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A BUY-SIDE MODEL OF LOCKUPS:  
THEORY AND EVIDENCE

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**ABSTRACT:** Lockups are an increasingly important element of M&A deals in the United States. We present, for the first time, descriptive data on lockup incidence, trends, and their relationship with Delaware case law. Prior commentators have argued that lockups should have little or no impact on allocational efficiency in the market for corporate control. We offer a new theoretical model of lockups that includes several “buy-side” distortions, such as agency costs, informational effects, switching costs, reputational effects, and endowment effects for bidders, and show that lockups can in fact change bid outcomes. We find strong support for this “buy-side” model of lockups from a large sample of M&A deals over the past twelve years. We also find that the type, size and structure of lockups affect deal outcomes. These results suggest that courts and corporate boards should scrutinize lockups more closely than prior commentators have advocated.

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# Theory and Evidence

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*“Generally the business people want to get the transaction done, to happen, and they generally want it to happen with the people they’ve picked. But legally you can’t always do what they want. Which is why business people don’t like lawyers.”<sup>1</sup>*

## **I. Introduction**

Lockups<sup>2</sup> are an increasingly important element of M&A deals in the United States.<sup>3</sup> In friendly U.S. mergers greater than \$50 million in value, lockups appeared in 80% of deals in 1998, compared to 40% of deals a decade ago.<sup>4</sup> Despite growing importance in practice, lockups have been largely misunderstood in the academic literature. Prior theories have failed to fully incorporate the tools of agency theory or behavioral economics. They have largely ignored real-world factors such as informational effects, switching costs, and reputational effects. Moreover, prior theories have not been tested against the available empirical evidence to assess their predictive (or even descriptive) power. This Article attempts to address these gaps in our understanding of lockups. In doing so it arrives at substantially different conclusions regarding the role of lockups in the market for corporate control.

M&A transactions involving public company targets face a (law-derived) risk of non-consummation that is unique (or at least rare) in three respects: (1) the law requires that shareholders of the target be given some opportunity to decide for themselves whether to accept or approve the transaction; (2) compliance with disclosure and other

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<sup>1</sup> Interview B, transcript at 2. Interviews remain anonymous until interviewees approve their quotes.

<sup>2</sup> The very word “lockup” can be controversial in the M&A context, since it implies the agreement is designed to ensure that an M&A transaction is completed. *See infra* Part VI. Many “lockups” do not provide complete insurance of that sort, and would be illegal if they did. We follow industry practice in using “lockup” to mean a term in an agreement related to an M&A transaction involving a public company target that provides value to the bidder in the event that the transaction is not consummated due to specified conditions (“trigger events”). *See infra* note 18. “Lockup” thus includes asset options, stock options, breakup fees and expense reimbursement terms.

<sup>3</sup> It is interesting that other countries have a much more skeptical view of breakup fees. *See* Interview K, transcript at 2 (“If you’re dealing with a non-U.S. company – say an English company – it’s a much more limited number. They’re beginning to develop some standards now, but there’s much more attitude now of letting the shareholders control the situation, and the board not assuming a role. So breakup fees tend to be much smaller.”).

rules regulating the process of obtaining target shareholder acceptance or approval entails delay, ranging from a minimum of 30 days up to six months in some situations; and (3) shareholders may decide not to accept or approve the transaction for any reason, including a third-party bid that emerges after agreements for the initial transaction are signed.<sup>5</sup> In effect, an M&A agreement gives shareholders of a public company target the option to accept the deal, and does not effectively bind the target (or its shareholders) to the deal.<sup>6</sup> Lockups have emerged as a second-best way for bidders to protect their expectancy interests in the transaction. Even if bidders cannot be sure to consummate a deal for a given target, they can at least get the consolation prize of a lockup payout.

All prior theoretical scholarship has been premised on several problematic assumptions relating to the “buy-side” of M&A transactions. First, it has made the implicit assumption that bidders are monolithic, and bidder managers, by extension, are perfect agents for their shareholders. Buy-side agency costs have been ignored. Second, prior scholarship has ignored the additional information that bidders gain from the decisions of other bidders. Third, prior scholarship has implicitly assumed that bidders can costlessly abandon an acquisition strategy whenever the expected value of a lockup payout exceeds the expected value of winning the auction. Fourth, prior scholarship has treated lockup decisions in a static, single-period model, without considering the effect of accepting a lockup payout on bidder reputation. Finally, prior scholarship has treated bidder managers as perfectly rational actors, and has neglected even the most basic and robust findings of cognitive psychology in predicting how lockups might affect bid outcomes.

In addition, prior scholarship has been almost entirely uninformed by statistical evidence.<sup>7</sup> At best, it has been built on arm-chair empiricism. None of the many

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<sup>4</sup> See *infra* Figure 1.

<sup>5</sup> The primary policy justification for this set of legal rules is that shareholders should have some power over fundamental corporate transactions, presumably to minimize agency costs. See Part VI *infra*.

<sup>6</sup> In most situations involving delay between the signing of an agreement and the closing of the trade, the parties are free to bind themselves fully to consummate the trade. Although conditions are frequently specified in real estate closings, for example, that might allow a seller to get out of the deal based on events or discoveries between signing and closing, the conditions are generally ones that are outside the control of the seller, and do not usually include a condition that no higher offer emerge between signing and closing.

<sup>7</sup> A search of business and legal academic sources revealed only one (unpublished) paper that involves empirical analysis of lockups. See Timothy R. Burch, *Locking Out Rival Bidders: The Use of Lockup*

conflicting positive predictions implicit in prior scholarship has been tested in a rigorous way. Despite the theoretical gaps in prior scholarship, and despite the complete absence of empirical scholarship, prior scholarship has also been uniformly normative in nature. Scholars have offered prescriptions ranging from a near-complete ban on lockups<sup>8</sup> to near-complete judicial deference to manager decisions on lockups.<sup>9</sup> Yet because of the lack of empirical testing, scholars have had no valid basis even for the implicit assumption that legal rules on lockups affect bidder strategy, target behavior or bid outcomes.

This Article attempts to address both the theoretical and empirical gaps in prior scholarship. After a preliminary exploration of lockup design and incidence and presentation of evidence that Delaware case law strongly shapes lockup decisions, we build on the theoretical contributions of Ayres<sup>10</sup> Fraidin & Hanson<sup>11</sup> and, more recently, by Kahan & Klausner.<sup>12</sup> Our framework departs from these prior commentators by introducing buy-side agency costs, information effects, switching costs, reputational effects, and endowment effects into the model. Introducing these elements leads us to

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*Options in Corporate Mergers* (University of Miami Working Paper, June 1999). However, this paper is limited in its usefulness because it fails to consider breakup fees as functionally equivalent to stock lockups. See Interview F, transcript at 1 (“Stock lockups, asset lockups, and plain old money lockups – ultimately, they all come down to money.”). Figure 1 shows that breakup fees are more common than stock lockups.

MergerStat does limited empirical analysis of lockups. E.g., *Prenuptial Agreements and Breakups*, MergerStat, at 3 (Sep. 3, 1999). For clients, investment bankers analyze recent data on lockup incidence and design. See Interview F, transcript at 5 (“Investment bankers ... show you breakup fees in 101 deals.”); Interview H, transcript at 4 (“Everybody ... has a chart of [lockups in] recent deals.”); Interview D, transcript at 2 (“The bankers typically have their charts. We categorize it [by] size [and] look at ... whatever the general range of the deal...”). Lockups may have been ignored by business academics, the most likely source for empirical analysis, because lockups are viewed as a legal issue. See Interview C, transcript at 1 (“More often than not it’s done between the lawyers. . . . Typically you don’t want to let the business people spend a lot of time with the nuts and bolts of figuring out how the lockup works.”); Interview B, transcript at 2 (“Generally the lawyers [negotiate lockups]. . . . If it’s unusual, you bring in a business person.”). As legal commentators have long recognized, the use and design of lockups have important implications for corporate governance and the market for corporate control.

<sup>8</sup> Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J. L. & Econ. Org. 229, 238 (1986). See also Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 377-78 (1987) (proposing requirement that shareholders approve lockups above reasonable negotiation expenses or involving 15+% of target’s stock or assets).

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

<sup>10</sup> Ian Ayres, *Analyzing Stock Lockups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682 (1990).

<sup>11</sup> *Supra* note 9.

<sup>12</sup> Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539 (1996).

make two predictions that depart from those implicit in prior work: (1) lockups substantially increase the likelihood that an initial bid will be consummated, and thus will affect allocational efficiency; and (2) stock lockups, often thought to raise more troublesome issues than breakup fees, are less likely to affect bid outcomes than fees of the same expected value.

Throughout, we are able to rely on two types of evidence on lockups. First, we draw upon eleven interviews with leading M&A practitioners to develop a better picture than exists at present of the way that Delaware law has shaped and continues to shape the choice, use and effects of lockups.<sup>13</sup> Second, we construct a large sample of friendly merger bids, starting with data from Securities Data Corporation, that allows us to test – and in large measure confirm – our specific predictions on lockup design, incidence and effect. We also reject a number of specific predictions implicit in prior scholarship. Finally, we make preliminary normative recommendations based on our findings.

The remainder of the Article proceeds as follows. Part II summarizes types, trends and statistics on lockup incidence, and then shows that lockup choice is responsive – indeed, “overresponsive” in a sense – to Delaware case law.<sup>14</sup> Part III reviews prior models of lockups, focusing on the implicit predictions in the work of Ayres and Fraidin & Hanson that lockups do not influence the market for corporate control, and in the more recent contribution of Kahan & Klausner. Part IV sets out our theoretical extension. Part V develops empirical tests for both the conventional model and our contribution. Part VI concludes with implications for both court scrutiny of lockups and decisions about lockups by directors of bidders and targets.

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<sup>13</sup> Attorneys interviewed are corporate partners at major law firms in New York City or Wilmington, Delaware. Four are managing partners of their firms; another three are heads of their firms’ corporate practices. In addition, one of the authors was a corporate partner in the New York law firm of Wachtell, Lipton, Rosen & Katz, where he negotiated numerous lockups.

<sup>14</sup> This Article focuses primarily on Delaware case law because nearly 60% of the Fortune 500 corporations, and one-half of the 30 companies in the Dow Jones Industrial Average, are incorporated in Delaware, *see* Lewis S. Black, Jr., *WHY CORPORATIONS CHOOSE DELAWARE* (Prentice Hall Legal & Fin. Servs. 1993), and no other state has more than a 5% share of the market for corporate charters. *See* John C. Coates IV, *The Contestability of Corporate Control: An Index of Contestability* (Working Paper July 1999). Delaware case law also has a strong impact on law in other states. *E.g.*, *Mullen v. Academy Life Ins. Co.*, 705 F.2d 971, 973 n.3 (8<sup>th</sup> Cir. 1983) (“We discuss Delaware case law as well, because of Delaware’s position as a leader in the field of corporate law.”) *See also* Interview J, transcript at 1 (“Most of the



## II. Descriptive Statistics on Lockup Incidence and Design

Three types of lockups can be distinguished.<sup>15</sup> Stock lockups give the acquirer a call option on a specified number of shares of the target at a specified strike price.<sup>16</sup> Asset lockups give the acquirer a call option on certain assets of the target at a specified price. Breakup fees give the acquirer a cash payment from the target if a specified event occurs.<sup>17</sup> The acquirer's rights under each type of lockup are typically "triggered" by specified events that vary but usually make consummation of the overall deal unlikely or impossible.<sup>18</sup> More than one type of lockup may be included in a deal.

We begin with data from Securities Data Corporation (SDC) on all mergers and acquisitions of U.S. public targets, announced between January 1, 1988 and October 31, 1999, greater than \$50 million in value (in 1999 dollars). Because we want to focus on deals in which lockups are reasonably likely to affect outcome, we exclude hostile deals and deals involving targets with a controlling shareholder.<sup>19</sup> In hostile deals, lockups are

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decisions are in Delaware. That's the one that's most commonly applicable. Even outside of Delaware people look there to figure out what's reasonable.").

<sup>15</sup> We focus on M&A lockups, not to be confused with shareholder lockups (agreements by large or controlling shareholders to support a deal involving a portfolio company), as described in text accompanying note 21 *infra*, or IPO lockups (agreements by pre-IPO shareholders to retain shares for a period following the IPO). No-shop provisions also protect deals from bust-up bids, but they are much less potent than M&A lockups because affirmative "shopping" is rarely important in large public company acquisitions, given attendant publicity. Contractual restrictions that go further (so-called "no-talk" provisions) are generally thought to be subject to the board's fiduciary duties to shareholders, regardless of whether a formal "fiduciary out" is contained in the agreement. *See Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (1993) ("a contract [that] purports to require a board to act or not act [so] as to limit the exercise of fiduciary duties ... is invalid and unenforceable.").

<sup>16</sup> Throughout we use "stock lockup" and "stock option lockup" interchangeably.

<sup>17</sup> Some lockups are written as expense reimbursements, rather than as breakup fees. The only difference between these two types of lockups is that the amount payable under the former is determined *ex post* based on outlays by the bidder, whereas the amount payable under the latter is fixed *ex ante*. Generally speaking, breakup fees in larger transactions will usually exceed documentable out-of-pocket expenses, so that expense reimbursements can be treated as a lesser form of breakup fee.

<sup>18</sup> Standard trigger events include (1) consummation of or agreement for a business combination with a third party, (2) rejection of the first bidder's deal by target shareholders, or (3) acquisition of a large block of target stock by a third party. Some lockups contain "dual triggers," which extend the life of the lockup if other events occur. Fees payable upon events unrelated to the risk of non-consummation (such as regulatory denials) are sometimes called "breakup" fees, but raise sufficiently distinct practical and policy issues that we do not treat them as lockups.

<sup>19</sup> Our exclusion of hostile deals is the primary reason that our lockup incidence numbers are higher than the numbers presented by Burch. *See* Burch, *supra* note 7, at 11.

by definition not available.<sup>20</sup> Where a target has a controlling shareholder, it is legal and advisable (and hence common) for a bidder to obtain a binding agreement from the controlling shareholder to vote for (or tender into) the deal, and to oppose other bids (a “shareholder lockup”). Unlike merger agreements, shareholder lockups are not generally subject to approval by other shareholders or regulators, or other significant conditions, so that shareholder lockups greatly if not completely reduce the odds of competing bids. Stock lockups, breakup fees, and asset lockups typically acquire teeth only when a properly drafted shareholder lockup is not feasible.<sup>21</sup> For similar reasons, we exclude minority purchases (including “white squire” purchases).<sup>22</sup> With these changes, we narrowed the sample to public targets with no controlling shareholder, in which the acquirer gained a controlling share of the target’s stock (n = 3254).

#### A. Overall Incidence, By Type and Over Time

Table 1 shows the incidence of stock lockups and breakup fees and the interaction between the two types of deal protection devices:

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<sup>20</sup> However, deals that are initially “hostile” (i.e., resisted by target managers) but that become “friendly” (often after target managers realize a takeover is inevitable) are included in the data set because lockups are possible in this situation. UNSOLICITED identifies these deals in the data set.

<sup>21</sup> A poorly drafted stockholder lockup was at issue in a recent Delaware case, [ACE]. The stockholder lockup there terminated if the merger agreement terminated, and the merger agreement contained a “fiduciary out,” allowing it to be terminated if the target board was required to do so to pursue a superior proposal; in effect, the stockholder lockup was unnecessarily made subject to the target board’s fiduciary duties. Stockholder lockups need not, and well-drafted ones do not, contain such escape hatches.

<sup>22</sup> Thus, we exclude asset and stock purchases not requiring a target shareholder vote. A white squire is a friendly suitor who buys newly issued shares of the target as a defensive measure against a hostile bidder. *See* Bruce Wasserstein, *BIG DEAL* 726 (1998). The sale of less than substantially all of a target’s assets or less than 20% of a target’s voting stock does not require a shareholder vote. *See* DGCL § 271; New York Stock Exchange Listed Company Manual §[312] (1999).

