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Michael G. Hatch

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CLEARLY DEFINING PRECLUSIVE CORPORATE LOCK-UPS: A BRIGHT-LINE TEST FOR LOCK-UP PROVISIONS IN DELAWARE

Michael G. Hatch

Abstract: Merger mania currently grips the United States as corporations scramble to find merger partners to achieve strategic goals. In their quest for a competitive advantage, large corporations are increasingly willing to use hostile takeovers to deny competitors the benefits of a strategic mergers. In response, merging corporations have granted record-breaking lock-up provisions in an attempt to protect their deals. Delaware's current framework for evaluating the validity of lock-up provisions requires courts to apply different levels of scrutiny depending on the form of the transaction. However, Delaware courts have inconsistently applied the correct standard and have failed to identify preclusive lock-ups. Although legal commentators have proposed alternatives to the current doctrine, none have been able to provide a solution without sacrificing the recognized benefits of lock-up provisions. This Comment examines the Delaware courts' inability to evaluate lock-up provisions properly and argues that a bright-line test severely limiting the value of lock-up provisions to three percent of a bidder's offer would solve the current dilemma. Without such a test, Delaware courts are unable to protect the interests of shareholders while still allowing the use of lock-ups to facilitate mergers.

Record-breaking merger and acquisition volume in each of the previous four years has placed the United States in the midst of an unprecedented merger phenomenon.¹ Ten of the largest transactions in history² were announced in 1998 and 1999.³ Fueling this merger boom is the fact that the merger, offering a quick solution for businesses seeking greater competitiveness, resources, market share, and new technology, has become the preferred tool for strategic and corporate development.⁴ This current wave of mega-mergers, coupled with the intense competition for merger partners, has resulted in merger battles with fiercely contested auctions⁵ for control of corporations.⁶

1. See Toby Myerson & Judith Thoyer, *Corporate Finance*, London, Jan. 2000, at 109–12.

2. Transactions are measured by equity value.

3. See Myerson & Thoyer, *supra* note 1, at 109–12.

4. See Martin Sikora, *Counting Transactions in the Trillions: Dealmakers Take Aim at the M&A Record of \$1.3 Trillion Set in Up-Tempo 1998*, *Mergers and Acquisitions Journal*, Mar.–Apr. 1999, at 5.

5. An auction occurs when directors decide to sell the corporation to the highest bidder. In an auction the target corporation will solicit bids and the highest bidder will obtain control of the corporation. See 3A James Solheim & Kenneth Elkins, *Fletcher Encyclopedia of the Law of Private Corporations* § 1041.50 (perm. ed.).

6. See Myerson & Thoyer, *supra* note 1, at 109–12.

Merging corporations often seek to defend their deals from subsequent bidders with defensive measures known as lock-up provisions. Lock-ups are promises by a target company's board of directors to compensate the prospective acquirer if the target breaches or does not consummate the merger agreement.⁷ Lock-ups are designed to protect the negotiated deal by compensating the prospective acquirer and by imposing the threat of additional costs on other competitors who might decide to make offers.⁸ Under certain circumstances, courts must enjoin lock-ups that preclude shareholders the opportunity to receive other potentially higher offers in the merger transaction. However, courts are unable to make this determination accurately because it involves evaluating competing bids, an increasingly complex calculation in the current merger environment. As a result, the size and scope of defensive measures have skyrocketed as both courts and corporations have been unsure how to determine the validity of lock-ups.⁹

This Comment examines Delaware courts' treatment of lock-up provisions granted in negotiated strategic mergers.¹⁰ Part I describes the emergence of the strategic merger, the accompanying costs and risks magnified by the current merger environment, and lock-up provisions in general. Part II discusses Delaware's current doctrinal framework and the legal standards for evaluating lock-up provisions. Part III describes legal commentators' proposed alternatives to the current standards. Part IV argues that courts are ill-equipped to identify preclusive lock-ups and, therefore, unable to apply the current standards to lock-up provisions. This Part further argues that the proposed alternate standards fail to solve the current dilemma because they sacrifice the recognized benefits of lock-up provisions. Part V of this Comment concludes that a new bright-line rule limiting lock-ups to three percent of the bidder's offer clearly defines preclusive lock-up provisions. This rule will not only facilitate mergers but also maximize shareholder value in the resulting transactions.

7. See *infra* Part II.

8. See *infra* Part II.

9. See Floyd Norris, *Is \$2 Billion Fair Payment for a Fiancée Left at the Altar?*, N.Y. Times, Nov. 5, 1999, at C1.

10. Delaware is the United States' preeminent corporate-law jurisdiction. The total number of firms incorporated in Delaware is 450,395, which includes more than half of all Fortune 500 firms. *Delaware Economic Development Office: 2000 Delaware Statistical Overview* (visited Aug. 9, 2000) <<http://www.state.de.us/dedo/publications/databook/index.htm>>.

I. MERGERS: CURRENT TRENDS, RISKS, AND THE USE OF LOCK-UPS

In the 1990s, large corporations began to use mergers to gain advantage within their industries.¹¹ This phenomenon, combined with rapidly increasing stock market values, has greatly increased the price paid in recent mergers.¹² As a result, corporations seeking merger partners have faced increasing transaction costs. In addition, large corporations are no longer content to sit by as competitors enter strategic mergers. Large corporations are willing to compete for targets¹³ by making unsolicited bids after a competitor has announced a merger agreement.¹⁴ In partial response to these increased costs and competition, the size and scope of deal-protecting lock-up provisions have skyrocketed.¹⁵

A. *The Strategic Merger*

Corporations are increasingly using strategic mergers to gain advantages within their industries.¹⁶ Intense foreign competition has focused many corporations' strategic goals on increasing efficiency and dominating their markets.¹⁷ While efficiency increases shareholder value by reducing overhead, corporations appear to have concluded that a short-term increase in shareholder value may result from boosting market share either by eliminating competitors or acquiring an important supplier that competitors need.¹⁸ Typically, strategic mergers are negotiated deals focusing on long-term growth and increasing efficiency,

11. See Richard G. Parker & David A. Balto, *The Merger Wave: Trends In Merger Enforcement and Litigation*, 55 Bus. Law. 351, 356 (1999).

12. See Myerson & Thoyer, *supra* note 1, at 109–12.

13. The target is the corporation that is to be acquired in a merger or acquisition. See *Black's Law Dictionary* 1468 (7th ed. 1999).

14. See Myerson & Thoyer, *supra* note 1, at 109–12.

15. See Norris, *supra* note 9, at C1.

16. See John C. Coffee, Jr., *Under the "Merger of Equals" Doctrine, Can a Target Board Always Favor a Friendly Suitor When a Second Bidder Makes a Higher, Unsolicited Offer?*, Nat'l L.J., Mar. 30, 1998, at B5.

17. See Parker & Balto, *supra* note 11, at 356. For example, Unilever recently acquired Bestfoods to become the world's second largest foodmaker. See Constance L. Hays, *Unilever Deal For Bestfoods Signals More Acquisitions*, N.Y. Times, June 7, 2000, at C1. Through the acquisition, Unilever hopes to increase efficiency and regain dominance in the food producing industry. See *id.*

18. See Parker & Balto, *supra* note 11, at 356.

either between former competitors or between a supplier and a producer.¹⁹ The merging corporations are often of similar size, and stockholders of the respective corporations own approximately an equal amount of the post-merger corporation.²⁰

A prospective acquirer must incur substantial costs in identifying and consummating a strategic merger. Initially, it may be expensive for the prospective acquirer to perform the research necessary to identify the target as a profitable opportunity.²¹ Once it identifies the target, the acquirer incurs additional costs negotiating the agreement and ensuring that the target is truthfully representing itself.²² These costly and time-consuming steps require expert analysis, due diligence reports²³ by lawyers, and fairness opinions²⁴ by investment bankers.²⁵ All of these costs and efforts are expended to determine the core issue in the merger: that the price to be paid for the target is fair in the eyes of both parties.²⁶

Although the fair value of the target is the core issue in a merger, considerable uncertainty surrounds the determination of that value. Valuation begins with the determination of how much the target is worth as it stands alone, and then focuses on how much its value will increase when combined with the acquirer.²⁷ To assist in the valuation, both sets of corporate directors will retain the services of investment bankers to determine a “fair” price for the target.²⁸ However, valuation is a very

19. See Nathan A. Treu, Comment, *Exxon Mobil, Can the Merger of Equals Doctrine Save the Proposed Marriage of Two Oil Giants?*, 36 Hous. L. Rev. 989, 993 (1999).

