fee even if the stock lockup is struck down as unwarranted, at least if it is clear that the two measures are intended to cover different aspects of a bidder's potential losses.

Second, initial bidders often buy a little less than ten percent of a target's stock in order to hedge their bet prior to making a bid. An obvious question in this context is whether a court should take into account in its assessment of the initial bidder's lockup any profits an initial bidder makes by eventually selling these shares to a higher bidder. The answer clearly is yes. If the initial bidder received both these profits and full reliance damages under its lockup, even a reliance-based lockup would overcompensate the initial bidder for its losses. In a sense, then, an initial bidder's stock purchase can be seen as a form of precontract mitigation that a court should incorporate into its analysis.

To better appreciate how the approach would work in a more concrete setting, consider the facts of the Paramount acquisition in greater detail. The lockup Paramount agreed to consisted of a $100 million termination fee, together with an option to purchase slightly less than twenty percent of Paramount's stock at the price of Viacom's bid in the event Paramount abandoned the merger agreement for another bid. In contrast to the Delaware Supreme Court decision,

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159 While the parties usually employ stock or asset lockups to guarantee a bidder's profits, and fixed fees to cover its costs, multipart lockups could also be structured in other ways.

160 A tension between the chancery and supreme court decisions in Paramount casts interesting light on this. The chancery court struck down Viacom's stock lockup but upheld the $100 million termination fee that would have covered, among other things, Viacom's costs. QVC Network, Inc. v. Paramount Communications, Inc., 635 A.2d at 1270-73. Paramount did not appeal the decision to uphold the termination fee, but the supreme court suggested that it would also have struck this fee down had the issue been appealed. Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 50-51; see also Bainbridge, supra note 8, at 327-32 (arguing that lockup provisions should be taken as a whole).

161 My thanks to Ed Rock for bringing this issue and some of its implications to my attention.

162 From another perspective, the stock purchase could be seen as a bidder's means of hedging against its reliance costs. See generally Cooter, supra note 137, at 16 (noting that mitigation and reliance are "identical but for time"). Another issue is whether an initial bidder should be "required" to engage in this form of mitigation—that is, whether courts should consider the possibility of prebid stock purchases even if the bidder has not engaged in them. The answer here would appear to be no, given, among other things, the difficulty of determining how much stock a bidder might realistically have purchased while still keeping its intended acquisition secret.
which suggested that the magnitude of the stock lockup and the tainted nature of Paramount’s decision-making process required that the lockup be voided altogether. A court might well uphold the termination fee under a reliance approach. The $100 million fee was explicitly designed to compensate Viacom for its expected out-of-pocket and related costs and, while perhaps on the generous side, can be seen as a plausible projection of Viacom’s costs.

By contrast, the reliance model would only uphold additional compensation—here, the stock option portion of the lockup—if Viacom could demonstrate that its negotiations and agreement forced it to forgo other opportunities that would have both come to fruition and produced profits roughly equivalent to the likely value of the lockup. Interestingly, Viacom appears to have made an argument of this sort in its negotiations with Paramount. Nevertheless, it seems doubtful that Viacom could show that it did in fact forgo similar opportunities during the same time frame. On the contrary, the Paramount deal was a singular event from Viacom’s perspective. Thus, a court would uphold the termination fee but not Viacom’s stock option.

As this illustration suggests, the most dramatic practical difference between the reliance approach and an expectancy-based or universal enforcement regime is that stock options and similar arrangements would be more difficult to justify. In order to invoke a lockup that extended well beyond its likely out-of-pocket costs, a bidder would have to show that it gave up other, similar opportunities—that is, that the lockup was designed to compensate real losses. As noted earlier, such a case would be strongest in an industry that is undergoing rapid consolidation.

163 Paramount, 637 A.2d at 50-51.
164 Vice Chancellor Jacobs took a similar view of the termination fee in his chancery court decision in Paramount, 635 A.2d at 1271.
165 In addition to the compensation-related focus on lost opportunities, the goal of giving Viacom appropriate mitigation incentives would also counsel against upholding the stock option.
166 Note also that, although Viacom was the first bidder—and initial bidder lockups generally are less problematic than lockups to subsequent bidders—Paramount’s directors clearly wished to preempt a QVC bid. Under such circumstances, courts should be particularly hesitant to award lost opportunity costs. See supra subpart IV.D.
167 Notice that this analysis suggests the Delaware Chancery Court reached a more sensible result than the Delaware Supreme Court in the actual case. See supra notes 160 & 164.
168 The Delaware Supreme Court expressed particular concern about the parties’ failure to impose a cap on the value of the stock option. Paramount, 637 A.2d at 39. Caps are much more the exception than the norm in practice. See, e.g., Fraidin & Hanson, supra note 9, at 1761. Thus, while the court’s outrage was puzzling to many observers, capping a stock option would be one way for a bidder to enhance enforceability under the reliance approach. Even if it could not make a compelling case as to lost opportunities, a bidder could use such an option for a limited profit in the event the target’s managers ultimately sold the target to another bidder.
The reliance model described in this section would not be perfect. Yet, it offers a coherent approach to corporate lockups that avoids many of the pitfalls both of the existing case law, and of a world where courts enforce every lockup.

CONCLUSION

Fraidin and Hanson make a powerful case for blanket enforcement of lockups, and in the process reveal serious flaws in both judicial treatment and previous commentators' analysis of these provisions. Full enforcement proves much more problematic on inspection, however, than Fraidin and Hanson's optimistic assessment of market behavior leads them to conclude. Not only does a reliance damages approach like the one proposed seem more attractive normatively than unblinking enforcement, but also, given the inevitability that courts will engage in some kind of scrutiny in order to prevent the process problems that excessive lockups would inevitably create, it is far more realistic from a descriptive perspective.

The reliance damages approach suggests that, while continuing to subject lockups to judicial oversight, Delaware courts should change their approach in several important respects. Most importantly, rather than simply treating lockups as part of the overall issue of directorial loyalty in the takeover context, Delaware courts should separate the loyalty and damages inquiries. Nor, in the absence of an overt duty of loyalty violation, should courts focus upon issues such as whether the lockup confers a "substantial benefit" on the target.169 Rather, courts should assess whether the lockup is a reasonable estimate of a bidder's damages, measured in reliance terms. If a court strikes down a lockup as excessive, a bidder still should be entitled to prove its actual damages.

The analysis of this Article also has important implications for corporate law scholarship generally. The contractarian analysis of corporation issues has proved extraordinarily fruitful in the last decade. The insights it has made possible are difficult to dispute, despite the fact that, as has often been pointed out, contractarian scholars frequently employ a limited, even simplistic view of contract.170 As this Article has attempted to demonstrate in the particular context of corporate lockups, a more systematic and nuanced consideration of the nature of corporate contracting may offer a new round of insights into the problems of corporate law.

169 See, e.g., Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1286 (Del. 1988). For Fraidin and Hanson's discussion of some of this approach's problems, see Fraidin & Hanson, supra note 9, at 1748-54.