<b>Table 1. Overall Incidence By Lockup Type</b>		
<b>Stock Lockup?</b>	<b>Breakup Fee?</b>	
	<b>No</b>	<b>Yes</b>
<b>No</b>	39.8%	37.3%
<b>Yes</b>	12.7%	10.2%
n = 3254: Incidence of stock option agreements and breakup fees in all friendly deals >\$50 million from January 1988 to October 1999 involving majority acquisition or merger of public company targets that lack a controlling shareholder		

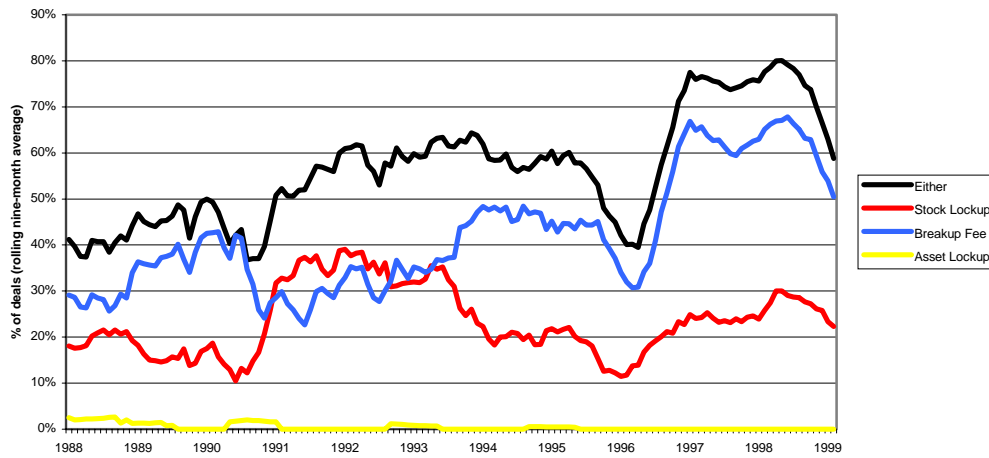
Table 1 shows that over the full time period, lockups are common, but far from universal: almost as many deals are “naked” as are those protected by some form of lockup (40% vs. 60%).<sup>23</sup> Breakup fees are more common than stock lockups (48% vs. 23%), and deals with both a stock lockup and a breakup fee are almost as common as deals with a stock lockup alone (10% vs. 13%).

Figure 1 shows that over the past twelve years significant changes have occurred in both type and overall level of lockup incidence.

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<sup>23</sup> M&A practitioners at a workshop sponsored by the New York University School of Law were surprised that 40% of deals were “naked.” *See also* Interview K, transcript at 4 (predicting stock lockups in 50% of nonbank deals and 90% of bank deals). A gap between expectation and our data may arise because practitioners who specialize in M&A are involved in bigger deals, or because they remember recent deals, both of which have a higher likelihood of deal protection. *See* Table 2 & Figure 1. The gap may also reflect a different approach between New York practitioners and practitioners elsewhere; research has found a “west coast” legal approach to takeover defenses in IPOs, *see* John C. Coates IV, *The Contestability of Corporate Control: Theory and Evidence* (Working Paper October 1998), at 33.

**Figure 1: Lockup Incidence Over Time**



As can be seen, lockup incidence has generally increased over the period (until 1999), growing from 40% of all deals in 1988 to more than 75% of all deals by 1998. Asset lockups, never popular in the period studied, fell almost entirely from the picture by the mid-1990s. Stock lockups have enjoyed varying levels of use, from a high of 39% in 1991 and 1992 to a low of 10% in 1996. Breakup fees have proven to be the most popular over time, being deployed in almost 70% of deals in 1998, although they too have gone through cycles of greater and lesser use.

### B. Deal Activity, Deal Characteristics, and Industry Effects

Practitioners commonly suggest that lockup incidence, type and design should be affected both by deal activity levels as well as deal characteristics such as size, consideration offered (stock, cash or mixed), method of acquisition (tender offer vs. merger); accounting (pooling vs. purchase); and relative size of the parties (mergers of equals vs. acquisitions). In addition, various industry effects – notably, “bank deals are different” – are part of practitioner lore on lockups. In this section, we partition the sample to test these claims. Lockup incidence for the partitions are shown in Table 2.

Table 2: Deal Protection Incidence Segmented by Major Control Variables

	N (% of sample)	Incidence: Stock Lockup	Breakup Fee	Both	Magnitude: Stock Lockup	Breakup Fee
OVERALL	3254 (100%)	12.7%	37.3%	10.2%	4.5%	3.0%
<b>Deal Activity:</b>						
Above Average	2421 (74%)	<b>11.2%</b>	<b>40.6%</b>	<b>10.8%</b>	4.2%	3.0%
Below Average	833 (26%)	<b>17.2%</b>	<b>28.0%</b>	<b>8.2%</b>	5.1%	2.8%
t-statistic		3.56	6.28	2.14	0.72	0.31
<b>Deal Size (\$MM):</b>						
> \$1000	569 (17%)	12.5%	<b>43.1%</b>	<b>18.3%</b>	3.7%	2.4%
\$500 - \$1000	392 (12%)	11.0%	<b>44.4%</b>	12.2%	3.9%	2.8%
\$100-\$500	1488 (46%)	12.8%	39.5%	8.6%	4.8%	3.1%
<\$100	805 (25%)	13.7%	<b>25.8%</b>	<b>6.2%</b>	5.1%	3.6%
<b>Consideration:</b>						
All Stock	1212 (37%)	<b>23.8%</b>	<b>30.2%</b>	<b>14.9%</b>	4.7%	3.1%
Part Stock	598 (18%)	<b>7.2%</b>	<b>44.1%</b>	11.2%	3.5%	2.7%
Cash & Other	1444 (44%)	<b>5.7%</b>	<b>40.5%</b>	<b>5.7%</b>	4.4%	3.0%
<b>Tender Offer?</b>						
Yes	659 (20%)	<b>4.7%</b>	<b>58.7%</b>	10.2%	3.8%	2.9%
No	2595 (80%)	<b>14.8%</b>	<b>31.9%</b>	10.1%	4.6%	3.0%
t-statistic		5.52	12.31	0.08	0.59	0.14
<b>Accounting:</b>						
Pooling	893 (27%)	<b>25.6%</b>	35.6%	<b>17.5%</b>	4.6%	3.0%
Purchase	2361 (73%)	<b>7.8%</b>	38.0%	<b>7.4%</b>	4.3%	3.0%
t-statistic		10.80	1.22	8.52	0.25	0.00
<b>Mergers of Equals?</b>						
Yes	59 (2%)	22.0%	25.4%	<b>20.3%</b>	3.1%	2.4%
No	3195 (98%)	12.6%	37.6%	<b>10.0%</b>	4.5%	3.0%
t-statistic		1.71	1.86	2.60	0.34	0.29
<b>Target industry:</b>						
Bank	650 (20.0%)	<b>48.2%</b>	<b>11.2%</b>	10.2%	5.7%	2.8%
Telecom	45 (2.9%)	3.2%	36.8%	12.6%	2.4%	2.8%
Utility	108 (3.3%)	<b>1.9%</b>	<b>53.7%</b>	8.3%	2.7%	2.8%
Healthcare	143 (4.4%)	<b>2.1%</b>	<b>52.4%</b>	9.1%	3.2%	3.1%
High Tech	118 (3.6%)	5.9%	<b>49.2%</b>	<b>20.3%</b>	2.6%	3.2%
<b>Public acquirer?</b>						
Yes	2533 (78%)	<b>15.0%</b>	38.1%	<b>12.2%</b>	4.5%	3.0%
No	721 (22%)	<b>4.9%</b>	34.7%	<b>2.9%</b>	4.5%	3.0%
t-statistic		5.70	1.61	7.30	0.00	0.00

Notes:

n = 3254; statistically significant differences (at 95% confidence) in bold.

Deal Activity. Parties may be more concerned about potential bust-up bids, and more likely to seek lockups, when overall deal activity has been higher than normal. We examine deal activity in the three months prior to a given deal, and divide the sample into deals that follow higher and lower than average deal activity levels over the whole period. Table 2 shows that breakup fees are more likely in periods of high deal activity (51.4% incidence compared to 36.2%), though stock lockups are not.

Deal Size. Larger deals attract more experienced and expensive lawyers, who may be more familiar with lockup design or more comfortable advising lockups be granted.<sup>24</sup> Larger deals generate more publicity, and produce larger fees for entrepreneurial investment bankers who assist a successful bust-up bidder, and so may attract more competition; on the other hand, larger deals are harder to finance, and so may enjoy “natural” protection from competition. We stratify the sample into very large (>\$1 billion), large (\$500 million to \$1 billion), mid-sized (\$100 to \$500 million), and small (\$50 to \$100 million). Table 2 shows that almost three-quarters (74%) of very large deals have some form of lockup, compared to less than half (46%) of small deals. Compared to small deals, very large deals have been more frequently protected by stock lockups (30.8% vs. 19.9%) and breakup fees (61.4% vs. 32.0%).

Consideration and Method of Acquisition. Cash tender offers can generally be completed more quickly than stock deals,<sup>25</sup> or cash mergers,<sup>26</sup> and cash tender offers can also produce a “pressure to tender,”<sup>27</sup> and so may be less in need of deal protection. On the other hand, an initial bidder concerned about competition may seek both a faster, more coercive deal structure as well as a lockup. In other words, lockups and deal structure may be complements as well as substitutes. Further, a bust-up bidder offering

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<sup>24</sup> Stock and asset lockup agreements are substantially more complex and lengthy to ensure that the value to be received by the defeated bidder is as expected. Such lockups also involve things of uncertain value, making the implicit pricing of the lockup more difficult to negotiate. We discuss in Part II.C below some of the legal issues lockups involve (as to both enforceability and liability for directors who approve them).

<sup>25</sup> Stock to be issued in a deal must be registered with the SEC under Rule 145, which normally takes longer than the 20 business day minimum tender offer period under the Williams Act.

<sup>26</sup> Cash mergers require target shareholder approval, which in turn requires a proxy solicitation, which in turn requires pre-clearance with the SEC, which normally will take longer than the 20 business day minimum tender offer period under the Williams Act.

<sup>27</sup> E.g., Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 *HARV. L. REV.* 1693 1708-33 (1985).

cash may more easily entice target shareholders if the original deal is all cash – stock must be valued, and target shareholders may defer to manager recommendations on close calls – making all stock or part-stock deals harder to bust-up (and so less in need of a lockup).

As reflected in Table 2, all-stock deals are more likely to have stock lockups than cash deals (38.7% vs. 11.4%) or deals involving mixed consideration (18.4%), but are not more likely to have breakup fees than cash deals (45.1% vs. 46.2%) or mixed deals (55.3%). Tender offers are more likely to have breakup fees than mergers or other deal structures (68.9% vs. 42.0%), but are less likely to have stock lockups (14.9% vs. 24.9%).

Pooling Accounting. Although neither the SEC nor the FASB has ever provided definitive guidance on the matter, stock lockups, if triggered, probably impair pooling-of-interest accounting in subsequent deals; breakup fees, by contrast, are not generally believed to affect pooling, even if triggered.<sup>28</sup> For public company bidders, pooling has in the 1990s been the sought-after accounting treatment for major acquisitions, as it generally results in higher reported earnings than purchase accounting.<sup>29</sup> When a target agrees to a pooling deal, subsequent publicly held bidders can be expected to also prefer pooling accounting, all else equal, because any higher bid would produce more goodwill than the initial deal.<sup>30</sup> Initial bidders have a reason to use stock lockups to deter such bids.<sup>31</sup> Table 2 shows that pooling deals are more likely to include stock lockups than other deals, at more than 99+% statistical significance.

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<sup>28</sup> If cash “put” rights are embedded in such options, see note 40 infra, and are exercised, the target has arguably engaged in an “alteration of equity interests” that would prevent it from engaging in a subsequent pooling for two years, and even the exercise of a significant stock option granted “in contemplation of” a merger may prevent pooling treatment. See APB Opinion No. 16 (listing criteria for poolings).

<sup>29</sup> Bidder motives in seeking pooling accounting remain controversial. Semi-strong market efficiency implies that accounting differences should not matter to investors. Yet it is clear that bidders are willing to incur significant costs to achieve pooling treatment. See T. Lys & L. Vincent, *An Analysis of Value Destruction in AT&T's acquisition of NCR*, 39 J. FIN. ECON. 353 (1995).

<sup>30</sup> Whether the FASB proceeds with its proposal to abolish pooling accounting under U.S. generally accepted accounting principles, see FASB [citation], the effect of lockups on pooling is relevant for studies of our deals done under existing rules, as with our sample.

<sup>31</sup> As of this writing, the contest between Pfizer and American Home Products to acquire Warner-Lambert involves this kind of “pooling-killing” lockup. In its friendly merger agreement, Warner-Lambert and AHP have agreed to 19.9% cross-options that prevent Pfizer from getting pooling accounting treatment if it were to consummate its bid. Pfizer has conditioned its hostile bid on the elimination of the stock lockup as well

Mergers of Equals. Stock lockups may also be more common in so-called “mergers of equals” (MOEs).<sup>32</sup> In MOEs the classic give-and-take negotiation between acquirer and target<sup>33</sup> is more likely to be replaced by a situation in which both parties have strong incentives to establish as large a lockup as feasible.<sup>34</sup> MOEs are often characterized as a unique fit for the two companies, something that shareholders should decide on without the distraction of potential other bidders.<sup>35</sup> Courts may also give greater deference to stock lockups in MOEs for the same reasons.<sup>36</sup> Using SDC’s classification,<sup>37</sup> Table 2 shows that MOEs are more likely than other deals to include stock lockups (42.3% vs. 22.6%), but not breakup fees (45.7% vs. 47.6%).

Industry Effects. Lockup incidence and type may also be affected by the industry of the companies involved in the deal. First, deals in regulated industries (such as banking, utilities and telecommunications) are believed to require on average a longer

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as the breakup fee, though it is considering removing this condition on its bid. *See* Steven Lipin, *Is Warner-Lambert Defense Playing Fair?*, WALL ST. J. (Nov. 17, 1999) at C1.

<sup>32</sup> It is often said that there is no such thing as a merger of equals, meaning one set of managers always comes to dominate the combined company. This may be true, but mergers between companies of roughly equivalent size, in which neither is clearly buying the other, do seem qualitatively different from cash acquisitions or “whale/minnow” mergers, in which one company is much larger than the other. *But cf.* *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994) (rejecting distinction between merger of equals and stock-for-stock “whale/minnow” merger for purposes of deciding whether the *Revlon* doctrine applies under Delaware law).

<sup>33</sup> Characterized best by Interviewee H: “The buyer says I’m not going to make an offer and be your stalking horse unless you give me 7%. The target says that’s totally absurd, I haven’t done any process, I’ve got all these widows and orphans, this is horrible, I could get a better deal, I’ll give you \$11.40. And we have a negotiation.” Interview H, transcript at 6. *But see* Interview F, transcript at 5 (“Usually, with a fee that big, you’re sort of throwing out numbers, and eventually you just agree on one.”).

<sup>34</sup> *See* Interview D, transcript at 5 (“If you’re doing a strategic [MOE], [with] reciprocal [stock lockups], you provide that no one can enter into the agreement. And ultimately, you’re saying to the shareholders, ‘You decide whether you want to do this. As far as we’re concerned, we’re not for sale. We’re doing a fundamental, strategic combination.’”); Interview H, transcript at 6 (“[In a MOE], it’s a little different, because everyone is negotiating with themselves. . . . We are collectively negotiating with hypothetical shareholders’ counsel.”).

<sup>35</sup> *See* Interview C, transcript at 6 (“In [MOEs], people feel more comfortable saying ‘Let’s lock this thing up because we’re all in this together.’”); Interview K, transcript at 2 (“In [MOEs] you tend to see – and it depends on the industry – both the breakup fees and mutual 19.9% stock [lockups]. They show an increased commitment to the deal.”).

<sup>36</sup> *Cf.* *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989) (court defers to business judgment of Time directors who agreed to mutual lockups with Warner in a “strategic merger”).