20. See *id.* at 993–94.

21. See Stephen Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 Minn. L. Rev. 239, 242 (1990).

22. See *id.*

23. Due diligence refers to the legal audit performed on the target company. In a due diligence investigation, lawyers investigate the books and records of the target company, check the accuracy of factual representations, and look for potential problems. See Dale A. Oesterle, *The Law of Mergers and Acquisitions* 270 (1999). The due diligence investigation precedes the signing of the final acquisition agreement in order to give the acquirer a high level of confidence in the accuracy and completeness of the target’s representations and warranties in the acquisition agreement. See *id.*

24. Fairness opinions are reports by investment bankers confirming that the acquisition price is within a range of fair prices that adequately compensates the target’s shareholders. See Oesterle, *supra* note 23, at 14.

25. See Mark F. Hebbeln, *The Economic Case for Judicial Deference to Break-up Fee Agreements in Bankruptcy*, 13 Bankr. Dev. J. 475, 494 (1997) (describing steps necessary in negotiating merger agreements).

26. See Oesterle, *supra* note 23, at 14.

27. See *id.*

28. See Hebbeln, *supra* note 25, at 494.

inexact inquiry, and often involves a range of values rather than a specific price.²⁹ Although valuation studies or fairness opinions may be important, a contested auction³⁰ will often lead to prices that substantially exceed any fair price determination, a price that a board of directors cannot know without an auction.³¹ In addition, the current trend of “deal-jumping” followed by hotly contested bidding wars has further widened the disparity between a fair price determined by an investment banker and a price obtained through competitive bidding at an auction for a company.³²

B. *The Threat of “Deal-Jumping”*

Hostile takeovers, or “deal-jumping,” by competitors represent the most serious threat to negotiated strategic mergers.³³ According to one study, deal-jumpers or second bidders prevail in a “substantial majority” of contests.³⁴ In a strategic merger, the acquirer and target will negotiate an initial offer; however, competitors within the industry may attempt to jump the deal by making unsolicited bids for the target corporation. In this situation, the initial prospective acquirer is at a disadvantage. Its initial bid may provide insights into the financial viability and long-term prospects of the target as well as a signal that existing management is amenable to a sale.³⁵ This allows the deal-jumper to avoid incurring identification and research costs.³⁶ The deal-jumper is then able to use

29. See Oesterle, *supra* note 23, at 15 (noting investment bankers frequently refer to valuation as “an art not a science”).

30. See *supra* note 5.

31. See T. Richard Giovannelli, Note, *Revisiting Revlon: The Rumors of Its Demise Have Been Greatly Exaggerated*, 37 Wm. & Mary L. Rev. 1513, 1553 (1996); see also Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & Econ. 151, 174 (1985) (noting that ultimate acquisition of target typically comes at additional 17 points after auction).

32. See *infra* notes 33–42 and accompanying text.

33. See Lee Meyerson, *Breaking Up an Existing Deal—The Art of “Deal-Jumping”*, in Financial Institutions Mergers and Acquisitions, at 647 (PLI Corp. L. & Practice Course Handbook Series No. 639 1997).

34. Bainbridge, *supra* note 21, at 242 (citing Richard S. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. Fin. Econ. 141, 147 (1983)); see also *infra* notes 41–42 and accompanying text.

35. See Hebbeln, *supra* note 25, at 497–500.

36. See Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 Stan. L. Rev. 1, 2 (1982).

the money saved on research costs in its attempt to top the initial bid.³⁷ Absent a large lock-up, a bidding war may result where the original acquirer must compete with other bidders for control of the target corporation.³⁸ Even if the initial bidder ultimately prevails, competition will likely force the final price much higher than the initial bid.³⁹ For example, 1999 witnessed a number of high profile jumped deals: AT&T's successful \$58 billion hostile takeover of MediaOne, which had previously agreed to a \$53 billion merger with Comcast;⁴⁰ Vodafone's successful \$60 billion takeover of Airtouch, topping Bell Atlantic's original bid of \$45 billion;⁴¹ and Pfizer's \$90.27 billion hostile takeover of Warner-Lambert, dwarfing the original \$72 billion bid by American Home Products.⁴² Given the deal-jumper's competitive advantage, acquiring corporations use a number of lock-up devices in an attempt to protect their negotiated deals.

C. Lock-Up Provisions in General

The current wave of mega-mergers, coupled with the growing threat of deal-jumping, has dramatically increased the size and scope of lock-up provisions⁴³ as directors attempt to protect their merger costs and expected profits. An acquiring corporation will often demand some form of lock-up provision,⁴⁴ such as a stock option, termination fee or other device, in the merger agreement to protect itself from deal-jumping as well as to guarantee some benefit in the event the merger is not

37. See Hebbeln, *supra* note 25, at 495.

38. See Myerson & Thoyer, *supra* note 1, at 109–12.

39. See Bainbridge, *supra* note 21, at 242.

40. See Seth Schiesel & Geraldine Fabrikant, *MCI Is Said to Weigh Bid for MediaOne*, N.Y. Times, May 4, 1999, at C1.

41. See Laura M. Holson, *British Carrier Wins Battle for Airtouch*, N.Y. Times, Jan. 16, 1999, at C1.

42. See Laura M. Holson, *Warner-Lambert's Chief Defends Decision to Ignore Pfizer's Bid*, N.Y. Times, Nov. 8, 1999, at C1; Melody Petersen, *Pfizer Gets Its Deal to Buy Warner-Lambert for \$90.2 Billion*, N.Y. Times, Feb. 8, 2000, at C1.

43. See Norris, *supra* note 9, at C1.

44. Delaware courts have tended to define the term "lock-up" expansively. See Vincent F. Garrity, Jr. & Mark A. Morton, *Would the CSX/Conrail Express Have Derailed in Delaware? A Comparative Analysis of Lock-Up Provisions Under Delaware and Pennsylvania Law*, 51 U. Miami L. Rev. 677, 678 n.4 (1997). Although the narrow interpretation of lock-ups only includes asset and stock options, for purposes of this Comment, such measures as termination fees and no-shop provisions are also lock-up devices. See *id.*

consummated.⁴⁵ The Supreme Court of Delaware, in its first evaluation of a lock-up, recognized that lock-ups may be necessary to facilitate mergers because they provide incentives to merging corporations to enter and complete the transaction.⁴⁶ However, lock-ups may also be excessive, deterring other, possibly better, offers.

1. *Types of Lock-Up Provisions*

Lock-ups are promises by a target's board of directors to compensate the prospective acquirer in some fashion if the target breaches or does not consummate the merger agreement.⁴⁷ Lock-ups are designed both to compensate the prospective acquirer in case of a breach and to protect the negotiated deal by imposing additional costs on other competitors who might decide to make offers.⁴⁸ The acquirer may ask the target's board of directors to grant a number of lock-up provisions including: (1) an irrevocable stock option, (2) an asset option, (3) a "topping" fee,⁴⁹ (4) an expense reimbursement provision, and (5) a termination or "break-up" fee.⁵⁰

The most common lock-up provision involves an irrevocable stock option by which the target corporation usually grants the acquirer the right to purchase ten to twenty percent⁵¹ of the target's stock at a favorable price.⁵² The right to exercise the option is usually conditioned upon the defeat of the favored bidder's attempt to acquire the target corporation.⁵³ In addition, use of the stock option by the original bidder

45. *See id.* at 689.

46. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183 (Del. 1986); *see also* Garrity & Morton, *supra* note 44, at 691 (noting that Delaware courts recognize benefits of lock-ups to shareholders).

47. *See* Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 Yale L. J. 1739, 1742 (1994).

48. *See* Garrity & Morton, *supra* note 44, at 689-90; *see also* Diane Holt Frankle, *Doing Deals: Understanding the Nuts and Bolts of Transactional Practice*, in *Counseling the Board of Directors in Choosing Alternatives*, at 825 (PLI Corp. L. & Practice Course Handbook Series No. 1034, 1998).

49. *See infra* notes 58-61 and accompanying text.

50. *See* Garrity & Morton, *supra* note 44, at 689-90.

51. *See, e.g.*, *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 39 (Del. 1994); *see also* Dennis J. Block et al., *Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals*, 51 U. Miami L. Rev. 623, 654 (1997) (noting that target will typically grant acquirer option to purchase from 10 to 20% of target's outstanding voting stock).