<sup>37</sup> MOEs in the SDC database are defined as a stock swap transaction between two companies of approximately equal market capitalization; in which the new entity is owned approximately 50-50 by shareholders of the respective companies; and both companies have approximately equal representation on the board. The definition is not based on how the parties to the deal characterize the transaction.



time frame for regulatory approval than other deals,<sup>38</sup> making lockups more important. Second, commercial and savings banks are constrained from effectively committing to cash breakup fees because of regulatory capital requirements.<sup>39</sup> Stock lockups offer an alternative that do not require cash,<sup>40</sup> and thus are more likely to be used than breakup fees in bank deals.<sup>41</sup>

Using industry categories developed by SDC based on standard industrial classification (SIC) codes, we examine the data for industry effects in the ten most common industry groupings (accounting for roughly 60% of the sample). We find four statistically significant industry effects ( $p < .05$  in each case) shown in Table 2. As predicted, stock lockups are more common in bank and S&L deals. Surprisingly, however, neither type of lockup is more common in utility or telecom deals – in fact, stock lockups are *less* common in utility deals. Also interesting is that breakup fees are more common in healthcare deals and high tech deals, perhaps because valuation of firms

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<sup>38</sup> Interview I, transcript at 6-7. *See also* Edward D. Herlihy *et al.*, FINANCIAL INSTITUTIONS MERGERS AND ACQUISITIONS 1998: CONSOLIDATION IN A SEA OF CHANGE (18<sup>th</sup> Annual Institute, Securities Activities of Banks) (November 1998), at 66-68. A comparison of the number of months between deal announcement and completion or abandonment in our sample confirms this belief for bank deals, which take 6.57 months on average, compared to 4.26 for nonbank deals ( $p < 0.001$ ). For small deals (\$50-100 MM), regulatory delay is more pronounced (6.70 months for bank deals vs. 4.01 for nonbank deals) ( $p < 0.001$ ).

<sup>39</sup> 12 C.F.R. § 225.4(b)(1) (cash paid out by bank holding company in lockup may not exceed 10% of consolidated net worth). *See* Herlihy *et al.*, *supra* note 38, at 67 (lockups must comply with Federal Reserve Board rules). *See also* Interview I, transcript at 6 (“Traditionally banks couldn’t do breakup fees, because it ended up hitting capital requirements. And so they needed a vehicle, i.e., options, to provide value to the loser, that didn’t have these bad capital requirement impacts.”).

<sup>40</sup> Most stock lockups also provide for a cash “put” right giving the holder of the option the right to put the option back to the issuer for a cash payment equal to the spread between the strike price and the current value of the stock covered by the option (or, if greater, the value of the stock implied by the bid triggering the option). But the issuer may elect to use stock if such cash payment would violate capital requirements or other laws. *E.g.*, Stock Option Agreement between NationsBank Corp. and BankAmerica Corp., filed as Appendix C to Joint Proxy Statement/Prospectus included in NationsBank Form S-4 filed Aug. 4, 1998 (available at <http://www.sec.gov/Archives/edgar/data/70858/0000950123-98-007069.txt>).

<sup>41</sup> *See, e.g.*, Interview K, transcript at 4 (“We’ve seen the cross-options quite often in the bank deals.”); Interview I, transcript at 6 (“I think ... it’s still statistically far more common to see [stock lockups] in the bank deals than in the nonbank deals, even in the nonbank stock-for-stock deals. . . . It’s not like they’re unheard of. But I think if you chart it out you’ll see that they’re in 90%+ of the bank deals and maybe they’re in 50% of the nonbank deals.”). *See also* Herlihy *et al.*, *supra* note 38, at 65-67 (“properly structured conventional stock [lockups] ... in a form similar to the options that have been granted in bank merger transactions entered into over the past 15 years are legal and justifiable within the specialized context of bank merger transactions”).

in such industries is more difficult, making predatory bust-up bids more of a concern.<sup>42</sup> Other industries have no significant impact on lockup incidence.

### C. The Impact of Case Law on Lockup Incidence and Type

Complicating analysis of lockup incidence is that (perceptions of) lockup legality may vary based both on deal and lockup characteristics, as well as judicial perceptions of trends in lockup incidence and design. In this section, we demonstrate two ways case law has affected lockup incidence: (1) the doctrinal distinction between *Revlon* and *Unocal*, which has been in large part a function of deal consideration; and (2) explicit judicial criticism of asset and stock lockups, on the one hand, and implicit judicial acceptance of breakup fees, on the other hand.

#### 1. Intermediate Judicial Scrutiny: *Revlon* vs. *Unocal*

Prior to the 1980s, Delaware courts employed two radically different standards to evaluate director behavior: entire fairness, a stringent test generally putting the burden on directors to show that self-dealing transactions (such as management buyouts) reflect both fair process and fair price; and the business judgment rule, which mandates judicial deference, absent proof the board acted on grossly inadequate information.<sup>43</sup>

Uncomfortable with either extreme in the takeover context, the Delaware Supreme Court set up new standards of “intermediate” review in two landmark cases in the mid-1980s – *Unocal Corp. v. Mesa Petroleum*,<sup>44</sup> and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>45</sup> – each of which bears on the legality of lockups. *Unocal* requires that directors reasonably perceive a “threat” before adopting takeover defenses (such as lockups, which raise the cost of bust-up bids, and so impair takeover bids for the issuer), and that

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<sup>42</sup> This was suggested to us by Professor Helen Scott.

<sup>43</sup> 1 E. Folk, R. Ward & E. Welch, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2.2, at 104 (2d ed. 1988); D. Block, N. Barton & S. Radin, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 2-3, 8 (3d ed. 1989); Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 *IOWA J. CORP. L.* 583, 583 (1994).

<sup>44</sup> 493 A.2d 946 (Del. 1985).

<sup>45</sup> 506 A.2d 173 (Del. 1986).

directors show that a defense is a reasonable response to the threat.<sup>46</sup> *Revlon* (described in more detail in Part II.C.2 below) requires directors approving a sale of the company for cash seek the highest short-term shareholder value reasonable available, something that lockups may impede.

Both *Unocal* and *Revlon* thus announced standards that would allow courts to intervene against lockups, even where self-dealing is not involved.<sup>47</sup> Commentators have sometimes argued that there is no coherent basis for the distinction between the two standards (implying the distinction may be illusory),<sup>48</sup> and others have questioned whether *Unocal* is essentially equivalent to the business judgment rule.<sup>49</sup> But the general consensus has been that deals subject to *Revlon* are more likely to be second-guessed by the courts than deals subject to *Unocal*, particularly if the deals involve lockups.<sup>50</sup> If this consensus is correct, *Revlon* deals should have fewer and weaker lockups than other deals in our sample.

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<sup>46</sup> In a subsequent Delaware Supreme Court case, *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995), a “reasonable” response under *Unocal* was elaborated to mean not “preclusive or coercive,” and otherwise in a “range of reasonableness.”

<sup>47</sup> See Martin Lipton & Erica H. Steinberger, TAKEOVERS AND FREEZEOUTS at §5A.03[1] (1998). Whether *Unocal* is a “substantive” standard requiring courts to second-guess boards on defenses (or lockups) or a “procedural” standard imposing higher-than-normal informational and deliberative requirements on boards adopting defenses is debatable. Cf. Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 268 (1989) (arguing the former) with Kahan, *supra* note 43 (arguing the latter).

<sup>48</sup> Lyman Johnson & David Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105, 2118 (1990) (arguing norms underlying distinction between *Unocal* and *Revlon* are unarticulated and unjustified); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 990 (1993) (arguing distinction between *Unocal* and *Revlon* is “without foundation”). Cf. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1287 (1989) (distinguishing *Unocal* “standards,” which apply in the *Revlon* context, from *Unocal* “responsibilities,” which differ from those applicable in the *Revlon* context).

<sup>49</sup> E.g., Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1944-45 (1991) (effort of Delaware courts to create intermediate standards collapsed due to socioeconomic and political factors); Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 338 (1987) (“*Unocal*’s loyalty tests are superficial. ... *Unocal* ... is ... unresponsive to target shareholders’ concerns because it is the directors’ loyalty to the corporation, not their care, that is at issue”); E. Ashton Johnston, *Defenders Of The Corporate Bastion In The Revlon Zone: Paramount Communications, Inc. v. Time Inc.*, 40 CATH. U.L. REV. 155, 168 (1990) (“Since *Unocal*, Delaware courts have found few defensive tactics unreasonable, giving rise to concerns that the ‘enhanced’ test is no more protective of shareholders’ interests -- in particular, their interest in preventing entrenchment of management -- than is the traditional business judgment rule”); cf. Gilson & Kraakman, *supra* note 47, at 256 (arguing *Unocal* is “not an empty threshold test”).

<sup>50</sup> E.g., Interview C, transcript at 4 (“[Y]ou have to look at deals as two separate [types] – one is in the *Revlon* mode, where you’re clearly for sale, and one is where you’re in a stock-for-stock deal, when you’re clearly not for sale.”).

We would like to test directly the effect of these cases on lockup incidence and design, by looking at lockups before and after these decisions, but SDC lockup data begins to be reliable only after these cases were decided. However, we can test the impact of the doctrinal distinction during our sample period. *Revlon* has been clearly applicable to all-cash deals and clearly not applicable to most all-stock deals.<sup>51</sup> By contrasting lockup incidence and design between these two types of deals, we can test whether Delaware standards have affected lockup incidence in M&A practice. If the doctrinal distinction is important, lockups of any sort should be less common in all-cash than all-stock deals, and lockup size should be smaller in all-cash than all-stock deals.

To test these predictions, we estimate two models using the sample described above.

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<sup>51</sup> In *Paramount Communications Inc. v. QVC Network Inc*, 637 A.2d 34 (1993), discussed in Part II.C.2 *infra*, *Revlon* was extended to stock deals where the acquirer had a controlling shareholder prior to the deal and the target did not, and the target did not negotiate for or receive contractual or other legal protections for the non-controlling shareholders that would remain after the deal. As a result, some all-stock deals in our sample were *Revlon* transactions (20% would be a first approximation, based on how many large U.S. companies have controlling shareholders, *see* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 848 (1999)). However, this misclassification only reinforces the conclusion of analysis below, since its effect would be to weaken the statistical relationship between consideration and lockup type.

Table 3: Deal Protection Incidence (multinomial logistic regression)

Variable	Dependent Variable is Type of Deal Protection:		
	Stock Lockup	Breakup Fee	Both
<b>Deal Characteristics:</b>			
Merger of Equals?	0.03 (0.50)	<b>-0.81 (0.41)</b>	-0.31 (0.46)
Log (Deal Value in Real Dollars)	<b>0.67 (0.15)</b>	<b>0.48 (0.10)</b>	<b>0.94 (0.13)</b>
Unsolicited?	-1.10 (1.05)	-0.20 (0.54)	NM
Tender Offer?	<b>1.28 (0.29)</b>	<b>1.30 (0.15)</b>	<b>1.72 (0.26)</b>
Months to Close/Withdrawal	0.05 (0.03)	0.03 (0.02)	0.02 (0.03)
Premium (%)	<b>0.46 (0.19)</b>	0.11 (0.13)	0.34 (0.18)
Deal Activity (three months prior)	-0.02 (0.01)	<b>-0.03 (0.01)</b>	-0.02 (0.01)
All Stock?	<b>0.58 (0.27)</b>	0.14 (0.17)	<b>1.11 (0.28)</b>
Part Stock?	-0.02 (0.29)	<b>0.37 (0.16)</b>	<b>1.00 (0.27)</b>
Pooling of Interests?	<b>1.19 (0.21)</b>	<b>0.67 (0.16)</b>	<b>0.91 (0.20)</b>
Other Bidder?	-0.00 (0.39)	0.09 (0.21)	0.45 (0.32)
Same Industry?	-0.05 (0.16)	0.13 (0.11)	0.13 (0.15)
<b>Acquirer Characteristics:</b>			
Public Acquirer?	0.29 (0.26)	0.16 (0.14)	<b>0.94 (0.29)</b>
Other Lockups? <sup>52</sup>	<b>0.12 (0.03)</b>	0.05 (0.03)	0.02 (0.04)
<b>Target Characteristics (Industry Effects):</b>			
Banking	<b>2.76 (0.21)</b>	<b>-0.65 (0.18)</b>	<b>0.75 (0.22)</b>
Telecommunications	-0.48 (0.65)	<b>-0.65 (0.31)</b>	-0.54 (0.44)
Utility	-0.20 (0.82)	<b>0.68 (0.33)</b>	0.58 (0.49)
High Tech	0.51 (0.50)	0.51 (0.29)	<b>0.89 (0.35)</b>
<b>Impact of Delaware Law:</b>			
After <i>Paramount</i> ?	<b>-0.73 (0.24)</b>	<b>0.71 (0.15)</b>	<b>-0.11 (0.24)</b>
After <i>Brazen</i> ?	<b>1.44 (0.34)</b>	<b>1.50 (0.21)</b>	<b>1.68 (0.31)</b>
<b>Constant</b>	<b>-4.89 (0.53)</b>	<b>-2.15 (0.31)</b>	<b>-6.00 (0.51)</b>

Notes:

N = 2567; Log likelihood = -2566.7; pseudo R-squared = 20.0%

NM = not meaningful. Standard errors in parentheses; coefficients significant at 95% confidence in bold.

Comparison group is the set of deals with neither a stock lockup nor a breakup fee.

<sup>52</sup> Breakup fee or stock lockup

Table 4: Deal Protection Magnitude (Tobit regressions)

Dependent Variable is Magnitude of Deal Protection (% of deal value):		
Variable	Stock Lockup	Breakup Fee
<b>Deal Characteristics:</b>		
Merger of Equals?	0.58 (0.79)	-0.87 (0.49)
Log (Deal Value in Real Dollars)	<b>1.02 (0.23)</b>	-0.06 (0.12)
Unsolicited?	-3.40 (2.03)	-0.66 (0.76)
Tender Offer?	<b>1.70 (0.43)</b>	<b>1.47 (0.19)</b>
Months to Close/Withdrawal	0.04 (0.05)	0.04 (0.02)
Premium (%)	<b>1.18 (0.30)</b>	0.10 (0.16)
Deal Activity (three months prior)	-0.00 (0.02)	<b>-0.02 (0.01)</b>
All Stock?	<b>1.95 (0.45)</b>	<b>0.51 (0.23)</b>
Part Stock?	0.74 (0.46)	<b>0.63 (0.22)</b>
Pooling of Interests?	<b>1.36 (0.34)</b>	<b>0.44 (0.19)</b>
Other Bidder?	0.54 (0.57)	0.19 (0.28)
Same Industry?	-0.14 (0.26)	0.16 (0.14)
<b>Acquirer Characteristics:</b>		
Public Acquirer?	<b>1.35 (0.43)</b>	0.34 (0.19)
Other Lockups? <sup>53</sup>	0.10 (0.05)	-0.02 (0.03)
<b>Target Characteristics (Industry Effects):</b>		
Banking	<b>5.85 (0.35)</b>	<b>-2.25 (0.21)</b>
Telecommunications	-0.36 (0.86)	-0.69 (0.41)
Utility	-0.51 (0.95)	0.74 (0.41)
High Tech	0.73 (0.63)	<b>0.66 (0.32)</b>
<b>Impact of Delaware Law:</b>		
After <i>Paramount</i> ?	<b>-2.38 (0.40)</b>	<b>1.22 (0.21)</b>
After <i>Brazen</i> ?	<b>1.30 (0.53)</b>	<b>1.70 (0.27)</b>
<b>Constant</b>	<b>-9.57 (0.87)</b>	<b>-1.19 (0.41)</b>
Number of Observations (n)	2567	<b>2567</b>
Pseudo R-sq	13.1%	5.8%

Notes:

Standard errors in parentheses; coefficients significant at 95% confidence in bold.

<sup>53</sup> Breakup fee or stock lockup

In the first (multinomial logistic) regression, shown in Table 3, the dependent variable is PROTECT, which equals 0 if the deal included no type of lockup, 1 if it included a stock lockup, 2 if it included a breakup fee, and 3 if it included both. In the second set of (Tobit) regressions, shown in Table 4, the dependent variable is LOCKUPSIZE and FEESIZE, which equal the size of the stock lockup and the breakup fee, respectively. In each regression, the explanatory variable being tested is ALLSTOCK, which equals 1 if the deal involves all-stock consideration. We distinguish between the effect of *Revlon* and the effect of delay imposed on deals involving stock consideration (which we assume practitioners can anticipate)<sup>54</sup> by including BETWEEN as a control variable, which represents the number of months between the time a deal is signed and announced and the time that it is closed (or abandoned). By including MOE, we are also able to control for the tendency of lockups to be granted in such transactions as a *quid pro quo*, regardless of legal constraint. We include a variable PARTSTOCK, to control for deals involving mixed consideration (to which *Revlon* is not clearly applicable). Another control variable, PREMIUM, tests whether lockups and deal premiums might be substitutes (because lockups and higher premiums both protect deals) or complements (because bidders may extract larger lockups in exchange for higher premiums). In addition, we control for acquirer characteristics (two variables), and target industry (four variables). Results are shown in Tables 3 and 4.<sup>55</sup>

As predicted, lockup incidence is significantly higher in all-stock deals (governed by *Unocal*) than in all-cash deals (governed by *Revlon*). Deals “outside” of “*Revlon*-land” are significantly more likely to have a stock lockup, or both a stock lockup and a breakup fee, than deals inside *Revlon*-land, even after controlling for other effects that the choice between all-stock and all-cash may have. A chi-square test for the model is highly significant ( $p < .0001$ ), and the overall fit for the incidence regression is fairly high (pseudo R-squared  $> 0.2$ ). Deals “outside” of *Revlon*-land also have larger breakup fees and stock lockups, as shown on Table 4. These results make clear that practitioners have

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<sup>54</sup> Delay is generally determined by legal rules known to deal lawyers. *See, e.g.*, notes 25-26, 38 *supra*.

<sup>55</sup> In addition, two case law variables, AFTERPARAMOUNT and AFTERBRAZEN, are discussed in more detail in Part II.C.2 below.

been affected by Delaware case law in providing advice on lockups, which in turn has had effects on lockup incidence.

Consistent with the results of our partition analysis, incidence coefficients on POOLING and LOGSIZE are large, positive and highly significant.<sup>56</sup> Interestingly, higher premiums lead to greater incidence of stock lockups (Table 3), and larger magnitudes of both stock lockups and breakup fees (Table 4). This supports the theory that the bidder often pays for deal protection with a higher deal premium. At 10% confidence, the time between signing and closing has an independent effect on breakup fee incidence (the longer the delay, the more likely a fee), stock lockup incidence (the longer the delay, the more likely a stock lockup), and breakup fee magnitude (the longer the delay, the larger the fee). MOEs are no more likely to have lockups than other deals, after controlling for delay, accounting treatment, and *Revlon/Unocal*, and in fact are significantly less likely to rely solely on breakup fees than other deals.

Industry effects persist in the multivariate regressions. Banks are more likely to use stock lockups or a combination of stock lockups and breakup fees than breakup fees alone, even after controlling for delay and accounting treatment, suggesting that regulatory capital rules are the principal reason that “bank deals are different.” High tech firms are more likely to rely on breakup fees or a combination of stock lockups and breakup fees (although not stock lockups alone), and also use larger breakup fees. Surprisingly, and contrary to the partition analysis in Part II.B, telecommunications firms are less likely to use breakup fees, and when they do, use smaller fees.<sup>57</sup> Utilities (even after controlling for deal delay) are more likely to employ breakup fees, and to use larger breakup fees, and (contrary to the partition analysis) are no less likely to use stock lockups. Although we do not have a general theory to explain all of these industry effects, path dependency and the existence of repeat players are likely to be an important part of the explanation. In particular, bank industry effects are likely to be explained by

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<sup>56</sup> Not surprisingly, breakup fee size and deal size do not have a strong relationship in the model tested in Table 4: breakup fees are measured as a percentage of deal size, so that *absolute* breakup fee size is already (by definition) increasing in deal size, and the insignificant coefficients only reflect that breakup fees do not increase as a *percentage* of deal size as deal size increases.

<sup>57</sup> The telecommunications industry effects present something of a puzzle: the transformation of that industry would justify lockups under the opportunity cost rationale accepted in *Brazen*.



these two phenomena, given that bank capital levels have been sufficiently high during the mid- and late 1990s that capital constraints are unlikely to have been binding.<sup>58</sup>

## 2. Judicial Commentary on Lockups

The prior section demonstrated that lockup incidence is sensitive to Delaware case law – lockups are more common outside of *Revlon*-land than within. This section demonstrates that the type of lockup used is also sensitive to judicial commentary. The remainder of this section discusses each type of lockup in turn – asset lockups, stock lockups, and breakup fees.

### a. Asset Lockups

Asset lockups were prominent during the hostile takeover wave of the 1980s, and were featured in high-profile fights that strongly shaped subsequent law and practice. In 1986, a bidding contest erupted between Ronald Perelman, a hostile bidder, and Forstmann Little, a white knight, to acquire Revlon. After several rounds of bidding, Forstmann conditioned its final offer on receipt of an option to purchase two of Revlon's divisions if another bidder acquired more than 40% of Revlon's stock. The contingent option price was fixed at \$525 million, allegedly 20% less than the fair market value of the divisions.<sup>59</sup> Revlon's board unanimously approved Forstmann's proposal,<sup>60</sup> but the Delaware Supreme Court struck down the lockup, holding that Revlon directors breached their duties of loyalty and care in part because "the result of the lockup was not to foster bidding, but to destroy it."<sup>61</sup> As noted above, the Court also announced a new standard for judicial review of director conduct in cash sale transactions, but it is clear from the

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<sup>58</sup> See John C. Coates IV, *Bank Capital Rules in the 1990s: Reassessing Risk-Based Capital*, in Y. Amihud & G. Miller, *BANK MERGERS AND ACQUISITIONS* (1999).

<sup>59</sup> See *Revlon* at 178.

<sup>60</sup> See *id.* at 179.

<sup>61</sup> *Revlon* at 183. Cf. Leo Herzel, Dale E. Colling & James B. Carlson, *Misunderstanding Lockups*, 14 SEC. REG. L.J. 150, 177 (1986) ("Classifying a lockup 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 after the lockup has been scrutinized by the courts.")

decision that the lockup was part of the factual basis for the court's conclusion that the sale to Forstmann Little did not meet the new standard.<sup>62</sup>

Three years later, in *Mills Acquisition Co. v. Macmillan, Inc.*,<sup>63</sup> the Delaware Supreme Court examined a bidding contest between KKR and Robert Maxwell to acquire Macmillan Publishing Company. KKR's final bid included an option to purchase seven Macmillan subsidiaries for \$865 million.<sup>64</sup> The Court struck down the option, stating that under *Revlon* a lockup "must confer a substantial benefit upon the stockholders in order to withstand exacting scrutiny by the courts."<sup>65</sup> In *Macmillan*, the lockup did not "materially enhance general stockholder interests" and in fact "was intended to have a directly opposite effect."<sup>66</sup> *Macmillan* was unusual in that the CEO had secretly "tipped" its favored bidder.<sup>67</sup> In addition, Macmillan management pursued a buyout only after a complex restructuring had been enjoined by the Delaware Chancery Court, in part on the grounds that management had acted disloyally.<sup>68</sup> Nonetheless, an asset lockup had again been enjoined in a high-profile takeover fight.

These cases sounded the death-knell for asset lockups by the early 1990s. Figure 1 shows that asset lockups were rare by the late 1980s and extinct by the late 1990s.<sup>69</sup> After *Macmillan*, only seven friendly mergers greater than \$50 million included

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<sup>62</sup> Shortly after *Revlon*, an asset lockup was struck down in a third high-profile case, *Hanson Trust PLC v. ML SCM Acquisitions, Inc.*, 781 F.2d 264 (2d Cir. 1986), after a bidding war for SCM between Hanson and SCM's management (in a leveraged buyout sponsored by Merrill Lynch). Merrill's final bid was conditioned on grant to Merrill of an option to buy two SCM businesses (earning the name "crown jewel" lockup) for \$430 million if any party acquired more than one-third of SCM's outstanding shares (any merger involving SCM would require a two-thirds vote under New York law at the time). The Second Circuit held the lockup grant was not protected by the business judgment rule because the board did not make an informed decision. The *Hanson* court focused on board process in approving the bid rather than the lockup's substantive effects on the auction, it as another prominent asset lockup enjoined by a court. <sup>63</sup> 559 A.2d 1261 (1989).

<sup>64</sup> See *Macmillan*, 559 A.2d at 1276, 1286. The Court calls the assets as "some of Macmillan's most valued properties." *Id.* at 1286. We do not know the market value of the seven divisions, but Maxwell was prepared to pay \$900 million for four of the divisions. See *id.*

<sup>65</sup> *Macmillan*, 559 A.2d at 1284.

<sup>66</sup> *Id.* at 1286.

<sup>67</sup> *Id.* at 1282. The CEO then tried to cover up the tip, "utterly destroy[ing]" his credibility to the Court. *Id.*

<sup>68</sup> *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1241-43 (Del. Ch. 1988).

<sup>69</sup> It would be interesting to see whether asset lockups were more common before 1988, the first year of the data set. Unfortunately, earlier SDC data is fairly unreliable. Anecdotal evidence from practitioners suggests that asset lockups were never common. See, e.g., Interview B, transcript at 2 ("I don't recall that we actually did those [crown jewel lockups]. We talked about them a lot."). Cases even earlier than those

asset lockups.<sup>70</sup> What is noteworthy about practitioner response to these cases, however, is not the direction but the magnitude. The Court in both *Revlon* and *Macmillan* explicitly stated that asset lockups were not *per se* illegal,<sup>71</sup> yet practitioners responded as if they were.<sup>72</sup> Furthermore, although the Court addressed lockups, it is clear that the behavior of management as a whole was considered by the court in determining the lockups' validity, making it difficult to draw any certain or general conclusion about asset lockups from these decisions. Presumably an asset lockup combined with otherwise immaculate manager behavior could withstand scrutiny, particularly if the deal were scrutinized under *Unocal* rather than *Revlon*. Nevertheless, the evidence demonstrates that practitioners have chosen to avoid these more nuanced readings in favor of a bright-line avoidance of asset lockups.

#### b. Stock lockups

Stock lockups have been similarly responsive to Delaware case law. Figure 1 shows that stock lockups were on an upswing in the early 1990s – appearing in almost 40% of deals by 1992 – but then dropped, dramatically, to half that level in 1994. This fall coincides with the Delaware Supreme Court's ruling in *Paramount Communications Inc. v. QVC Network Inc.*,<sup>73</sup> an important stock lockup case decided in December 1993. The case involved Viacom's announced acquisition of Paramount for about \$69 per

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discussed in the text suggested that courts would view asset lockups skeptically. *See, e.g., Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 375 (6<sup>th</sup> Cir. 1981) (enjoining asset lockup).

<sup>70</sup> For the curious, the seven deals with asset lockups since *Macmillan* are: International Fish & Meat's acquisition of Wilson Foods in September 1988 (option to acquire Wilson's Fischer Packing Unit for \$35 million); ConAgra's acquisition of Holly Farms in November 1988 (option to acquire certain businesses); Banner's acquisition of Fairchild in May 1989 (option to acquire Fairchild's Voi-Shan aerospace fasteners unit for \$150 million); Chesebrough-Pond's acquisition of Minnetonka in July 1989 (option to buy certain assets of Minnetonka's Calvin Klein Corp. for \$80 million); General Cinema's acquisition of Harcourt Brace Jovanovich in January 1991 (option to acquire HBJ's Academic Press unit for \$390 million); Olsten's acquisition of Lifetime in May 1993 (option to acquire two Lifetime units for \$36 million); CR Bard's acquisition of MedChem Products in May 1995 (option to acquire Gesco unit of MCP). *Cf.* Interview I, transcript at 4 (“I haven't seen an [asset] option done in years. The last one I ... remember using was in Macmillan for KKR, ... competed with by ... Maxwell.”). The first three asset lockups are excluded from samples analyzed in Parts II and V because they involved second-bidder lockups.

<sup>71</sup> *See Revlon* at 183; *Macmillan* at 1285-86.

<sup>72</sup> *See* Interview I, transcript at 4 (“If you're talking about [asset] lockups, early 80s, it was the wild west. We were doing preclusive crown jewel options and all sorts of stuff, and I just don't think the law now lets you do that.”). *But cf.* Interview K, transcript at 3 (“I'm not saying that there are no situations where you can do an asset lockup, but the courts seem to frown on that generally, though they could be lawful under present circumstances.”).

share. The stock lockup granted in that deal gave Viacom the right to buy 19.9% of Paramount's outstanding shares at the deal price of \$69.<sup>74</sup>

The stock lockup also contained what the Court called two “unusual” features “highly beneficial” to Viacom: a provision allowing Viacom to pay for optioned shares with subordinated notes “of questionable marketability,” avoiding the need to raise cash to exercise the option (the “note feature”); and the absence of any kind of cap on the option, which would have limited Viacom's net proceeds from exercise to a reasonable level.<sup>75</sup> While the note feature does appear to have been novel for a stock lockup, the absence of a cap on the lockup was standard at the time, as shown by agreements entered into by NCNB/C&S-Sovran and Manufacturers Hanover/Chemical shortly prior to the Paramount/Viacom deal.<sup>76</sup>

Despite admonitions from Viacom CEO Sumner Redstone that only a “nuclear attack” could prevent the deal,<sup>77</sup> QVC launched a hostile cash tender offer for 51% of Paramount's shares at \$80 per share, conditioned on, among other things, invalidation of the stock lockup.<sup>78</sup> Viacom raised its bid to \$80, and later to \$85 per share, but kept the stock lockup intact.<sup>79</sup> QVC responded with a bid of \$90 per share, and sued to enjoin the Paramount/Viacom deal.<sup>80</sup> In a harshly worded opinion, the Delaware Supreme Court struck down the “draconian” and “unreasonable” lockup, pointing to the fact that it would give Viacom over \$200 million in value if triggered, as well as to the Paramount board's “deficient” process in considering QVC's higher-value offer.<sup>81</sup>

To isolate the impact of *Paramount* from other variables that could influence stock lockups incidence, we include in the regressions described in Part II.C.1 a dummy variable AFTERPARAMOUNT, set to 1 if the deal was announced after the *Paramount*

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<sup>73</sup> 637 A.2d 34 (1993).

<sup>74</sup> See Paramount at 39. Viacom also negotiated an additional \$100 million breakup fee, which was upheld by the Chancery Court. This ruling was not appealed by QVC, but it was specifically criticized by the Delaware Supreme Court on appeal.

<sup>75</sup> See *id.* at 39.

<sup>76</sup> See [SEC filings]. [Add a nonbank stock lockup prior to Paramount/Viacom.]

<sup>77</sup> See *id.*

<sup>78</sup> See *id.*

<sup>79</sup> See *id.* at 40-41.

<sup>80</sup> See *id.* at 41.

<sup>81</sup> *Id.* at 51.

decision. Results are shown in Table 3. The regression analysis strongly supports the hypothesis derived from Figure 1: stock lockups were significantly less common in deals after the *Paramount* decision. Using the method of recycled predictions, we find that *Paramount* reduced the likelihood of a stock lockup by 42%.<sup>82</sup> Moreover, Column 1 of Table 4 shows that the magnitude of stock lockups also decreased significantly after *Paramount*. The high sensitivity of stock lockup incidence to Delaware case law matches the impact of *Revlon* and *Macmillan* on asset lockups.