52. Typically the price of the stock option is market price before the bid. *See* Block et al., *supra* note 51, at 654.

53. *See, e.g.*, *Paramount Communications*, 637 A.2d at 39.

may preclude an intervening third party from using “pooling of interests” accounting,⁵⁴ a significant deterrent itself.⁵⁵

In an asset option or “crown jewel” defense, the target grants the acquirer the option to purchase a particularly desirable asset of the target at a negotiated price.⁵⁶ If the deal is not consummated, this option compensates the prospective acquirer, because it will still acquire the desirable asset at a price below fair market value. In addition, an asset option may deter bidders as they may be unwilling to suffer the loss from a sale of the asset at below fair market value.⁵⁷ Furthermore, regardless of the price, other bidders often lose interest once they cannot acquire the truly vital asset of the target.⁵⁸

Topping fees are a type of lock-up where the target must pay a fee to the initial bidder if the target accepts another bidder’s offer.⁵⁹ The fee is based on a percentage of the amount by which the accepted bid exceeds the initial bid.⁶⁰ For example, in *In re KDI Corp. Shareholder’s Litigation*,⁶¹ the parties agreed to a topping fee or “override” equal to one-half of the difference between the stock price and any other future offer.⁶²

54. See Linda Vincent, *Equity Valuation Implications of Purchase Versus Pooling Accounting*, J. Fin. Statement Analysis, Summer 1997, at 5. Pooling of interests accounting is a favorable accounting method under which the asset and liability accounts of the bidder and target are combined at book value as though the two firms had always been a single enterprise. See *id.* at 7. This method allows corporations to record their combined assets at historical values and the surviving entity to avoid recording goodwill. See *id.* Not recording goodwill results in greater annual earnings on paper and is the preferred method of accounting for business combinations. See Phillip J. Azzollini, Note, *The Wake of Paramount v. QVC: Can a Majority Shareholder Avoid Triggering the Auction Duty During a Merger and Retain a Significant Equity Interest? Suggestion: A Pooling of Interests*, 63 Fordham L. Rev. 573, 596 (1994).

55. See Stephen R. Volk et al., *Negotiating Business Combination Agreements—The “Seller’s” Point of View*, 33 San Diego L. Rev. 1077, 1118 (1996). The body responsible for setting U.S. accounting standards, the Financial Accounting Standards Board, has proposed to eliminate pooling accounting by the end of 2000. See Robert Tie, *The Battle Over Pooling Of Interests*, 188 J. Accountancy 14, 14–16 (1999).

56. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178–79 (Del. 1986) (noting Revlon granted asset lock-up option for key division at price below market value).

57. See Block et al., *supra* note 51, at 654.

58. See *id.*

59. See Garrity & Morton, *supra* note 44, at 690.

60. See *id.*

61. No. 10278, 1990 WL 201385 (Del. Ch. Dec. 13, 1990).

62. See *id.* at *3.

A fourth type of lock-up is an expense-reimbursement provision, which is similar to a liquidated-damages provision although not subject to the same analysis.⁶³ In an expense-reimbursement provision, if the target accepts another bid, then the target reimburses the initial prospective acquirer for any costs incurred during the initial merger effort.⁶⁴ The reimbursement covers any actual or estimated out-of-pocket expenses such as research or legal fees incurred by the prospective acquirer in its unsuccessful attempt to merge with the target.⁶⁵ For example, in *Kahn v. Dairy Mart Convenience Stores, Inc.*,⁶⁶ Dairy Mart agreed to reimburse the acquirer for expenses up to \$2.25 million if the merger failed for any reason other than a breach of warranty or representation by the acquirer.⁶⁷

Finally, an acquirer may negotiate for a termination or “break-up” fee. In the event the target terminates the merger, this provision requires the target to pay the acquirer often as much as three percent of the value of the transaction.⁶⁸ For example, in 1995 the Supreme Court of Delaware approved a termination fee of \$550 million designed to protect the \$28 billion merger of Bell Atlantic and NYNEX.⁶⁹ Recently, Warner-Lambert agreed to a record-breaking \$1.8 billion termination fee to American Home Products as protection for their original merger agreement valued at \$72 billion.⁷⁰

2. *Benefits and Drawbacks of Lock-up Provisions*

Delaware courts have long recognized that lock-up provisions may facilitate corporate mergers and acquisitions and benefit both targets and acquirers.⁷¹ For the target corporation, the lock-up may be necessary to entice reluctant bidders⁷² “to enter a contest for control of the

63. See *infra* note 177.

64. See Garrity & Morton, *supra* note 44, at 690.

65. See *id.*

66. No. 12489, 1996 WL 159628 (Del. Ch. Mar. 29, 1996).

67. See *id.* at *3.

68. See, e.g., *infra* note 198; see also Dennis J. Block & Stephen A. Raidin, *Termination Provisions After Bell Atlantic*, 11 *Insights*, Aug. 1997, at 2, 2.

69. See *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49 (Del. 1997).

70. See Petersen, *supra* note 42, at C1.

71. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183 (Del. 1986); see also Garrity & Morton, *supra* note 44, at 690.

72. The lock-up may be necessary to entice either initial or secondary bidders.

corporation, creating an auction for the company and maximizing shareholder profit.⁷³ By agreeing to the lock-up the target not only confers a significant advantage upon the bidder but also demonstrates to the bidder that the target's board is serious about the offer and willing to proceed in good faith with negotiations.⁷⁴ In addition, the lock-up may serve as insurance by compensating the initial bidder for any out-of-pocket costs or lost opportunities.⁷⁵ Furthermore, the lock-up may deter competitors, as a deal-jumper would not only have to pay the target's purchase price but also would bear the costs and other burdens resulting from the lock-up provisions.⁷⁶

Despite their use in facilitating mergers, lock-ups can harm the shareholders of a target corporation. Lock-ups may be preclusive in that other potential bidders, deterred by the size of the lock-up, might refrain from offering higher bids for the target corporation.⁷⁷ However, even non-preclusive lock-ups reduce the value that target shareholders receive, as some portion of the offer goes to the first bidder. In the absence of a lock-up, the purchaser would still bid the same price and no part of the offer would go to the initial bidder. Furthermore, target company directors, motivated by self-interest rather than concern for shareholder welfare, may grant preclusive lock-ups to the bidder that seems most responsive to their concerns about job security.⁷⁸ In such a case, the directors, at the expense of the shareholder, will depress the sale price rather than auctioning the target to the highest bidder.⁷⁹ Finally, management's enthusiasm may inadvertently lead to an excessively large lock-up in an effort to entice a reluctant bidder to make an offer.⁸⁰ An excessively large lock-up also precludes other potential offers and ultimately denies shareholders the opportunity to receive a higher value for their shares.⁸¹

73. *Revlon*, 506 A.2d at 183.

74. See Thomas A. Swett, *Merger Terminations After Bell Atlantic: Applying A Liquidated Damages Analysis to Termination Fee Provisions*, 70 U. Colo. L. Rev. 341, 356 (1999).

75. See David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 Nw. U. L. Rev. 564, 568 (1996).

76. See Block et al., *supra* note 51, at 654.

77. See Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups*, 21 Cardozo L. Rev. 1, 114 (1999).

78. See Skeel, *supra* note 75, at 574.

79. See Fraidin & Hansen, *supra* note 47, at 1742-43.

80. See Skeel, *supra* note 75, at 576-77.

81. See *id.*

II. DELAWARE'S DOCTRINAL FRAMEWORK FOR VALUATING THE VALIDITY OF LOCK-UP PROVISIONS IN STRATEGIC MERGERS

Depending on the form of the transaction, Delaware courts apply a doctrinal framework that contains three different standards used to determine the validity of a lock-up.⁸² The central inquiry in the doctrinal framework is whether the lock-up is preclusive.⁸³ If the lock-up is not preclusive and if the transaction does not involve a change of control, the business judgment rule will protect the lock-up from court invalidation, provided the decision to grant the lock-up was reached in an informed manner.⁸⁴ If the transaction involves a change of corporate control, under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁸⁵ the validity of a lock-up provision depends on whether it facilitates receipt by target-company shareholders of a maximum value for their shares.⁸⁶ If the lock-up was intended solely as a defensive measure against a subsequent hostile threat and the merger involves no change of control, the lock-up's validity, under *Unocal Corp. v. Mesa Petroleum Co.*,⁸⁷ depends on whether the lock-up is a balanced response to the threat posed by the future bidder.

A. Lock-Ups Under the Business Judgment Rule

A non-preclusive lock-up in a transaction that does not involve a change of control is protected by the business judgment rule and will not be disturbed provided it was reached in an informed manner.⁸⁸ Following the business judgment rule, courts generally presume that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in an honest belief that the action was taken in the best interests of the company."⁸⁹ Any party challenging the applicability of the presumption has the burden of establishing facts

82. See Garrity & Morton, *supra* note 44, at 691-94.

83. See *supra* note 76 and accompanying text.

84. See Garrity & Morton, *supra* note 44, at 691.

85. 506 A.2d 173 (Del. 1986).

86. *Id.* at 185.

87. 493 A.2d 946 (Del. 1985).