As with the asset lockup cases, however, practitioners may have acted as if *Paramount* stood for more than it did. First, *Paramount* by its terms applies only in deals governed by *Revlon*, when the company has put itself up for “sale,” either when target shareholders are being cashed out (as in *Revlon*) or when a single shareholder is acquiring a control block in a stock-for-stock deal (as with Redstone in *Paramount*). Many practitioners, however, assumed (or worried) that the Delaware Supreme Court would view all stock lockups suspiciously, even “outside” of “*Revlon*-land.”<sup>83</sup> Second, as noted above, the *Paramount* court focused on the absence of a cap on the stock lockup.<sup>84</sup> In response, most practitioners now cap their stock lockups,<sup>85</sup> but the empirical evidence suggests that a significant number have stayed away from stock lockups altogether. Third, *Paramount* may have been specific to the peculiar negotiation – or lack thereof – that occurred between Paramount and Viacom after QVC entered the picture. As [Interviewee C] of [firm] describes it:

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<sup>82</sup> The method of recycled predictions compares stock lockup incidence in two hypothetical scenarios: one in which all deals take place before *Paramount*, and another where all deals take place after *Paramount*. Before *Paramount*, stock lockups are predicted in 19.7% of deals; after *Paramount*, stock lockups are predicted in 11.5% of (the same) deals.

<sup>83</sup> See Interview C, transcript at 4 (“What happened in *Paramount* was that people got skittish after that about giving [stock] lockup options. But people got very confused, because you have to look at deals as two separate [modes] – one is in the *Revlon* mode, where you’re clearly for sale, and one is where you’re in a stock-for-stock deal, when you’re clearly not for sale. [In] the years after Viacom-Paramount, people stopped giving lockup options, [but] that’s a prudent thing to do [only] if you’re in the *Revlon* mode.”).

<sup>84</sup> See Interview C, transcript at 6 (“What happened in *Paramount* was that the option ended up being worth \$700-\$800 million, and the court basically said, ‘We don’t understand – you guys never even thought about capping the option?’”).

<sup>85</sup> See Interview I, transcript at 5 (“Current practice tends to be that if you’re going to have both the stock option and the breakup fee you cross-cap them. The days of getting 3% in the breakup fee and an unlimited theoretical upside in the option, additive, have ... gone....”). Cf. Fraidin & Hanson, *supra* note 9 (arguing options are still not capped). [cite AHP/Warner-Lambert and other capped options]

The problem was that QVC came in with their bid, and then [Paramount] had to re-negotiate [its] deal with Viacom. And the court said, “Let me see if I get this straight – you signed up a new deal with Viacom, knowing that you had a competing bidder, and you signed up this competing deal over some weekend, and it never dawned on you to ask them to change any of the breakups? ... Viacom needed your approval to sign up this new restructured deal, and you never even thought about asking Viacom to cap the option, or to reduce the option, or reduce the breakup fee? That shows us that you were willing to do a deal with Viacom at any cost.”<sup>86</sup>

In short, as with the asset lockup cases, *Paramount* can easily be read to turn on the specific characteristics of the case. The empirical evidence, however, suggests that the decision cast a much larger shadow over the use of stock lockups for at least the next several years after the decision.<sup>87</sup>

### c. Breakup Fees

Breakup fees have also been responsive to case law. Breakup fee usage jumped twice: first in 1994 and again in 1997. The 1994 jump appears to have been a by-product of *Paramount*. Although the court struck down both a stock lockup and a breakup fee in that case, most criticism specific to the lockups (as opposed to the process by which they were approved by the Paramount board) was directed at the stock lockup, not the breakup fee.<sup>88</sup> In fact, the court reserved judgment on whether the fee was “unreasonable by itself,” but held that it “clearly made Paramount less attractive to other bidders, when coupled with the [stock lockup].”<sup>89</sup> In view of this language, practitioners may have viewed breakup fees as a safer alternative to stock lockups. Table 3 shows a shift that is very close to one-for-one: the AFTERPARAMOUNT coefficient for breakup fees (+0.71, from Column 2) is almost exactly the same magnitude as the coefficient for stock lockups (−0.73, from Column 1).

A larger jump occurred in 1997, when breakup fee incidence increased from 33% to 65%. This dramatic increase followed the most recent major decision on lockups,

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<sup>86</sup> Interview C, transcript at 6.

<sup>87</sup> Cf. Interview B, transcript at 4 (“[Stock lockups] legitimately got there originally because people thought it would protect the deal. You saw what happened in *Paramount* when it got too large.”).

<sup>88</sup> This may be because the \$100 million breakup fee in *Paramount* was only 1.8% of deal value. Similarly small payments had been upheld in prior cases: e.g., *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 619 (S.D.N.Y. 1987) (approving agreement to reimburse expenses up to \$ 25 million); *DMG, Inc. v. Aegis Corp.*, No. 7619, slip op. at 3 (Del. Ch. June 29, 1984) (approving agreement to reimburse legal expenses up to \$ 1.25 million).

*Brazen v. Bell Atlantic*, in March 1997.<sup>90</sup> In *Brazen*, a shareholder challenged a \$550 million breakup fee negotiated by Bell Atlantic in its 1996 merger with NYNEX. The Delaware Supreme Court upheld the fee, finding it was not “egregiously large” and did not coerce shareholders to vote for the deal. Practitioners seem to have viewed *Brazen* as a general judicial endorsement of lockups independent of the particular scrutiny invoked.<sup>91</sup>

Two elements of the court’s opinion support their interpretation. First, the court explicitly considered lost opportunity costs in determining the reasonableness of the fee.<sup>92</sup> This factor opens the door to much larger breakup fees than could otherwise be justified as reimbursement for expenses or transaction costs. Nearly every major deal negotiation comes at the expense of at least one deal or other corporate opportunity.<sup>93</sup> In particular,

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<sup>89</sup> Paramount at 49.

<sup>90</sup> 695 A.2d 43 (1997).

<sup>91</sup> Commentators have focused on *Brazen*’s discussion of liquidated damages. See, e.g., Philip J. Pilbosian, *Brazen v. Bell Atlantic: Cause for Concern?*, 72 TUL. L. REV. 1903 (1998); Dennis J. Block & Stephen A. Radin, *Termination Provisions After Bell Atlantic*, 11 No. 9 INSIGHTS 2 (1997); Thomas A. Swett, *Merger Terminations After Bell Atlantic: Applying a Liquidated Damages Analysis to Termination Fee Provisions*, 70 U. COLO. L. REV. 341 (1999). In contrast, M&A practitioners view the Court’s distinction as an irrelevant diversion, since the liquidated damages test applied by the *Brazen* Court can easily be avoided by omitting language characterizing a breakup fee as liquidated damages. See, e.g., Interview B, transcript at 2 (“I’m not sure that [Brazen] makes a difference. What makes a difference is how big you want to make it, and what you’re trying to do.”); Interview I, transcript at 7 (“I think most people look at [Brazen] and go ‘Oh, Jesus. Why?’ [It] was a stupid way to shoehorn the analysis.”); Interview H, transcript at 3 (“I know ... when we did [a subsequent] deal [involving] Bell Atlantic ... , we didn’t spend one second talking about [the liquidated damages] language.”).

<sup>92</sup> See *Brazen* at 49 (“Is the liquidated damages provision here within the range of reasonableness? We believe that it is, given the undisputed record showing the size of the transaction, *the analysis of the parties concerning lost opportunity costs*, other expenses and the arms-length negotiations.”) (emphasis added). See also Interview A, notes at 1 (“The multi-factor test in *Brazen* gives rise to a broader range of factors [than previously allowed]. *Brazen* gives you the opportunity to widen the mix. . . . If the fee is substantially beyond what the expenses might conceivably be, then I think about liquidated damages.”).

<sup>93</sup> David Skeel argues that opportunity cost is low. See David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564, n.134 (1996) (“The market for similar target corporations is not nearly so extensive, or ‘thick’ as the market 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.”). In fact, bidders frequently do lose opportunities from pursuing a given bid. See, e.g., Interview H, transcript at 5 (“The potential harm for either of [Bell Atlantic or GTE], for someone who screws around for a year and a half trying to get a deal done, and then winds up standing when the music stops – there’s no way to come up with a number as small as \$2 billion.”). These opportunities are sometimes other bids, but frequently (but no less significantly) other managerial initiatives, such as restructurings, new lines of business, or financings. Anyone who has participated in a bidding war for a large public company knows how all-consuming for management the process can be. Any assumption that lost opportunities are small relative to out-of-pocket costs also seems difficult to defend in light of the large amounts of money that corporations

mergers in volatile or rapidly deregulated industries can involve enormous opportunity costs that the *Brazen* court was willing to consider in assessing the reasonableness of the fee.<sup>94</sup> Second, the Court's discussion of shareholder coercion suggests that lockups are unlikely to be struck down as interfering with shareholder voting rights under a line of cases running from *Chris-Craft*<sup>95</sup> to *Blasius*<sup>96</sup> to *Stroud*,<sup>97</sup> which hold that a board may not without a compelling purpose take action primarily intended to impair shareholder voting. The *Brazen* court appears to have eviscerated this test in the context of lockups by defining coercion as "actions which have the effect of causing the shareholders to vote in favor of the proposed transaction for some reason other than merits of the transaction,"<sup>98</sup> but then stating that the lockup provisions "were an integral part of the merits of the transaction."<sup>99</sup> Under this (circular) definition, no lockup could ever fail the coercion test.

Some commentators argue that the shareholder coercion test lacks bite anyway (and therefore its elimination is unimportant) because breakup fees only amount to 2%-3% of deal value.<sup>100</sup> Losing 2-3%, goes the argument, could hardly be deemed "coercive" because no shareholder (or manager) could measure the value of the merged

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(and not just public corporations where agency problems may come into play) spend on executive compensation.

<sup>94</sup> See Interview H, transcript at 5 ("These are such big companies. And so, under those circumstances, I don't think there's a lot of nervousness about reasonableness of the fee. I mean, delaying the synergies for a year would cost three or four hundred million dollars. Not having them at all, who knows?").

<sup>95</sup> *Schnell v. Chris-Craft Indus.*, 285 A.2d 437 (Del. 1971) See also Richard Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671, 1699, 1706 (1985) (criticizing large breakup fees as interfering with shareholder franchise); Kahan, *supra* note 43, at 596-97 (arguing the *QVC* case can be explained in part because the lockups there "severely constrained the ability of Paramount's shareholders" to vote against the merger with Viacom); Skeel, *supra* note 90 at 574-77 (criticizing lockups triggered by shareholder vote on ground that they make directors, not shareholders, final decision-makers of M&A transactions).

<sup>96</sup> *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988)

<sup>97</sup> *Stroud v. Grace*, 606 A.2d 75 (Del. 1992)

<sup>98</sup> *Brazen* at 50 (quoting *Williams v. Geier*, Del. Supr., 671 A.2d 1368, 1382-83 (1996)). For a prior case suggesting breakup fees were unlikely to be struck down as interfering with shareholder voting rights, see *Friedman v. Baxter Travenol*, No. 8209, slip op. at 4-6 (Del. Ch. Feb. 18, 1986) (stating plaintiffs faced "substantial obstacles" in showing a \$ 300 million liquidated damages clause impermissibly infringed on shareholders' voting rights in merger).

<sup>99</sup> *Id.*

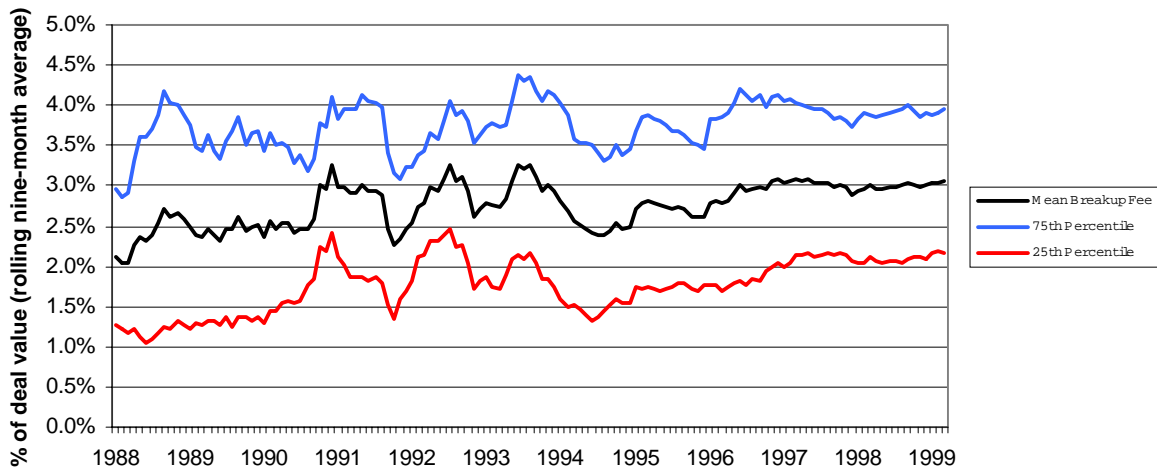
<sup>100</sup> See Philip J. Pilbosian, *Brazen v. Bell Atlantic: Cause for Concern?*, 72 TUL. L. REV. 1903, 1911 (1998).



entity with such precision.<sup>101</sup> Under this view, a breakup fee amounts to nothing more than rounding error in the shareholders' voting calculation. However, 2-3% of deal value can be important at the margin, particularly when event studies have generally shown that mergers are only barely if at all profitable (on average) for public company bidders.<sup>102</sup> The argument also implies an absurdity: if it were true, a bidder could be induced to raise its bid in small increments to infinity, because by definition no small increase is ever large relative to total purchase price.

Finally, basing an argument against coercion on an assumed fee range of 2-3% is increasingly vulnerable. Figure 2 shows the trend in average breakup fees over the twelve years in our sample, as well as the 75<sup>th</sup> and 25<sup>th</sup> percentile fee levels.

**Figure 2: Breakup Fee Magnitude Over Time**



<sup>101</sup> Cf. Interview E at 1 (“Maybe a 15% lockup would keep someone out, but 2-3% isn’t going to make much of a difference. Bankers know that they’re not that smart. The deal could easily be worth 2-3% more.”).

<sup>102</sup> See generally Mark L. Sirower, *THE SYNERGY TRAP: HOW COMPANIES LOSE THE ACQUISITION GAME* (1997) (reviewing empirical evidence; generally concluding that bidders earn zero or slightly negative average returns on acquisitions); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (reviewing studies; noting zero average abnormal stock price reactions for bidders announcing mergers); Gregg A. Jarrell, J. A. Brickley & J.M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988) (reviewing studies; noting that abnormal stock price reactions for bidders announcing acquisitions have generally declined from an average of 4% for tender offers in 1960s to an average of zero in the 1980s); G. William Schwert, *Markup Pricing in Mergers and Acquisitions*, 41 J. FIN. ECON. 153 (1996)

After high volatility in the first half of the 1990s, typical breakup fees have been trending upward since 1995 and (absent judicial intervention) may continue upward in view of *Brazen*.<sup>103</sup> This finding is consistent with the perceptions of practitioners who report a slight increase in the size of breakup fees over the past few years.<sup>104</sup> Clearly, if breakup fees continue upward, they will become more coercive to shareholders.<sup>105</sup>

In short, *Brazen*'s language on opportunity cost and shareholder coercion both suggest that Delaware courts are willing to cast a generous eye toward lockups in general and breakup fees in particular.<sup>106</sup> This decision may have spurred both the popularity and size of breakup fees beginning in 1997 and continuing until recently. This hypothesis is tested in Table 3 (Column 2) and Table 4 (Column 2). In both regressions, the coefficients for AFTERBRAZEN are positive and statistically significant, supporting the conclusion that *Brazen* has contributed to the increased incidence and size of breakup fees. Using the method of recycled predictions, *Brazen* increased the likelihood of a breakup fee by 52%,<sup>107</sup> and the average fee size from 2.8% to 3.2%. In addition, the *Brazen* decision had nearly the same impact on stock lockup incidence and size as it did on breakup fees, supporting the view of practitioners that *Brazen* endorsed lockups generally, unlike *Paramount*, where practitioners substituted breakup fees for stock lockups.

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(finding zero average abnormal stock price reactions for bidders announcing acquisitions from 1975 to 1991).

<sup>103</sup> In his preliminary injunction decision in the Asarco fight, Chancellor Jacobs recently criticized a 6% fee in dicta, [cite] but no court has yet struck down a breakup fee of even that magnitude.

<sup>104</sup> See, e.g., Interview B, transcript at 3 (“The percentage that is okay has crept up. A year ago, two years ago, people were talking about two percent, two-and-a-half percent. Now, you hear them talking about three, three-and-a-half percent. Some are even saying four percent. You sit there and say, ‘On what basis are you doing that? Where did you get that number?’ There hasn’t been a specific challenge, so everybody pushes the envelope.”); Interview J, transcript at 2 (“I think it’s been creeping up. I used to think of it as 2%. Now I think of it as 2-3%. Until somebody comes down with a bright line, people tend to keep pushing, and pushing, and pushing. Three’s okay, so three-and-a-half can’t be that bad.”). Cf. Wasserstein, supra note 22, at 589 (1998) (“For a large transaction [in the 1980s], the typical [breakup] fee is in the range of 1 to 2 percent .... [F]ees in smaller deals (\$50 to \$500 million) tend toward the higher end ....”).

<sup>105</sup> Cf. Interview C, transcript at 3 (“In large measure, a lot of people are just making this up. There’s no law that says that in a stock-for-stock deal it can’t be five percent.”).

<sup>106</sup> See Interview D, transcript at 2 (“[Brazen] is certainly an endorsement of larger lockups.”).

<sup>107</sup> Before *Brazen*, breakup fees are predicted in 34.1% of deals; after *Brazen*, breakup fees are predicted in 51.8% of (the same) deals.

## D. Synthesis

Prior legal scholarship has largely taken lockup incidence, size, and type as exogenous, without reference to background law on lockups.<sup>108</sup> In contrast, this Part has shown that background case law has a significant impact on the incidence and design of lockups. At a general level, lockup incidence is affected strongly by whether a given deal is subject to the type of “enhanced scrutiny” announced in *Revlon*, with lockups being more likely and breakup fees being larger “outside” the borders of “*Revlon*-land.”

At the more specific level of lockup design, Delaware case law on lockups can reasonably be viewed as favoring breakup fees over other types of lockups. Substitution among lockup types is relatively inexpensive,<sup>109</sup> making lockup types fungible,<sup>110</sup> so practitioners have an incentive to “overreact” to Delaware law, favoring breakup fees even more than the express language and holdings of the Delaware cases might suggest. Risk-averse lawyers use the instrument that has invoked the least objection from the Delaware courts, moving as a herd across lockup types:<sup>111</sup> following *Revlon* and *Macmillan*, practitioners shifted away from asset lockups; following *Paramount*, practitioners shifted away from stock lockups; and in the aftermath of *Brazen*, the lockup

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<sup>108</sup> Fraidin & Hanson note that law can affect lockup choice and use, but they neither test the proposition empirically nor examine choice among lockup types, and confine the impact of law to their policy analysis.

<sup>109</sup> Each type of lockup provides a bidder with value, which can be fixed with a greater or lesser degree of certainty in advance, contingent upon specified trigger events, which can be (and usually are) identical from lockup to lockup, regardless of type. See Interview F, transcript at 1 (“Stock lockups, asset – crown jewel – lockups, and plain old money lockups – ultimately, they all come down to money. . . . A stock lockup, anything else, all it is is money.”); Interview I, transcript at 5 (“[Stock lockups] are just another way to deliver value like a breakup fee.”); Interview J, transcript at 4 (“If you sell something for a bargain price, then that’s just the equivalent of a breakup fee. The difference between the real value and the price you pay is equivalent to a breakup fee, and it gets analyzed and probably lumped with the breakup fee.”).

<sup>110</sup> Some differences exist. Stock lockups are more complex, and are subject to an important regulatory constraint – each major stock exchange, as well as the NASDAQ with respect to NMS companies, imposes rules requiring shareholder approval of any stock issuance exceeding 20% of pre-issuance outstanding shares – which puts an effective cap on the size of stock lockups. However, there are (perhaps surprisingly) no significant regulatory constraints on the pricing of stock lockups, meaning that the total implicit value provided by such a lockup can be made equivalent to any plausible breakup fee, and practitioners use boilerplate and pricing precedents to economize on negotiation costs.

<sup>111</sup> See Interview H, transcript at 1 (“[T]here’s a sense that there’s a market, and . . . as long as they’re doing what’s been done, even though they may have very different views about why it’s okay, they think it’s okay.”).

of choice has increasingly been the breakup fee.<sup>112</sup> We return to this point and explore its implications for the market for corporate control in Part IV.

### **III. Current Theories of Lockups**

With this factual background, we turn to two important and related questions: what impact (if any) do lockups have on bid outcomes? And what impact (if any) do lockups have on allocational efficiency in the market for corporate control? Traditional analysis explains that lockups can have two ex post effects: first, they can foreclose bidding; and second, they can induce (higher) bids. A lockup forecloses bidding when it makes alternative bids so expensive that they are not made. Depending on the situation, foreclosing bidding may have positive, negative or no effect on target shareholder returns. A lockup induces further bidding by compensating later bidders for investigation or bidding costs by providing them with insurance against losing the deal. Inducing bids in this fashion will tend to increase overall target shareholder returns, and reduce bidder returns. Recent theoretical analysis also shows that lockups can have ex ante effects on both target agency costs (by giving target managers the ability to favor one bidder over another and thus extract side payments) and bidders' incentives to search for undervalued targets (by changing expected average returns from bidding). The remainder of this Part reviews the current theoretical framework for examining lockups.

#### A. The Ayres Model

We start with four stylized examples. For each, assume a target is being sold in an English auction to one of two bidders. Assume perfect certainty and perfect information, except only that bidders do not know other bidders' reservation values.

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<sup>112</sup> See Interview I, transcript at 5 (“My general view of life is, if all you’re using the [stock] option for is economics, do it with a breakup fee. It’s cleaner, it’s easier.”).

Example 1. Bidder 1 values the target at \$100 and has bid \$95. Bidder 2 values the target at \$105. Absent a lockup, Bidder 1 will match any bid by Bidder 2 up to \$100. Standard analysis predicts that Bidder 2 will win at some price between \$100 and \$105.

Example 2. Now introduce a \$10 breakup fee. Bidder 1 again values the target at \$100, and Bidder 2 again values the target at \$105. But now Bidder 1 agrees to buy the target for \$95 only if it receives a breakup fee of \$10 from the target in the event that the target is acquired by another bidder. Assuming that the fee is enforceable, Bidder 2 must bid at least \$95 and effectively pay the \$10 fee.<sup>113</sup> The combined cost of \$105 is too high, Bidder 2 does not bid, and Bidder 1 wins at \$95. In effect, the breakup fee lowers Bidder 2's reservation value dollar-for-dollar.

Example 3. Alternatively, assume that Bidder 2 has a much higher reservation value, say \$120, and bids \$100. Bidder 2 wins – its reservation value has not been reduced below that of Bidder 1 – but part of what would otherwise be Bidder 2's profit is shifted to Bidder 1, who receives the \$10 fee.

Example 4. Finally, imagine that Bidder 1 has a reservation value of \$100 and has bid \$95, and that Bidder's reservation value is again \$105, but this time the breakup fee is only \$5. Bidder 2 now bids \$96, topping Bidder 1. Consider Bidder 1's options. If Bidder 1 bids \$97, it will receive \$3 of expected profit from the deal. Instead, if Bidder 1 drops out of the bidding, it will receive a guaranteed \$5 profit from the lockup. A rational value-maximizing Bidder 1 will not up the bid, and Bidder 2 will win the target at \$96.

The points of examples 2 and 3 – lockups increase the cost of a bust-up bid, and so either deter bust-up bids or shift some of the bust-up bidder's expected profit to the lockup recipient – are straightforward and intuitive. In example 4, something counterintuitive happens: Bidder 1 again extracts profit from losing, but now the lockup effectively shifts value from the target, causing both bidders to pay less than they otherwise would have. This last insight – introduced in a 1990 article by Ian Ayres<sup>114</sup> – is that once obtained, the right to a breakup fee represents an opportunity cost to Bidder

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<sup>113</sup> The fee comes out of Bidder 2 or the target – but either way it reduces Bidder 2's expected profit.

1, as well as a transaction cost to Bidder 2. Bidder 1 may benefit more from losing the bidding contest (and taking the breakup fee) than from winning. The lockup<sup>115</sup> reduces both bidders' reservation values – in fact, in Ayres' model, the effects are exactly proportional,<sup>116</sup> so the lockup has no impact on the ordinal ranking of bidders' reservation values. From a social welfare perspective, lockups that do not affect which bidder wins have no impact on allocational efficiency, even though they will, if triggered, affect distribution of gains from the deal.

Ayres acknowledges a scenario in which a lockup could foreclose subsequent higher-value bidders. Return to our example 2. Here, Bidder 1 and the target have agreed to fee of \$10 in exchange for Bidder 1's bid of \$95. This lockup "overinsures" Bidder 1 in the sense that Bidder 1 would gain less by closing the deal at \$95 (gain of \$5) than if the lockup is triggered (gain of \$10). Absent an agreement, Bidder 1 would prefer letting Bidder 2 win with a bid as low as \$90. But because the target can condition its grant of a lockup on simultaneously entering into a binding deal agreement providing for Bidder 1's bid of \$95, and vice versa, Bidder 1 does not have that choice.<sup>117</sup> In effect, the target can "lock in" Bidder 1 to the deal. More important, the lockup causes Bidder 2's reservation value to fall below \$95, so Bidder 2 never bids, and Bidder 1 never has the choice of taking the payout from the lockup. In this scenario, Bidder 2 is foreclosed from bidding even though it is the higher-value bidder.

Ayres nevertheless concludes from his analysis that lockups are generally a poor tool for management entrenchment because they must be larger than a bidder's expected

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<sup>114</sup> Ayres, *supra* note 10.

<sup>115</sup> Ayres' point applies to stock lockups as well. Assume an option for 20% of target stock is granted to Bidder 1. As bids begin to exceed the strike price, the stock lockup goes "in the money" and becomes valuable to Bidder 1. As with a breakup fee, a stock lockup lowers reservation values of both Bidder 2 and Bidder 1 in proportion to each other. Ordinal rankings, and allocational efficiency, are preserved.

<sup>116</sup> Ayres explains: "The 'diluting' costs of [a stock lockup] for the third-party bidders is identical to the 'opportunity' cost for the initial bidder. The 'diluting' cost to the third-party bidder is the initial bidder's profit from losing the takeover." *Supra* note 10 at 695. Fraidin & Hanson note that the effects of a stock lockup on the initial and third-party bidder will be proportionate, not identical, if the bidders have different reservation values, because the value of the lockup varies with the value of the target in the hands of the winner of the bidding contest. *Supra* note 9 at 1771 n.113. Still, Fraidin & Hanson rightly call the qualification "trivial." *Id.*

<sup>117</sup> Such a lockup could be value-creating if both parties prefer it to a \$90 bid with no or smaller deal protection. Nevertheless, it is overinsuring because Bidder 1's expectation in the deal is \$5 and the value of the breakup fee is \$10.

profit to prevent a higher-value bidder from winning an auction. Ayres calls such a lockup “extreme,” which he asserts is sufficiently rare that only “unmistakably foreclosing lockups should be enjoined.”<sup>118</sup>

## B. Extensions

Fraidin & Hanson pick up the ball here, making two arguments that expand on Ayres. First, they argue that foreclosing lockups will not occur (or will occur very rarely) because target boards will always want to sell to the higher-valuing bidder:

Takeover bids can be understood to have two facets: first, the public facet, containing a per share stock price offered to all target shareholders and, second, the nonpublic facet, containing side payments offered to the target’s management. Because a higher valuing bidder could always match the public facet and still beat the non-public facet of a lower valuing bidder’s bid, [even] disloyal boards will want to sell to the highest valuing bidder. In short, that target boards may sometimes act on their own behalf instead of on shareholders’ behalf does not alter their incentive to sell to the highest valuing bidder.<sup>119</sup>

Fraidin & Hanson make a second argument as well.<sup>120</sup> Even if a target board gives an over-insuring lockup to Bidder 1, Bidder 2 will not be foreclosed if there are gains to trade between Bidder 1 and Bidder 2. If Bidder 1 makes a bid in exchange for a foreclosing lockup (as in example 3 above), there will be a Pareto-efficient trade between Bidder 1 and Bidder 2, because the bidders can create value by agreeing as between themselves to let Bidder 2 get control of the target. Even if Bidder 1 is required by contract to go through with its acquisition of the target at \$95, Bidder 2 will agree to pay at least \$96 to buy the target once the Bidder 1 acquisition is complete. Since lockups terminate upon closing of the underlying deal, Bidder 1 gains more by reselling than by winning and holding onto the target. Anticipating this outcome, Bidder 1 and Bidder 2 may also be able to work out an arrangement with the target, in which the original deal is terminated and Bidder 2 steps into Bidder 1’s shoes in exchange for a fee of \$6 – again, less than the agreed-upon lockup, but more than Bidder 1 would earn by winning and holding onto the target.

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<sup>118</sup> See Ayres, *supra* note 10 at 1077.

<sup>119</sup> Fraidin & Hanson, *supra* note 9 at 1785-88.

<sup>120</sup> *Id.* at 1788-1804.

For these reasons, Fraidin & Hanson are even less concerned about lockups than Ayres. Even disloyal target boards are unlikely to agree to foreclosing lockups, and if they do, their application of the “basic lesson of the Coase Theorem” leads Fraidin & Hanson to predict that even foreclosing lockups will not affect bid outcomes or allocational efficiency. All lockups, they conclude, should be upheld by courts.<sup>121</sup>

Two replies to this sanguine view of lockups followed immediately, both focusing on the relationship of transaction costs and lockups. First, as Fraidin & Hanson themselves recognize, the classic response to any Coasian argument is that transaction costs and tax effects can be expected to inhibit pre-sale or resale in many situations, and the size and effect of transaction costs cannot be resolved at the level of theory.<sup>122</sup> Second, Kahan & Klausner argue that the transaction costs inherent in bidding require a partial but important qualification to the core claim in the Ayres model.

While agreeing with Ayres that a lockup cannot affect who gains control among parties already engaged in a bidding contest,<sup>123</sup> Kahan & Klausner note that bidders will enter a bidding contest only if the expected returns from bidding exceed the costs of bidding. By compensating for bid costs should a bidder ultimately lose the auction, a lockup can induce a bid from a bidder who would otherwise not participate.<sup>124</sup> First-bidder lockups, Kahan & Klausner argue, reward first-bidders for search costs and the

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<sup>121</sup> Fraidin & Hanson make a number of other important points. They rightly stress the difficulty courts may have in drawing the fine distinctions that drive theoretical models of lockups, and question policy recommendations that depend on courts making such distinctions. For example, they note that a foreclosing lockup need not be overinsuring (or supercompensatory, in their terminology), nor need an overinsuring lockup be foreclosing. At 1781-82. To see why, note that the profits Bidder 1 loses if overbid by Bidder 2 will be a function of Bidder 1’s reservation value, whereas the possibly foreclosing effect of a lockup on Bidder 2 is a function of Bidder 2’s reservation value. They also note that a stock option with a strike price equal to or greater than the lockup recipient’s bid cannot be foreclosing – any higher-valuing bidder will profit (albeit at a lower level) by overbidding. *Id.* at n.176.

<sup>122</sup> *Id.* at 1790-94. *Cf.* Skeel, *supra* note 90 at 577 (offering a priori reasons transaction costs will affect bid outcomes and allocational efficiency) *with* Fraidin & Hanson, 1790-94 (offering a priori reasons transaction costs will not affect allocational efficiency, even if they may be large in absolute terms).

<sup>123</sup> *See* Kahan & Klausner, *supra* note 12 at 1546 (“Ayres’ central insight – that lockups reduce the reservation values of the lockup bidder and a locked-out party equally and therefore do not affect relative valuations – is important and correct.”).