88. See Garrity & Morton, *supra* note 44, at 691.

89. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

rebutting the presumption.⁹⁰ The business judgment rule recognizes the inability of a court to judge a board's business decisions accurately because the decisions involve complex business factors that courts are not equipped to evaluate.⁹¹ Therefore a court's inquiry under the business judgment rule focuses on the process by which the board reached a decision, not the merits of the decision itself.⁹² Accordingly, a Delaware court will not interfere with the board's substantive decision to grant lock-up provisions provided there is any rational business purpose and the decision was reached in an informed manner.⁹³

B. The Limited Application of Revlon Duties to Lock-Ups in Transactions Involving a Change of Control or Break-Up of the Target

Under *Revlon*⁹⁴ and its progeny,⁹⁵ if a transaction involves a change of control the validity of the lock-up depends on whether it facilitates receipt by target-company shareholders of a maximum value for their shares.⁹⁶ If it does not, then the lock-up is preclusive and should be enjoined.⁹⁷ In *Revlon*, the Supreme Court of Delaware found that Revlon's directors effectively had put the company up for sale and granted lock-ups⁹⁸ that precluded further bids offering a higher value to Revlon's shareholders.⁹⁹ According to the *Revlon* court, the critical inquiry for lock-up provisions involves distinguishing "those lock-ups which draw bidders into the battle" from those that "end an active auction and foreclose further bidding."¹⁰⁰ Therefore, in a sale of a

90. *See id.*

91. *See* Fraidin & Hanson, *supra* note 47, at 1752.

92. *See* Aronson, 473 A.2d at 812.

93. *See* Garrity & Morton, *supra* note 44, at 691.

94. 506 A.2d 173 (Del. 1986).

95. *See, e.g.,* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989).

96. *Revlon*, 506 A.2d at 183.

97. *See id.*

98. Revlon's directors agreed to a \$25 million termination fee and an asset lock-up option allowing Forstmann Little to acquire certain key Revlon divisions at \$100-\$175 million below market value. *See id.* at 178-79.

99. *See id.* at 185. According to the court, when the directors put the company up for sale, their "role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* at 182.

100. *Id.* at 183.

corporation implicating *Revlon* duties, courts must enjoin preclusive lock-ups that prevent the target corporation's shareholders from obtaining the maximum value for their shares.

In two decisions subsequent to *Revlon*, the Supreme Court of Delaware both clarified and limited the application of *Revlon* duties in the strategic-merger context. In *Paramount Communications, Inc. v. Time, Inc.*,¹⁰¹ Time and Warner Brothers proposed a strategic stock-for-stock merger that, in response to an unsolicited hostile bid from Paramount, the boards recast as an outright cash and securities acquisition of Time by Warner Brothers.¹⁰² The court held that the proposed merger agreement between the boards of Warner Brothers and Time, in which Warner Brothers stockholders would own sixty-two percent of the resulting combined entity, did not trigger *Revlon* duties.¹⁰³ Noting the absence of a controlling shareholder, the court held that there was no change of control because control of both Time and the merged Time-Warner would remain in "a fluid aggregation of unaffiliated shareholders."¹⁰⁴

In *Paramount Communications, Inc. v. QVC Network, Inc.*,¹⁰⁵ the Supreme Court of Delaware further clarified the limited application of *Revlon* duties in strategic mergers.¹⁰⁶ Paramount and Viacom entered a merger agreement that included a \$100 million termination fee and a lock-up stock option for 19.9% of Paramount's outstanding stock worth approximately \$1.6 billion.¹⁰⁷ Subsequently, QVC made an unsolicited offer for Paramount, exceeding Viacom's offer.¹⁰⁸ This offer resulted in a bidding war, with the Paramount board ultimately rejecting the QVC offer.¹⁰⁹ The court emphasized that the directors' duty "to seek the best value reasonably available to the stockholders" is broader than previously recognized and includes any transaction that involves either (a) a change in corporate control or (b) a break-up of the corporate

101. 571 A.2d 1140 (Del. 1989).

102. *Id.* at 1148.

103. *See id.* at 1146.

104. *Id.* at 1150 (quoting Chancellor's conclusion).

105. 637 A.2d 34 (Del.), *aff'g* 635 A.2d 1245 (Del. Ch. 1993).

106. *QVC*, 637 A.2d at 46.

107. *See id.* at 39.

108. *See id.*

109. *See id.* at 39-41.

entity.¹¹⁰ The court determined that the Paramount-Viacom merger did implicate *Revlon* duties because the controlling stockholder of Viacom would own approximately seventy percent of the voting stock of the combined entity after the merger.¹¹¹ In contrast, the court also emphasized that *Revlon* duties would not have been triggered if, as in *Time*, control of the post-merger entity had remained widely held by an unaffiliated group of public shareholders.¹¹²

After the Supreme Court of Delaware's decisions in *Time* and *QVC*, most strategic mergers will not trigger *Revlon* duties.¹¹³ Although a change of control always occurs if the consideration is paid in cash or debt, most strategic mergers involve only transfers of stock as consideration.¹¹⁴ In addition, directors now actively seek to structure mergers so that the post merger entities remain widely held, so as to avoid implicating *Revlon*.¹¹⁵ As such, courts are most likely to review lock-up provisions in the strategic merger context under the enhanced scrutiny of *Unocal* or the business judgment rule.¹¹⁶

C. *Unocal: Enhanced Scrutiny for Lock-Up Provisions Granted in Response to Hostile Threats*

When the lock-up is a response to a transaction where control will not change, the rule of *Unocal Corp. v. Mesa Petroleum*¹¹⁷ determines the validity of the lock-up. In *Unocal*, the court considered an exchange offer by Unocal for its own shares in order to defend against a hostile bid for shares by Mesa Petroleum.¹¹⁸ The court subjected the defensive measures to enhanced scrutiny on the theory that the Unocal board of directors might be acting primarily in self-preservation rather than in the

110. *Id.* at 47.

111. *See Paramount Communications*, 635 A.2d at 1251.

112. *See QVC*, 637 A.2d at 46.

113. *See Treu, supra* note 19, at 1013; *see also, e.g., Arnold v. Society for Sav. Bancorp, Inc.*, No. 12883, 1993 Del. Ch. LEXIS 275, at *33 (Del. Ch. Dec. 15, 1993) (noting that strategic merger did not trigger *Revlon* duties).

114. *See Treu, supra* note 19, at 993.

115. *See Treu, supra* note 19, at 1013; *see also, e.g., In re Santa Fe Pac. Corp. Shareholders Litig.*, 669 A.2d 59, 71 (Del. 1995) (noting that board was firmly committed to stock-for-stock strategic merger not implicating *Revlon*).

116. *See Bainbridge, supra* note 21, at 316-17.

117. 493 A.2d 946 (Del. 1985).

118. *Id.* at 956-57.

shareholders' best interests in defending against a hostile offer.¹¹⁹ The court held that when a target board uses lock-ups in response to a hostile threat, the board must demonstrate: (1) a reasonable belief that a threat to corporate policy and effectiveness existed, and (2) that the lock-ups adopted were reasonable in relation to that threat.¹²⁰ A reasonable, good-faith investigation into the threat by the board of the target satisfies *Unocal's* first prong.¹²¹ *Unocal's* second prong focuses on the proportionality of the response to the hostile bid. Defensive measures that are preclusive, denying shareholders the opportunity to receive offers at all, are disproportionate responses and should be enjoined as violations of *Unocal's* second prong.¹²²

Therefore, the Delaware courts' doctrinal framework hinges on an initial determination of whether a lock-up is preclusive. Courts evaluate non-preclusive lock-ups under the business judgment rule. Courts subject preclusive lock-ups to the enhanced scrutiny of *Unocal* or to *Revlon* if there has been a change of control in the transaction. However, despite the doctrinal framework adopted by the Delaware courts, prominent scholars contend that alternate methods of evaluating the validity of lock-ups would be more effective.

III. ALTERNATE APPROACHES FOR EVALUATING THE VALIDITY OF LOCK-UPS

Legal commentators have suggested a wide variety of alternate approaches to the current doctrinal framework for lock-ups. Some commentators have suggested invalidating all lock-ups on the grounds that they all ultimately decrease shareholder wealth.¹²³ Others have proposed blanket enforcement of lock-ups, believing that market forces will protect shareholder value through a subsequent sale to any bidder who values the asset more than the recipient.¹²⁴ Finally, some

119. See *id.* (noting "omnipresent specter that a board may be acting primarily in its own interests").

120. See *id.* at 958.

121. See Garrity & Morton, *supra* note 44, at 692 (noting that presence of majority of disinterested, independent directors on board supports finding of reasonable, good-faith investigation); see also *Unocal*, 493 A.2d at 955.

122. See Garrity & Morton, *supra* note 44, at 692.

123. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1164 (1981).