<sup>124</sup> Kermit Roosevelt has recently argued (*pace* Schwartz, *supra* note 8) that Fraidin & Hanson’s policy prescription is wrong for a different reason: second-bidder lockups allow a target with a well-motivated board to extract more surplus from bidders, reducing incentives for search, and so impair allocational efficiency. First-bidder lockups, by contrast, allow an initial bidder to compensate for harmful effects on search incentives of the Williams Act. *Understanding Lockups: Effects in Bankruptcy and the Market for Corporate Control*, Working Paper (Yale Law School 1999) (available at <http://www.ssrn.com>), at 24.



informational externality a bid creates (*i.e.*, second bidders free-ride on the information that a first-bidder values the target more than its initial bid), enhancing the market for corporate control and allocational efficiency.<sup>125</sup> By contrast, lockups granted to “second bidders” (*i.e.*, white knights) do not induce a sale *process*. Second bidders willing to bid only if granted a lockup, they argue, are unlikely to value the target more than a first bidder. Whatever efficiencies second-bidder lockups create are outweighed by inefficient side payments extracted by disloyal target managers from second-bidders that reduce the discipline of the market for corporate control.<sup>126</sup>

Kahan & Klausner are clearly correct that bid costs play a role in determining the allocational efficiency of an auction, and may well be correct that first-bidder and second-bidder lockups have different effects on bid outcomes and social welfare.<sup>127</sup> However, they concede too much by not challenging the core empirical claim implicit in the Ayres and Fraidin & Hanson models, namely, that a lockup is unlikely to (or will not) influence bid outcomes after bidders have incurred search costs and commenced bidding.<sup>128</sup> Part III.C challenges this core claim on empirical grounds, demonstrating that based on actual lockup and overbid size, foreclosing lockups in fact plausibly exist in

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<sup>125</sup> At 1563-64. Roosevelt, *supra* note 123, argues that Kahan & Klausner’s concerns about lockups impairing the market for corporate control are “chimerical” because (a) the threat of “takeovers [has already been] fatally compromised by the . . . poison pill,” (b) lockups are ineffective takeover defenses, and (c) Fraidin & Hanson are right that target managers can extract side-payments from all bidders equally. *Id.* at 16-18. These claims are overstated: (a) the market for corporate control continues to be vigorous, despite the poison pill, *see* Coates, *supra* note 51, at 852-59 (1999); (b) Kahan & Klausner do not claim lockups function as takeover defenses *per se*, only that they give target managers a way to favor one bidder over another, and so extract compensation, which in turn blunts the disciplinary fear takeovers might have on managers *ex ante*, and (c) not all bidders will be equally able or willing to make the kinds of side-payments (in whatever form) that target managers may seek.

<sup>126</sup> *Supra* note 12 at 1552-58. Kahan & Klausner also note that first-bidder lockups that are granted in anticipation of a hostile bid should be analyzed and treated more like second-bidder lockups, since they are not necessary to start the sale process, and are also likely to result in side payments. *Id.* at 1559.

<sup>127</sup> *See* Roosevelt, *supra* note 121 (arguing first-bidder lockups mitigate, and second-bidder lockups exacerbate, the harmful effect on search incentives of the Williams Act). An additional reason to favor first-bidder lockups is that they can prevent a deal from resulting in a free-for-all auction, in which the target’s likely future owner changes daily, employee and customer morale drops, and value erodes. *See* Interview I, transcript at 9 (“Auctioning is not something that works for most companies. It has huge internal risks with the employee base. . . . And you could just find at the end of it that you have [no real buyer] there, which is a terrible thing for a company. So there are lots of costs – not dollar and cents costs – but real operational, strategic, tactical costs to just having everyone who decides they want to sell do it through public auction. . . . I think that justifies the decision that most public companies make, that, if you want to sell, you will, at most, tend to have your banker do soft contacts to a fairly controlled group of people, not a full-blown, put out the banner, show up with the gavel auction.”). Second bidder lockups, by contrast, are unlikely to play this role – by definition they are used to extend an auction or sale process.

real-world transactions. Part IV challenges this claim in a theoretical and more general way, arguing that a non-foreclosing lockup could affect bid outcomes (even if bid costs were negligible). Part V presents empirical tests that support the theory presented in Part IV, suggesting that lockups in fact do affect allocational efficiency.

### C. An Empirical Critique

The basic Ayres model depends critically on the assumption that foreclosing lockups are rare if not non-existent, yet none of the prior commentators provide evidence to support this belief. In fact, an assessment of the empirical data reveals that foreclosing lockups are not “extreme” (as characterized by Ayres) but in fact plausibly exist in real-world transactions. To demonstrate this point we start with a deal in which Bidder 1 and the target have a stock lockup. In this situation Bidder 2’s profits from the deal would be the profits from winning the target minus the lockup payout to Bidder 1:

$$(V_2 - B_2)N - (B_2 - P)T$$

where  $V_2$  is Bidder 2’s pre-lockup per share reservation value,  $B_2$  is Bidder 2’s bid,  $N$  is the number of currently outstanding target shares,  $P$  is the strike price for the option, and  $T$  is the number of shares optioned. Setting this expression equal to zero and solving for  $B_2$  gives Bidder 2’s reservation value:

$$B_2 = (NV_2 + PT) / (N + T)$$

The lockup is foreclosing when  $B_2 < B_1$  or:

$$(NV_2 + PT) / (N + T) < B_1$$

To use our data on real-world lockups we make three substitutions. First we set  $P = kB_1$ , where  $k$  establishes the relationship between the deal price and the lockup strike price:  $k = 1$  implies that the lockup is at the money;  $k > 1$  implies that the lockup is out of the money; and  $k < 1$  implies that the lockup is in the money at grant. Second, we set  $T = qN$ , where  $q$  is the percent of shares optioned. Finally, we set  $V_2 = zB_1$ , where  $z$  is

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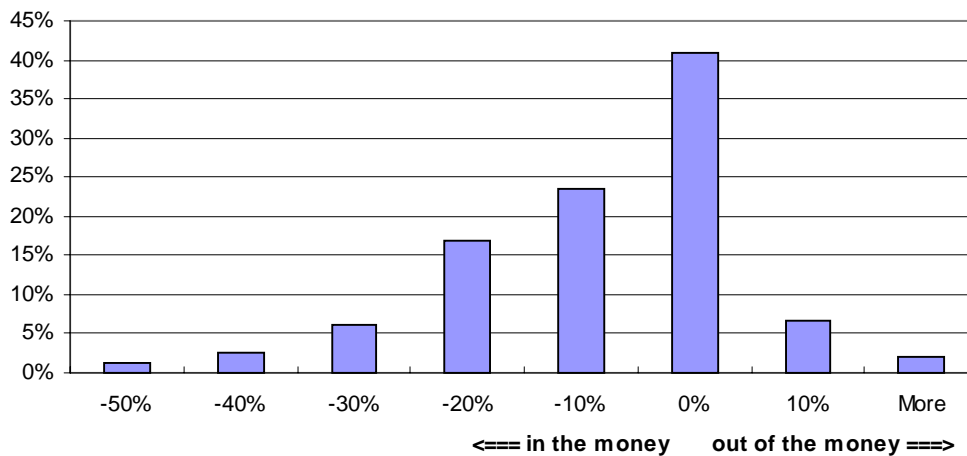
<sup>128</sup> Roosevelt seems to make the same mistaken concession. *Supra* note 123 at 24.

Bidder 2's valuation for the target over Bidder 1's current bid. Substituting for P, T, and  $V_2$  and solving for  $B_1$ , we get that a lockup is foreclosing when:<sup>129</sup>

$$z - 1 < q(1-k)$$

As a starting point, this equation allows us to limit the possible set of foreclosing lockups to lockups that are in-the-money. Note that when the lockup strike price is at the deal price (i.e.,  $k = 1$ ), a lockup will be foreclosing only when  $z < 1$ . But if  $z < 1$  then Bidder 1 is the higher-value bidder (or at least the equal-valuing bidder) and a foreclosing lockup given to Bidder 1 will not affect allocational efficiency. In fact we only care about foreclosing lockups when  $z > 1$ . Therefore a lockup with a strike price equal to or greater than the deal price cannot foreclose higher-value bidders.<sup>130</sup> Figure 3 shows that approximately half of all lockups in the data set fall into this category:

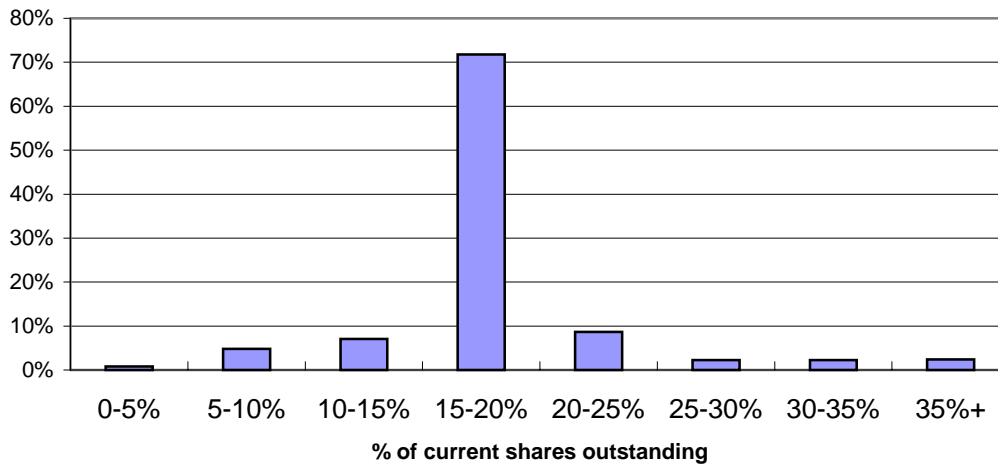
**Figure 3: Stock Lockup Strike Price Distribution**



To analyze the remaining 50% of lockups, we need to examine their structure and design in more detail. We start with an analysis of the number of shares optioned, as a percent of the target's total shares outstanding. Figure 4 shows that the vast majority of stock lockups are for 15-20% of the target's shares:

<sup>129</sup>  $V_1$  does not appear in the equation, either directly or indirectly. By extension, the difference  $V_1 - B_1$ , or Bidder 1's expectation in the deal, does not appear. This is a formalization of Fraidin & Hanson's point (refining Ayres) that foreclosing lockups are not necessarily supracompensatory, or vice versa. Supra note 9, at 1774.

Figure 4: Stock Lockup Shares Optioned



As noted in Part II, the major exchanges (as well as the NASDAQ for NMS targets) require a shareholder vote for stock option grants of 20% or greater. Therefore a 19.9% grant is the largest possible stock lockup without going to the target’s shareholders for approval.<sup>131</sup> We can therefore simplify the equation above, with little loss of descriptive power, by setting  $q=0.2$ . Doing so we find that a lockup is foreclosing when:

$$z + 0.2 k < 1.2$$

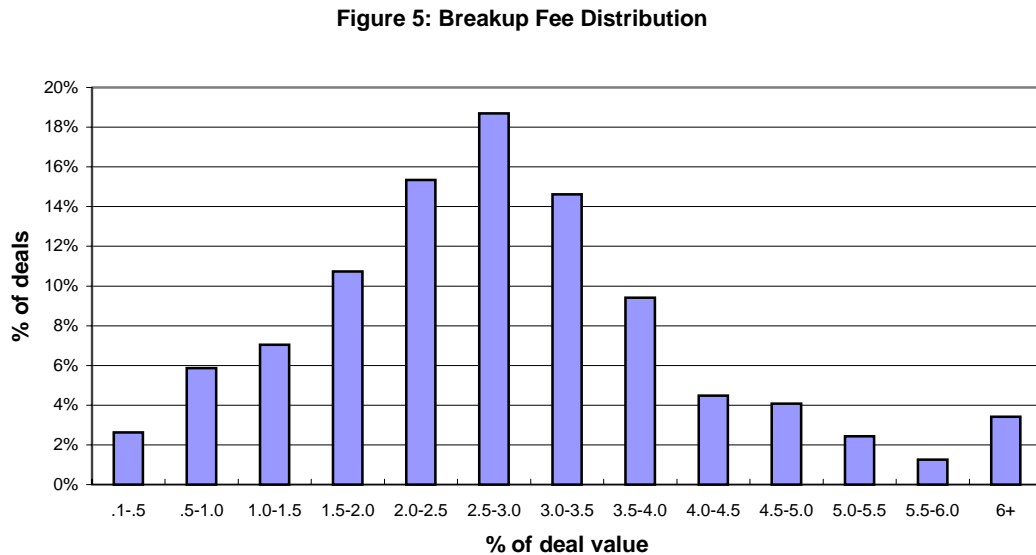
From Figure 3 we know stock lockups can be as much as 50% in the money ( $k=0.5$ ). At this level the lockup will foreclose any bidder who values the target less than 10% more than Bidder 1’s bid ( $z=1.10$ ). The average successful overbid in the data set is 14.9%, which is the average of the bids that, by definition, were not foreclosed. Presumably the average overvaluation among all would-be bidders would be significantly lower than this number, and almost certainly lower than 10%. It seems likely, therefore, that a non-trivial number of potential bids are foreclosed by stock lockups.

Breakup fees are considerably easier to analyze than stock lockups. Expressed as percentage of deal value, a breakup fee will by definition be foreclosing when it is larger

<sup>130</sup> Fraidin & Hanson reach this conclusion as well, though less formally. *Id.* at 1784 n. 176. They assert that this conclusion applies to “many” lockups but do not document this assertion. *See id.*

<sup>131</sup> *See* Paul S. Bird & Richard G. Thorpe, *Selected Issues in Documenting Deals: Lockups, Deal Protection and Social Issues*, 1085 PLI/CORP 245, 256 (Nov. 1998).

than Bidder 2's valuation as a percent of Bidder 1's current bid.<sup>132</sup> Figure 5 shows the distribution of breakup fees from the data set, as a percent of deal value:



As discussed in Part II, 2-3% of deal value can be important at the margin, particularly when event studies have generally shown that mergers are only barely if at all profitable (on average) for public company bidders.<sup>133</sup> Almost a quarter of deals have breakup fees that are larger than 3% of deal value. These lockups have a reasonable likelihood of foreclosing higher-value bidders.

To summarize, this section has used the basic empirical data on lockup design and structure to cast doubt on a basic assumption of the conventional models – namely, that foreclosing lockups are rare or non-existent. Foreclosing lockups exist, and (even in the Ayres model) they can affect allocational efficiency in the market for corporate control. In Part IV we go beyond this empirical critique of the existing theory to formulate a more general argument: all lockups (not just foreclosing lockups) can affect the ordinal ranking of reservation values among active bidders. This is true for one or more of five

<sup>132</sup> Bidder 2's profits from the deal are:  $(V_2 - B_2)N - \text{Fee}$ . Rearranging gives a reservation price of:  $B_2 = V_2 - \text{Fee} / N$ . The lockup is foreclosing when  $B_2 < B_1$ , or:  $V_2 - \text{Fee} < N < B_1$ . Rearranging terms, multiplying both sides by  $N$ , dividing both sides by deal value ( $B_1N$ ), and substituting  $z = V_2/B_1$  gives the intuitive result that a breakup fee is foreclosing when  $z < 1 + \% \text{Fee}$ , where  $\% \text{Fee}$  is the breakup fee as a percent of deal value.

<sup>133</sup> See text accompanying note 102 supra.

buy-side reasons: agency costs, informational effects, switching costs, reputational effects, and endowment effects. As a result, the Ayres model is unlikely to provide good predictions of bid outcomes in practice, or a reliable model for setting lockup policy. Part V goes on to test this new theory of lockups against the available empirical evidence.

## IV. A Buy-Side Model of Lockups

In Part III we reviewed prior academic debate on lockups, highlighting the general agreement that lockups cannot affect allocational efficiency among existing bidders. Both Fraidin & Hanson, who argue for a rule allowing all lockups, and Kahan & Klausner, who argue for a rule allowing only first-bidder lockups, agree with Ayres on this point. In Part III.C, we provided an empirical critique of this existing theory. In this Part we offer a more general argument that lockups can affect allocational efficiency in the market for corporate control, even among existing bidders. We identify several types of distortions on the behavior of bidders in an auction setting with lockups—agency costs, informational effects, switching costs, reputational effects, and endowment effects—and introduce them in a new theoretical model of lockups. The introduction of these buy-side distortions leads to diametrically opposite predictions on the effect that lockups have on bid outcomes. This Part discusses each buy-side effect in turn, and concludes with their collective implications for allocational efficiency.