124. See Fraidin & Hanson, *supra* note 47, at 1788-89.

commentators have argued that bright-line rules setting threshold requirements for invalidating lock-ups are a reasonable compromise.¹²⁵

A. *Invalidation of All Lock-Ups*

Two prominent law-and-economics scholars, Frank Easterbrook and Daniel Fischel, have suggested all lock-up provisions ultimately decrease shareholder wealth and should be enjoined.¹²⁶ They have argued that a takeover is beneficial to all shareholders because shareholders will receive a premium over market value for their shares.¹²⁷ Conversely, if the target's board successfully employs defensive measures against a tender offer, the shareholders will lose whatever premium over market value the bidder would have offered.¹²⁸ Even if the takeover never occurs, the threat will force managers to become more efficient, resulting in higher prices for shareholders.¹²⁹

Easterbrook and Fischel have further argued that defensive measures ultimately eliciting a higher bid are socially wasteful. Although the target's shareholders may receive a higher price, these gains are offset by the equal loss incurred by the bidder's shareholders.¹³⁰ According to Easterbrook and Fischel, shareholders as a whole lose because resistance to tender offers discourages prospective bidders and ultimately reduces the threat of takeovers.¹³¹ This reduced threat removes the incentive for a corporation's management to maximize efficiency and ultimately reduces stock prices.¹³²

Accordingly, Easterbrook and Fischel have argued that directors should refrain from implementing any sort of defensive measures.¹³³ Under this view, directors should simply carry on the company business, although it may be appropriate for them to express their views to shareholders.¹³⁴ Easterbrook and Fischel would allow directors to

125. See Bainbridge, *supra* note 21, at 324.

126. See Easterbrook & Fischel, *supra* note 123, at 1164.

127. See *id.* at 1173.

128. See *id.* at 1174–75.

129. See *id.* at 1174.

130. See *id.* at 1175.

131. See *id.* at 1176–77.

132. See *id.*

133. See *id.* at 1194–204.

134. See *id.* at 1201.

overcome the presumption that lock-ups are invalid only if the directors substantially demonstrate they granted the lock-up for the benefit of the corporation rather than to defeat the offer.¹³⁵

B. *Enforcement of All Lock-Ups*

In contrast, Stephen Fraidin and Jon Hanson have suggested that courts should enforce all lock-ups. They have argued that lock-ups are unlikely to preclude the highest valuing bidder from acquiring the target corporation.¹³⁶ In their view, directors of a target have every reason to seek out the highest possible bidder; but even if they do not, directors simply cannot prevent the highest bidder from acquiring the target.¹³⁷ A higher-valuing bidder will either outbid the competition or, if the lock-up is truly preclusive, will contract for resale with the winning bidder.¹³⁸ Although Fraidin and Hanson acknowledge that a resale will increase transaction costs, they simply conclude that the costs will neither be prohibitively high nor interfere with the subsequent sale.¹³⁹ Therefore, Fraidin and Hanson reason that lock-ups should be enforced without exception.¹⁴⁰

C. *Bainbridge's Ten-Percent Rule*

Finally, Stephen Bainbridge has suggested a bright-line rule that determines the validity of a lock-up based on a specified value limit for the lock-up provision.¹⁴¹ According to Bainbridge, courts should invalidate all lock-ups equal to more than ten percent of the value of the favored bidder's proposal.¹⁴² For purposes of the bright-line rule, Bainbridge defines lock-ups to include: (1) all termination fees, (2) any transaction where the target issues stock to the favored bidder, and (3) asset options or any sale of target assets to the favored bidder.¹⁴³ When calculating the ten-percent limit, courts should consider the combined

135. *See id.* at 1171, 1203–04.

136. *See Fraidin & Hanson, supra* note 47, at 1785.

137. *See id.* at 1787.

138. *See id.* at 1788–89.

139. *See id.* at 1792–93.

140. *See id.* at 1784.

140. *See Bainbridge, supra* note 21, at 324.

142. *See id.*

143. *See id.* at 324–25.

value of all lock-up devices in a particular transaction.¹⁴⁴ Bainbridge concedes that in some cases his bright-line rule “will not capture bid-preclusive lock-ups and in others it will allow them;” however, he argues that the benefits of certainty outweigh the risk of not enjoining some preclusive lock-ups.¹⁴⁵ In addition, Bainbridge proposes that if a board wishes to grant a lock-up in excess of ten percent, then it must fairly and “voluntarily shop the company among other bidders before agreeing to the lock-up.”¹⁴⁶

IV. NEITHER LEGAL STANDARDS NOR CURRENT PROPOSALS PROVIDE AN EFFECTIVE RULE FOR EVALUATING LOCK-UP PROVISIONS

Both the current Delaware rules and the proposed alternatives fail to provide an effective doctrinal framework for determining the validity of lock-up provisions. Largely because they are unable to make the complex determinations of valuation necessary to identify preclusive lock-ups, Delaware courts misapply the legal doctrine and consider inappropriate factors when evaluating lock-ups. Also, the suggested alternate approaches for evaluating lock-ups are not viable substitutes for the current framework as they fail to retain the long-recognized benefits of lock-up provisions.

A. *Courts Do Not Have the Valuation Skills Necessary to Identify Preclusive Lock-Ups Consistently*

Delaware courts are unable to apply the current doctrinal framework because courts are ill-equipped to take the necessary first step and determine if a lock-up is preclusive and should be enjoined.¹⁴⁷ Identifying a preclusive lock-up in the absence of a competing bidder is extremely difficult because it requires an assessment of valuation

144. *See id.* at 326.

145. *Id.* at 324.

146. *Id.* at 327–28.

147. *See* Bainbridge, *supra* note 21, at 282–83 (determining whether lock-up fosters or forecloses bidding is “costly, dangerous, but essentially meaningless, ritual”); *see also* Leo Herzel, *Misunderstanding Lock-ups*, 14 Sec. Reg. L.J. 150, 177 (1986) (“Classifying a lock-up as a permissible type that promotes bidding, or a harmful strain that discourages bidding, appears to be no more than conclusory judicial labels that are affixed by hindsight.”).

procedures.¹⁴⁸ In order to identify a preclusive lock-up, courts must determine if the initial bid and the added costs of the lock-up exceed the amount any rational bidder would pay for the target.¹⁴⁹ Therefore, courts must in effect determine whether the initial bid is within the top range of values for the target corporation.¹⁵⁰ This requires an evaluation of complex business factors that are “precisely the types of issues that [courts] are ill-equipped to explore and whose judicial exploration the business judgment rule is designed to preclude.”¹⁵¹ Accordingly, courts are no better equipped to evaluate whether a lock-up was preclusive at the time it was granted than they are to assess non-takeover-related business decisions, which courts shield from scrutiny under the business judgment rule.¹⁵² As a result, without the presence of a second bidder courts are unable to apply the current doctrine because they cannot consistently determine whether a lock-up should be denied the protection of the business judgment rule and evaluated under *Unocal Corp. v. Mesa Petroleum, Inc.*¹⁵³

B. Delaware Courts Consistently Misapply the Doctrine for Determining the Validity of Lock-Ups and Consider Inappropriate Factors when Evaluating Lock-Ups

Given Delaware courts' inability to identify preclusive lock-ups, the current framework leads courts to be inappropriately influenced by both the manner in which the challenge to the validity is raised and the form of the lock-up. Courts consistently fail in their initial determination of whether a lock-up is preclusive and therefore subject to *Unocal*. Instead, Delaware courts only identify and enjoin preclusive lock-ups when a hostile, competing bidder, who would have offered a comparable or higher bid but for the presence of the lock-up provision, challenges the

148. See *Hanson Trust PLC v. MLSCM Acquisition, Inc.*, 781 F.2d 264, 291 (2d Cir. 1986) (Kearse, J., dissenting).

149. See generally Bainbridge, *supra* note 21, at 282–83; Fraidin & Hanson, *supra* note 47, at 1750–51.

150. See generally Bainbridge, *supra* note 21, at 282–83; Fraidin & Hanson, *supra* note 47, at 1750–51.

151. Bainbridge, *supra* note 21, at 281–82 (quoting *Hanson Trust*, 781 F.2d at 291 (Kearse, J., dissenting)).

152. See Fraidin & Hanson, *supra* note 47, at 1752.

153. 493 A.2d 946 (Del. 1985).

lock-up provision.¹⁵⁴ In the absence of a competing bidder, courts evaluate lock-ups under the extremely deferential business judgment rule without first determining if the lock-up is preclusive.¹⁵⁵ As a result, Delaware courts only enjoin lock-ups challenged by a competing bidder and uniformly uphold those granted by directors only considering a single offer for control of the company.¹⁵⁶ In addition, courts sometimes fail to recognize termination fees as lock-ups, construing them as liquidated-damages provisions and excluding them entirely from the established doctrinal framework.¹⁵⁷

1. *Delaware Courts Enjoin Only Those Lock-Ups Challenged by a Competing Bidder*

The current method for evaluating lock-ups is inadequate because Delaware courts appear to ignore the doctrinal framework and identify and enjoin preclusive lock-ups only when a hostile competing bidder challenges the lock-up provision.¹⁵⁸ Delaware courts fail to take the initial step of determining whether a lock-up is preclusive, and instead identify and enjoin preclusive lock-ups only when challenged by a competing bidder with a higher offer. For example, in *Mills Acquisition Corp. v. Macmillan, Inc.*,¹⁵⁹ the Supreme Court of Delaware enjoined preclusive lock-up provisions challenged by a spurned bidder.¹⁶⁰ The court determined that the bidder would have offered a higher value to the Macmillan shareholders.¹⁶¹ The court stated: "In this case, a lock-up agreement was not necessary to draw any of the bidders into the contest . . . [b]y all rational indications it was intended to have a directly

154. See Fraidin & Hanson, *supra* note 47, at 1765–66.

155. See Giovannelli, *supra* note 31, at 1552 (noting that in absence of second bidder, courts defer to decision of directors provided directors have sufficient knowledge and have conducted reasonable investigation).

156. See Fraidin & Hanson, *supra* note 47, at 1765–66.

157. See generally Swett, *supra* note 74.

158. See, e.g., *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 36–37 (Del. 1994) (enjoining preclusive lock-up provisions that had been challenged by competing bidder with significantly higher offer in hand); *In re Holly Farms Shareholders Litig.*, No. 10350, 1988 Del. Ch. LEXIS 164, at *17 (Del. Ch. Dec. 30, 1988) (enjoining lock-up provisions challenged by competing bidder because they were intended to preclude auction); see also Fraidin & Hanson, *supra* note 47, at 1765–66.

159. 559 A.2d 1261 (Del. 1988).

160. *Id.* at 1265.

161. See *id.* at 1274.

opposite effect.”¹⁶² Therefore, the court enjoined the lock-up, as it was easily able to determine that the shareholders would have received a higher offer if not for the lock-up provision.

2. *Delaware Courts Uphold All Lock-Ups Granted by Directors Considering a Single Offer for Control of the Corporation*

Conversely, Delaware courts dismiss all shareholder challenges to lock-up provisions granted by directors considering only one offer for control of the company.¹⁶³ This asymmetry points to the inability of Delaware courts to apply the doctrinal framework. Although *Revlon*¹⁶⁴ requires courts to enjoin preclusive lock-ups, Delaware courts instead retreat to a business-judgment-like analysis and uniformly uphold lock-ups granted in the absence of a competing bidder.¹⁶⁵ For example, in *In re KDI Corp. Shareholder’s Litigation*,¹⁶⁶ the Court of Chancery rejected a shareholder challenge to lock-ups in a single-bidder situation.¹⁶⁷ Rather than evaluating the effect of the lock-up, the court noted that the KDI directors had made an informed decision based on an independent valuation.¹⁶⁸ The court concluded that the lock-up provisions did not violate the directors’ *Revlon* duties.¹⁶⁹

In addition, Delaware courts are generally unwilling to apply *Unocal* to lock-ups granted in a single bidder situation.¹⁷⁰ Courts do not

162. *Id.* at 1286.

163. *See* Fraidin & Hanson, *supra* note 47, at 1765–66.

164. *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

165. *See, e.g.*, *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1287–88 (Del. 1989) (dismissing shareholder challenge to no-shop provision because board had sufficient knowledge of relevant markets); *In re Vitalink Communications Corp. Shareholders Litig.*, No. 12085, 1991 WL 238816, at *11–12 (Del. Ch. Nov. 8, 1991) (upholding lock-ups challenged by shareholders by concluding that investment banker’s advice constituted reliable information for basis of decision).

166. 1990 WL 201385 (Del. Ch. Dec. 13, 1990).

167. *Id.* at *1.

168. *See id.* at *4.

169. *See id.*

170. *See, e.g.*, *State of Wis. Inv. Bd. v. Bartlett*, No. 17727, 2000 Del. Ch. LEXIS 42, at *21–22 (Del. Ch. Feb. 24, 2000). However, even when evaluating lock-ups challenged by a competing second bidder, Delaware courts do not enjoin lock-ups under *Unocal* as preclusive and therefore disproportionate responses to hostile takeover threats. *See, e.g.*, *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1155 (Del. 1994) (finding use of lock-up agreement, no-shop clause, and various other defensive mechanisms to be reasonable responses); *Wells Fargo & Co. v. First Interstate Bancorp*, Nos. 14696 & 14623, 1996 WL 32169, at *6 (Del. Ch. Jan. 18, 1996) (refusing to dismiss *Unocal* claim relating to lock-up provisions, court indicated that break-up fees and stock

determine whether such lock-ups are preclusive, and thus subject to the enhanced scrutiny of *Unocal*, but simply evaluate these cases under the deferential business judgment rule. Yet, because the business judgment rule examines procedure but not substance, Delaware courts have never identified or enjoined a preclusive lock-up under the business-judgment rule.¹⁷¹ For example, in *In re IXC Communications, Inc. Shareholders Litigation*,¹⁷² IXC shareholders sued to enjoin the proposed merger between IXC and Cincinnati Bell.¹⁷³ The merger agreement included a \$105 million termination fee and a lock-up stock option capped at \$26.25 million.¹⁷⁴ Without considering whether the lock-ups might have precluded other bidders, the Court of Chancery simply concluded that the lock-ups were not implemented in response to the perceived threat of a potential acquirer.¹⁷⁵ Instead of ensuring maximum shareholder return, the court afforded these lock-ups the protection of the business judgment rule.¹⁷⁶

options equaling two percent of transaction value were not coercive or preclusive and were within range of reasonableness); *In re Santa Fe Pac. Corp.*, No. 13587, 1995 Del. Ch. LEXIS 70 (Del. Ch. May 31, 1995), at *33, *rev'd on other grounds*, *In re Santa Pac. Shareholders Litig.*, 669 A.2d 59, 72 (Del. 1995) (concluding that \$50 million termination fee and \$10 million expense reimbursement provision were reasonable, proportionate responses); *see also* Fraidin & Hanson, *supra* note 47, at 1765-66. In fact, under *Unocal* Delaware courts have shown great deference to board's decisions and have determined few defensive measures of any kind to be disproportionate responses. *See* Robert M. Bass Group v. Evans, 552 A.2d 1227, 1238, 1242 (Del. Ch. 1988) (striking down management-sponsored restructuring that was economically inferior to plaintiff's tender offer and structured so that no shareholder vote was required); *City Capital Assocs. Ltd. Partnership v. Intero Inc.*, 551 A.2d 787, 798 (Del. Ch. 1988) (finding refusal to redeem poison-pill plan to be preclusive); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 114 (Del. Ch. 1986) (finding company's self-tender offer in response to takeover attempt coercive, leaving rational shareholder with no choice but to tender); Gregory W. Werkheiser, Comment, *Defending the Corporate Bastion: Proportionality and the Treatment of Draconian Defenses from Unocal to Unitrin*, 21 Del. J. Corp. L. 103, 109-14 (1996) (citing *Grand Metro. Pub. Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1060 (Del. 1988) (finding draconian and preclusive board's refusal to redeem poison-pill stock rights in face of all shares and all cash tender offers at price characterized as generous)).

171. *See, e.g., Bartlett*, 2000 Del. Ch. LEXIS 42, at *21-22 (applying business judgment rule to lock-ups granted in single bidder situation without examining whether they were preclusive and in violation of *Unocal*); *Repairmen's Service Corp. v. National Intergroup, Inc.*, No. 7811, 1985 WL 11540, at *3 (Del. Ch. March 15, 1985) (same).

172. 1999 WL 1009174 (Del. Ch. Oct. 27, 1999).

173. *Id.* at *1.

174. *See id.* at *2.

175. *See id.* at *10.

176. *See id.*

3. *Termination Fees as Liquidated Damages*

The influence the form of a lock-up has on Delaware courts also demonstrates the inadequacy of the doctrine for evaluating lock-ups. For example, courts occasionally uphold termination fees using only a liquidated-damages analysis¹⁷⁷ rather than identifying them as lock-ups and subjecting them to rigorous scrutiny.¹⁷⁸ For example, in *Brazen v. Bell Atlantic Corp.*,¹⁷⁹ the Supreme Court of Delaware upheld a termination fee under a liquidated damages analysis rather than evaluating it under the *Unocal/Revlon* framework based on “the express intent of the parties to have it so treated.”¹⁸⁰ The shareholder plaintiff argued that the termination fee was invalid because the fee was “unconscionably” high and designed to coerce the shareholders into voting for the proposed merger.¹⁸¹ Noting that the fee represented two percent of Bell Atlantic’s market capitalization,¹⁸² the court upheld the \$550 million termination fee as reasonable.¹⁸³ The Delaware courts tendency to evaluate termination fees under a liquidated-damages analysis further demonstrates the uncertainty of what constitutes a valid lock-up provision.

B. Suggested Alternatives for Evaluating the Validity of Lock-Ups Are Also Inadequate

Because suggested alternate approaches for evaluating lock-ups fail to retain recognized benefits of lock-up provisions, they are not viable substitutes for the current doctrine. First, enjoining all lock-ups would eliminate any benefit the lock-up might provide in enticing reluctant

177. Liquidated damages are an amount in a contract agreed to in advance to compensate a party for injuries suffered because of a breach of contract by the other party to the agreement. *See Black’s Law Dictionary* 942 (7th ed. 1999). In Delaware, liquidated damages are upheld “[w]here the damages are uncertain and the amount agreed upon is reasonable” *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 48 (Del. 1997) (citing *Lee Builders, Inc. v. Wells*, 103 A.2d 918, 919 (Del. Ch. 1954)).

178. *See Brazen*, 695 A.2d at 48; *Kysor Indus. Corp. v. Margaux, Inc.*, 674 A.2d 889, 897–98 (Del. 1996).

179. 695 A.2d 43 (Del. 1997).

180. *Id.* at 48.

181. *See id.* at 46–47.

182. *See id.* at 49.

183. The court cited the following factors in determining the reasonableness of the amount: (a) the lost opportunity costs, (b) the costs incurred in negotiating the merger, (c) the likelihood of a higher bid emerging, and (d) the size of termination fees in other mergers. *See id.* at 48–49.

bidders to auction. Second, enforcing all lock-ups may stifle competitive bidding and deny shareholders the highest value for the sale of their shares. Finally, while a bright-line rule may be the best solution, Bainbridge's ten-percent proposal is too arbitrary.

1. *Enjoining All Lock-Ups Does Not Provide an Adequate Solution Because It Eliminates Usefulness in Enticing Reluctant Bidders*

Invalidating all lock-up arrangements, as Easterbrook and Fischel advocate,¹⁸⁴ would fail to solve the current dilemma because it would prevent lock-ups from being used to entice reluctant bidders into an auction. This approach would provide certainty by eliminating the need for any judicial evaluation.¹⁸⁵ In addition, it would remove barriers to competitive bidding by eliminating preclusive lock-ups, thereby leading to an auction in most cases and higher value bids for the target shareholders. However, blanket invalidation would also eliminate the usefulness of lock-ups in compensating bidders for costs and enticing reluctant bidders to participate in auctions.¹⁸⁶ Easterbrook and Fischel's argument that defensive measures eliciting higher bids are socially wasteful also fails because target directors' duties run only to their own shareholders, not to society in general.¹⁸⁷

2. *Enforcing All Lock-Ups May Stifle Competitive Bidding*

Blanket enforcement is also an inadequate solution because it would fail to ensure that target shareholders receive the highest value available to them. Similar to blanket invalidation, a full-enforcement regime would increase certainty by eliminating the need for judicial assessment of business issues.¹⁸⁸ However, enforcing preclusive lock-ups would also stifle competitive bidding by deterring potential bidders. Therefore, target shareholders' interests under a full-enforcement regime would be protected only if, despite the existence of a preclusive lock-up, the higher valuing bidder were still to attain the target through a resale by the initial

184. See *supra* notes 124–32 and accompanying text.

185. See Skeel, *supra* note 75, at 587.

186. See *id.* at 587.

187. See *supra* notes 128–30 and accompanying text.

188. See Skeel, *supra* note 75, at 587.

acquirer.¹⁸⁹ Although Fraidin and Hanson assert that resale costs are not likely to be an impediment to a resale,¹⁹⁰ this conclusion is extremely controversial.¹⁹¹ Therefore, it is unlikely that a resale would effectively protect target shareholders' interests.¹⁹²

3. *Bainbridge's Ten-Percent Rule Is Unsatisfactory Because It Fails to Promote Auctions that Benefit Shareholders*

Bainbridge's proposed rule, invalidating lock-ups greater than ten percent of the favored bidder's proposal,¹⁹³ offers the best possibility for a solution to the current dilemma, but fails to promote adequately auctions for the benefit of the shareholders. Bainbridge's rule would provide certainty without the corresponding drawbacks of blanket enforcement or invalidation regimes.¹⁹⁴ In addition, it would prevent disproportionate increases between the size of lock-ups and the purchase prices of target corporations.¹⁹⁵ However, Bainbridge concedes his ten-percent designation is somewhat arbitrary as not all lock-ups above the ten-percent limit are preclusive.¹⁹⁶ Therefore, Bainbridge's rule would invalidate beneficial lock-ups that exceed the ten-percent limit while allowing preclusive lock-ups that do not exceed the ten-percent limit.¹⁹⁷ Although shareholder benefit and certainty may outweigh these risks, Bainbridge's proposal would still fail to protect shareholders from

189. *See id.* at 580.

190. *See supra* note 139 and accompanying text.

191. *See Skeel, supra* note 75, at 581; *see also* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv. L. Rev. 1028, 1037-38 (1994); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 Stan. L. Rev. 23, 59 (1982); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defenses*, 35 Stan. L. Rev. 51, 62-63 (1982).

192. *See Skeel, supra* note 75, at 581.

193. *See supra* notes 139-43 and accompanying text.

194. *See supra* notes 181-89 and accompanying text.

195. *See supra* note 42 and accompanying text.

196. Although the 10% limit is arbitrary, Bainbridge refers to the 10% limit as a compromise, because courts have held that lock-ups equaling 8% of a transaction price did not impede competitive bidding but that a lock-up totaling 17% did deter an auction. *See* Bainbridge, *supra* note 21, at 324. In addition, the 10% threshold also corresponds to the federal securities laws presumption that a 10% shareholder is a controlling person. *See id.* Finally, Bainbridge believes that the 10% trigger approximates the maximum that a bidder could reasonably expect to acquire in a stock acquisition program before the acquirer discloses its intentions. *See id.*

197. *See id.*

preclusive lock-ups. Instead, a new bright-line rule is needed that retains certainty while limiting the arbitrariness of a threshold limitation.

V. LIMITING LOCK-UPS TO THREE PERCENT OF THE BIDDER'S OFFER WILL PROVIDE CERTAINTY AND RETAIN THE BENEFITS OF LOCK-UPS

Courts should enforce lock-up provisions only if they do not exceed three percent of the bidder's offer; as a matter of law, any lock-up over the three-percent limit should be preclusive and therefore invalid. This bright-line rule would share Bainbridge's certainty by eliminating the need for judicial review, but would avoid his arbitrariness. By lowering the threshold for invalidating lock-ups, the proposed rule would err toward maximizing shareholder value by forcing auctions. Furthermore, unlike other alternatives, the new rule would clearly define preclusive lock-ups without sacrificing the recognized benefits of lock-up provisions. Finally, the three-percent rule would still facilitate mergers by promising bidders compensation for reliance costs and an additional premium in the event the merger is terminated.

A. *The Proposed Rule Is Not Arbitrary and Lock-Ups that Exceed the Three-Percent Safe Harbor Should Be Enjoined Without an Opportunity for Judicial Review*

The proposed rule restricting the value of lock-ups to three percent of the total value of the favored bidder's offer would limit arbitrariness by ensuring that courts will enjoin most preclusive lock-ups. Unlike Bainbridge's ten-percent designation, the three-percent rule is not arbitrary because it is intentionally designed to promote auctions, thereby maximizing shareholder value. In addition, courts have consistently held that termination fees amounting to two to three percent of the total value of the transaction are not preclusive of other potential offers.¹⁹⁸ For

198. See Myerson, *supra* note 33, at 671; Volk et al., *supra* note 55, at 1117 (noting that termination fees of one to three percent of transaction value are likely to be deemed reasonable if they result from arm's-length bargaining and are not supplemented by other lock-up options); see also generally Lewis v. Leaseway Transp., No. 8720, 1990 WL 67383, (Del. Ch. May 16, 1990) (dismissing challenge to break-up fee and related expenses of approximately three percent of transaction value); Braunschweiger v. American Home Shield Corp., No. 10755, 1989 WL 128571 (Del. Ch. Oct. 26, 1989) (finding 2.3% break-up fee was not onerous).

example, in *Kysor Industrial Corp. v. Margaux, Inc.*,¹⁹⁹ the Supreme Court of Delaware held that a termination fee representing 2.8% of Kysor's offer was reasonable.²⁰⁰ Similarly, in *Brazen v. Bell Atlantic Corp.*,²⁰¹ the court upheld a termination fee equaling two percent of the value of the transaction.²⁰²

When applying the new rule, courts should define lock-ups broadly and consider the aggregate effect of all lock-ups in a merger. Like Bainbridge's rule, lock-ups should include: (1) all termination fees paid to the favored bidder; (2) stock options, sales, or other transactions in which the target corporation issues target shares to the favored bidder; and (3) asset options or a sale of target assets to the favored bidder.²⁰³ If the target board grants more than one of these lock-up arrangements, the court should aggregate the value of all the arrangements to determine whether they exceed the three-percent limit.²⁰⁴

Under the proposed rule, directors would not have an opportunity to justify an excessive lock-up. Although bright-line tests typically allow for an opportunity to demonstrate the appropriateness of exceeding the safe harbor,²⁰⁵ a review of excessive lock-ups would not provide a meaningful safeguard against preclusive lock-ups. For example, Bainbridge's bright-line rule would require directors who wish to grant a lock-up in excess of the ten-percent limit to voluntarily shop the company among other bidders before agreeing to the excessive lock-up.²⁰⁶ Other types of review shift the burden of proof to the party seeking to enforce the presumptively invalid transaction.²⁰⁷ Bainbridge's requirement of a voluntary auction for lock-ups that exceed ten percent

199. 674 A.2d 889 (Del. 1996).

200. *See id.* at 897.

201. 695 A.2d 43 (Del. 1997).

202. *See id.* at 49.

203. *See* Bainbridge, *supra* note 21, at 324–26.

204. *See id.*

205. *See, e.g.,* Committee on Corporate Laws of the Section of Business Law, *Changes in the Model Business Corporation Act Pertaining to Appraisal Rights and to fundamental Changes—Final Adoption*, Bus. Law., Nov. 1999, at 406. The committee is proposing a bright-line safe-harbor rule under which a corporation would be conclusively deemed to have retained a significant business activity if the continuing business activity represents at least 25% of the total assets and 25% of either income from continuing operations before income taxes or revenues from continuing operations. *See id.* If the corporation retains less than the 25% safe harbor, then the transaction would be put to a vote for shareholder approval. *See id.*

206. *See supra* note 146 and accompanying text.

207. *See supra* note 135 and accompanying text.

would eliminate the danger of preclusive lock-ups; however, this voluntary auction mechanism is no different than requiring a fair auction in the first place.²⁰⁸ In addition, methods of review that shift the burden to the party seeking to enforce the excessive lock-up present the same problem as the *Revlon* and *Unocal* standards; they require ill-equipped courts to evaluate business factors such as valuation.²⁰⁹ As courts cannot determine the general effect of lock-ups, they will also be unable to determine if a preclusive lock-up is in the shareholders' best interests. Accordingly, the presumption that lock-ups in excess of the three-percent limit are preclusive would be final, and directors would have no ability to justify excessive lock-ups.

B. Enforcing Lock-ups Within the Three-Percent Safe Harbor Would Retain the Recognized Benefits of Lock-Ups

The three-percent rule is a more effective method for evaluating lock-ups because, unlike the alternatives proposed by legal commentators, the proposed rule would retain the benefits of lock-up provisions. The three-percent limit would enjoin most lock-ups, thereby removing barriers to competitive bidding and ensuring that shareholders receive maximum value for their shares at auction. In addition, the proposed rule would still entice reluctant bidders to make offers as three percent of the bidder's offer is sufficient to cover costs and provide an extra premium to the initial bidder.

1. The Three-Percent Safe Harbor Is an Effective Method for Evaluating Lock-Ups Because It Errs on the Side of Auctions Maximizing Shareholder Value

The proposed rule would benefit shareholders by erring on the side of enjoining lock-ups, thereby forcing auctions that maximize shareholder value. The proposed rule would strike an appropriate balance between blanket enforcement and blanket invalidation. By lowering the threshold limit for lock-ups the three-percent safe harbor would reduce the chance of underinclusiveness and promote auctions for the benefit of shareholders. Of course, it is possible that a lock-up will be preclusive even though it does not exceed three percent; however, because the

208. See *supra* note 146 and accompanying text.

209. See *supra* notes 169–73 and accompanying text.

three-percent threshold is so low, this “preclusive” lock-up would only preclude a minimal increase in value.

The proposed rule should also increase value for shareholders by streamlining the auction process. Unable to rely on exorbitant lock-ups to protect the initial bid from competition, potential acquirers would have to rely on the size of their initial bids to deter potential competitors. This would force bidders to offer initial bids with large premiums in an attempt to shield the deal from competition.²¹⁰ In cases where directors consider only single offers, initial bids will more closely resemble prices attained through an auction if the acquirer is concerned about potential competitors. Likewise, in cases where multiple bidders are competing for control, the increase in initial offers should serve to shorten the auction process,²¹¹ reducing costs and more quickly attaining the highest price available.

2. *The Proposed Rule Would Facilitate Mergers by Allowing Bidders to Recover Costs in Addition to a Premium for Alerting the Market to the Merger Opportunity*

By limiting lock-ups to three percent of the bidder’s offer, the proposed rule would allow for the unsuccessful bidder to recover reliance costs and an additional premium. Three percent of the offer will usually exceed the reliance costs the bidder has incurred in the unsuccessful merger effort.²¹² Reliance costs include the expense associated with researching and identifying the target, the expense of hiring investment bankers and other experts, as well as the value of executive time spent on the takeover bid.²¹³ Courts have long recognized that lock-ups facilitate mergers by assuring the bidder that its costs will be reimbursed in the

210. See Morton A. Pierce, *Mergers and Acquisitions in the 80's and 90's*, in *Contests for Corporate Control*, 972 PLI/Corp 279, 289 (1997).

211. See *supra* note 5 and accompanying text.

212. See *Costs of Exxon-Mobil Deal to top \$2 Billion*, N.Y. Times, Apr. 6, 1999, at C1 (noting \$90 million paid to lawyers, bankers, and others who put \$80 billion deal together); Jeffrey McCracken, *The DealMakers*, Crain's Detroit Bus., Jan. 31, 2000, at 11 (noting that investment bankers' fees are generally one percent of transaction value, although may be lower on deals in excess of \$500 million); Stanley Reed & Leah Nathans Spiro, *For Investment Bankers, An M&A Bonanza*, Bus. Wk., Nov. 18, 1996, at 55 (noting that average fees have fallen to around one percent of transaction value, down from two percent in 1980s).

213. See *supra* note 208.

event the merger is not completed.²¹⁴ Therefore, the promise of reliance costs alone may be enough to encourage reluctant bidders.²¹⁵

In addition to reliance costs, the proposed rule would also allow the bidder to receive a premium above costs for identifying the acquisition opportunity. Awarding a “finder’s fee” compensates the initial bidder for putting today’s merger-hungry market on notice of the opportunity.²¹⁶ Because the initial bidder is less likely to succeed without the aid of large lock-up provisions, some additional incentive is necessary to ensure that corporations undertake merger research. Finally, this finder’s fee would compensate the initial bidder were some other party to usurp the opportunity and enjoy a substantial benefit from the efforts of the initial bidder. Therefore, bidders could still expend the effort and resources on a merger and know that regardless of the outcome, they would still profit from the transaction.

VI. CONCLUSION

The current Delaware doctrine for evaluating the validity of lock-ups is unworkable. Courts are ill-equipped to consider complex business factors necessary to apply the correct legal standards for identifying preclusive lock-ups. As a result, Delaware courts fail to ensure that shareholders’ interests are adequately protected from preclusive lock-ups that deny them the opportunity to receive more lucrative offers in negotiated strategic mergers. While legal commentators have proposed other standards, these alternatives are not viable because they sacrifice the recognized benefits of lock-ups in facilitating mergers.

Therefore, Delaware should adopt a new rule limiting the value of a lock-up to three percent of the value of the bidder’s offer. This rule would clearly define preclusive lock-ups and would facilitate mergers by covering costs incurred by the initial bidder and providing an additional finder’s fee for the initial bidder. This rule would ensure shareholders receive the highest value for their shares by erring on the side of enjoining lock-ups and forcing auctions that maximize shareholder value. By limiting lock-up provisions to three percent of the bidder’s offer, the

214. *See Skeel, supra* note 75, at 567.

215. *See id.* at 599–600 (noting that bidders are most concerned with post-merger profitability, not likelihood that merger will fall through).

216. *See supra* notes 33–42 and accompanying text.

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new rule would provide certainty without sacrificing the recognized benefits of lock-up provisions in corporate mergers and acquisitions.