### A. Five Buy-Side Distortions

#### 1. Agency costs

The first buy-side distortion is that agency costs may affect the behavior of bidders in an auction setting.<sup>134</sup> The point, simply put, is that bidders do not (necessarily)

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<sup>134</sup> Agency costs fall into three categories: *monitoring* costs by the principal (here, shareholders, or their agent, the board); *bonding* costs by the agent (here, management) to guarantee the agent will not harm the principal; and the *residual loss*, which is the remaining divergence (after the effects of monitoring and bonding) between the agent's decisions and decisions that would maximize the welfare of the principal. Jensen & Meckling, *The Theory of the Firm*, reprinted in Michael C. Jensen, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 54 (1998).

maximize bidder firm wealth in making choices in an auction setting. For public company bidders, lockups are affected by the same agency costs that (on the target side) give the market for corporate control its importance in law and economics scholarship generally and in Kahan & Klausner's treatment of lockups in particular. Bidder managers take actions that are not necessarily in the best interest of bidding firms. In particular, managers may have a preference for maximizing size or stability, and may pursue expansion or diversification programs when a perfectly loyal agent of shareholders would not.<sup>135</sup> Size may be good for its own sake (managers may prefer making decisions that affect more people and are more likely to attract front-page stories in the *Wall Street Journal*), because executive compensation and perquisites of office tend to rise with firm size,<sup>136</sup> or because large firms are less vulnerable to hostile takeover bids, at least at very large scales (where financing constraints impair debt-financed takeovers), or because large firms may better pursue acquisition strategies, particularly in consolidating industries (where economies of scale may allow larger companies to buy smaller companies, but not *vice versa*).<sup>137</sup> Stability may be advantageous for its own sake (managers may prefer the "quiet life"), or because managers have firm-specific human or financial capital, and are unable to diversify optimally as individuals.<sup>138</sup>

Whatever the motivation, once the wedge of agency costs for public companies on the buy-side is acknowledged, the traditional Ayres model in which a first bidder's reservation value for the target falls by an amount proportionate to the opportunity cost of foregoing a lockup payout is no longer valid. Initially it might seem that buy-side agency

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<sup>135</sup> See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 75 AM. ECON. REV. 323 (1986) (size); Michael C. Jensen, *The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems*, 48 J. FIN. 831 (1993) (size); James S. Ang, Rebel A. Cole & James Wuh Lin, *Agency Costs and Ownership Structure*, \_\_ J. Fin. \_\_ (1999 forthcoming) (presenting evidence supporting agency cost theory of over-investment and empire-building); David Denis, Diane Denis & Atulya Sarin, *Agency Problems, Equity Ownership and Corporate Diversification*, 52 J. FIN. 135 (1997) (diversification); Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 4 J. FIN. ECON. 101 (1985) (diversification). *But see* Rajesh K. Aggarwal & Andrew A. Samnick, *Empire-Builders and Shirkers: Investment, Firm Performance and Managerial Incentives* (NBER Working Paper Sep. 1999) (arguing that incentive to shirk may cause managers to underinvest, and that shirking may dominate empire-building/overinvestment incentives, and presenting evidence supporting that view).

<sup>136</sup> See S. Rosen, *Contracts and the Market for Executives*, in L. Werin et al., eds., *CONTRACT ECONOMICS* (1992).

<sup>137</sup> The Petrofina deal, for example, gave Total the bulk to buy Elf; Starwood's deal for Westin gave it the bulk to serve as a white knight for ITT.

<sup>138</sup> See Fama & Jensen, *supra* note 131.

costs would affect all bidders (on average), and so lower all bidders' reservation values by proportional amounts (on average), preserving the striking claim that lockups reduce all reservation values proportionately. But once it is recognized that agency costs vary from bidder to bidder in predictable ways, this claim must also be discarded. For example, private companies can be expected to have lower agency costs of management, on average, than public companies. Likewise, as argued by Jensen & Meckling, public companies generating large amounts of free cash flow can be expected to generate higher agency costs of management, on average, than companies that do not. Managers of bidders with higher agency costs, in turn, can be expected to be more likely to pursue size or diversification over profit.

As a result, a bidder manager facing a choice between a lockup payout worth \$1 and a merger profit of \$1 will not be indifferent between the two. The lockup payout will fall straight to the bottom line but will have little effect on firm size or diversification. The merger profit, by contrast, will increase both profit and size, and may also provide diversification benefits. If bidder managers are willing to trade off some profit for size or risk-reduction, then bidder managers will be reluctant to take \$1 in lockup payouts even when merger profits fall below \$1. How much larger lockup payouts must be than merger profits to make losing a bidding auction more attractive than winning will depend on the size of bidder agency costs. The net effect, in extreme cases, could be that an initial bidder manager would be willing to take a substantial loss on a merger, even when the manager has the opportunity to let another bidder win an auction and trigger the manager's lockup. What is certain is that lockups will not simply reduce reservation values for a target, but will reduce them in ways that do not preserve their ordinal rankings.

## 2. Informational effects

Asymmetric information introduces a second buy-side distortion. Bidder 1 does not usually have the benefit of other bidders' valuations of the target when it first bids. When Bidder 2 enters the bidding contest, however, Bidder 1 earns important new information: at least one other potential acquirer values the target as high as the initial bid (in fact higher). If synergies are roughly comparable between each of the two bidders



and the target, Bidder 1 could rationally shade its bid upward in view of this new information.<sup>139</sup> This response is the converse of the well-known negotiations phenomenon of “reactive devaluation:” an offer made by one side is automatically worth less to the other side for the very reason that it was offered by a perceived opponent.<sup>140</sup> Here, “reactive revaluation” causes Bidder 1 to increase its own perception of value based on the information revealed through Bidder 2’s process of making an offer.<sup>141</sup>

Although reactive revaluation may exist to some extent in any bidding contest, its effects are magnified by the presence of a lockup. To see this, consider an example in which Bidder 1 has bid \$100 for the target and Bidder 2 is the higher-value bidder. In the situation where Bidder 1 does not have a lockup, Bidder 2’s rational bid is some small increment above \$100, say \$101. The reason is that Bidder 2 will want to “test” Bidder 1’s reservation value in as small increments as possible, in order to win the target at the lowest possible price.<sup>142</sup> Using this strategy, Bidder 2 will win the target for \$1 more than Bidder 1’s reservation value. The problem from an information revelation perspective is that this strategy does not reveal very much to Bidder 1. In fact, in this example, each subsequent bid only reveals that Bidder 2 values the target at \$1 more than Bidder 1. In the absence of a lockup, informational effects and reactive revaluation will therefore be small.

Now consider a scenario in which Bidder 1 receives a \$5 breakup fee in exchange for its \$100 bid. Now a \$101 bid reveals that Bidder 2 values the target at least \$106 – the \$101 bid plus the \$5 breakup fee. In contrast to the prior scenario, Bidder 1 receives considerable information from Bidder 2’s bid, because to justify a bid Bidder 2 must

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<sup>139</sup> An alternative (but equivalent) way of putting this point is to say Bidder 1, in its distribution of possible valuations for the target, could now place greater weight on valuations on the high end of its distribution. The result of this re-weighting would be to make the expected value of the target higher to Bidder 1.

<sup>140</sup> See Robert H. Mnookin, *Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict*, NIDR Forum (1993) at 28; Robert J. Robinson, *Errors in Social Judgment: Implications for Negotiation and Conflict Resolution* (HBS Case N9-897-103) (Feb. 6, 1997). See also A CIVIL ACTION at 1:34 (in which William H. Macy tells John Travolta: “So the only offer you are willing to accept is the one that they won’t make? Listen to yourself!”).

<sup>141</sup> More formally, the bidders’ valuations are affiliated. “Signals are affiliated if, as a bidder’s signal rises, he expects others’ signals to rise as well, in the sense that higher values for other bidders’ signals become relatively more likely.” Jeremy Bulow & Paul Klemperer, *Auctions Versus Negotiations*, 86 AMER. ECON. REV. 180 (1996).

value the target significantly more than Bidder 1's initial bid. Bidder 1 may rationally revise its valuation of the target upward by as much as the overbid plus the value of the lockup, although in general, Bidder 1 will revise its bid up only part of the way to Bidder 2's full, implicit reservation value.

To summarize this point, the existence of the lockup makes Bidder 2's bid more informative to Bidder 1 than an unprotected deal, which may lead to greater reactive revaluation by Bidder 1. The result, as with the agency cost distortion, is that Bidder 1 will rationally bid higher for the target than it would in the absence of a lockup.

### 3. Switching Costs

A third buy-side distortion consistent with rational expectations is that bidder behavior may be affected by switching costs. If switching among corporate strategies generates costs, a bidder may rationally be more reluctant to cease bidding once it has publicly committed itself to a deal than if it has not. Consider a bidder with a hierarchical organization with multiple layers; costs must be incurred to communicate a new corporate strategy down through the hierarchy. Once a given strategy has been devised and communicated, remaining committed to that strategy will be "free," and optimal, as long as the net gain from switching to a new strategy is less than the cost of communicating the new strategy.<sup>143</sup> Initial bidders thus have reason to continue to bid and achieve merger benefits rather than accept a lockup payout of what would be equivalent value (but for switching costs). Third-party bidders will usually not incur switching costs if they never formally enter the bidding; if anything, they face switching costs if they bid, rather than if they decline to bid.

To illustrate this point, note that once Bidder 1 announces an acquisition, it may effectively be forced into telling some of its own employees that they will be laid off as a result of the transaction. When BankAmerica acquired Continental Bank, for example,

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<sup>142</sup> This strategy assumes that the process of making subsequent bids is costless or at least relatively inexpensive.

<sup>143</sup> Switching costs of this sort can also be indirect. Lower-level managers or employees may be reluctant to take actions that give rise to personal career risks if they expect (based on past firm behavior) that a newly communicated strategy may be abandoned or dramatically modified in rapid fashion. The general notion is that some degree of stability is important to allow for coordinated action among dispersed individuals whose dealings with the firm will be affected by a given strategic decision.

BankAmerica's corporate lending officers knew that there was a high likelihood that they would soon be out of a job, or forced to move to Chicago, because Continental Bank's corporate lending group was generally considered to be stronger than BankAmerica's. Those employees had an incentive to search for new jobs, and certainly to exert less effort, almost immediately. For BankAmerica to then lose the bid as a result of an overbid by a third party, it would not only have lost its expected profit from the acquisition, but would also incur damage to its stand-alone franchise. But if BankAmerica completed the transaction, that damage would be irrelevant. From its perspective, the choice between switching from the strategy of winning the bid to a strategy of taking a lockup payout was distorted by costs generated by announcement of the deal itself. Potential third-party bidders, by contrast, did not face this distortion: the costs of a potential lockup payout would be counted dollar for dollar against the net expected benefits of winning the bid.

As with informational effects, switching costs will exist even without a lockup (and to that extent may be viewed as a form of bid cost that Kahan & Klausner argue justify first-bidder lockups). But switching costs are also magnified by the presence of a lockup. The reason is that target and bidder managers tend to intertwine more between the time a deal is announced and closed when there is a lockup.<sup>144</sup> Decisions between the time of an initial deal announcement between Bidder 1 and the target will continue to increase the size of switching costs as closing approaches. This is not entirely irrational – as we show in Part V, deals with lockups are more likely to succeed than deals without lockups. The result is a mutually reinforcing effect between switching costs and lockups: initially, deals with high switching costs will lead to a greater likelihood of a lockup; once the lockup is in place, the intertwining that takes place will create larger switching costs. Put another way, the lockup allows the parties to commit to the deal in a way that creates larger switching costs. Only if the size of the lockup when initially negotiated is so large that it would compensate for post-announcement switching costs would the bidder be indifferent between taking the lockup and proceeding with the underlying deal.

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<sup>144</sup> See, e.g., Interview I, transcript at 6-7 (“You just keep intertwining the two companies more and more as you move forward, and you get to a point where you say, ‘We really need to have a relatively high degree

#### 4. Reputational effects

Reputational effects may also distort bidder decisions on how to bid given a lockup.<sup>145</sup> The basic point is relatively simple: bidders develop a reputation when they engage in high-profile bidding contests. A reputation for “toughness” in a bidding setting can benefit a bidder in the long run. Other potential bidders may decide not to enter a competition if they know that a “tough” bidder has already entered the competition, or may drop out if such a bidder enters after them. Such reputational effects may be most pronounced, somewhat counterintuitively, precisely when a bidder’s reputation for tough bargaining is built on bids that may correctly be viewed as “irrationally” high. A reputation of “irrational” overbidding may be even more of a deterrent to potential competing bidders in future auctions, since they will believe that the only way they can win is by overbidding themselves. If bid costs are not trivial, then it may not be worth even entering a bidding contest with such a competitor. In the long run, of course, a reputation for “irrational” overbidding may well be rational to develop. Thus, a bidder may rationally decide to “irrationally” overbid in one round to establish a reputation for doing so.<sup>146</sup>

As with agency costs, reputational effects might at first seem to be symmetric, affecting all bidders equally. In fact reputational effects are likely to be greater for Bidder 1 than for Bidder 2. The reason is that if Bidder 2 decides not to bid because Bidder 1’s lockup is too large, no one will know that Bidder 2 was ever “in” the auction. Reputational effects are more pronounced when they are based on observed action than where they must be based on inferred inaction. Bidder 1, on the other hand, will always

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of comfort that this deal is going to happen, because otherwise we’re going to have to hold back on doing some of these intertwining things.”).

<sup>145</sup> Classic models similar to the one informally presented in the text are D. Kreps & R. Wilson, *Reputation and Imperfect Information*, 27 J. ECON. THEORY 253 (1982) and P. Milgrom & J. Roberts, *Predation, Reputation and Entry Deterrence*, 27 J. ECON. THEORY 280 (1982). No formal model precisely captures the situation described in the text, where reputational effects arise only if a bidder bids, and not if a bidder never bids, in a given auction. Fraidin & Hanson discuss one way lockups may affect bidder reputations: bidders might make implicit contracts to retain target managers and not resell a target to a higher valuing third party, thereby building a reputation that could enable them to acquire other targets at less than full prices in the future. *Supra* note 9 at 1795-1801. Our focus, by contrast, is not on bidders’ reputations with target managers, but bidders’ reputations with other bidders.

be known to be “in” the auction, so if Bidder 1 takes the lockup consolation prize, everyone will know Bidder 1 “lost” – or put otherwise, was willing to take the short-term rational step of accepting the lockup payout, in lieu of continuing to “irrationally” overbid. Bidder 2 will often be a silent loser<sup>147</sup> while Bidder 1 will always be a public loser.

As with switching costs and information effects, reputational effects are amplified by lockups, for two reasons. First, the size of a lockup payout provides additional information about the maximum profit Bidder 1 expected to obtain on the underlying deal, which in turn reveals how much of its total expected deal profit it gave up in negotiations. A second reason lockups magnify the reputational effect of losing becomes clear when we note that, for a given bidder, a stock lockup and a breakup fee can serve both a “consolation prize” purpose<sup>148</sup> and a “deal protection” purpose.<sup>149</sup> While these goals are not mutually exclusive, taking a lockup payout reveals that at least part of a bidder’s purpose for a lockup was to serve as a consolation prize. Taking a lockup payout has an additional reputational cost because it suggests the bidder’s future lockups will also not solely be about deal protection. Third-party bidders will consider this fact in deciding whether to bid in future. This “lockup reputation” is distinct from and in addition to a bidder’s reputation in winning deals. Thus, a bidder with a lockup may rationally continue to bid beyond its nominal reservation value, to preserve a reputation in deal negotiations, and for negotiating lockups only of the “deal protection” variety.

### 5. Endowment effects

The final buy-side distortion results from the “endowment effect.” Richard Thaler coined this term to describe the reluctance of people to part with assets that belong

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<sup>146</sup> Reputational effects will be enhanced by agency costs, to the extent that a bidder manager is more concerned about establishing a personal (and portable) reputation for being a “tough” bidder, using firm resources to do so.

<sup>147</sup> Not always, since Bidder 2 might enter the auction and force Bidder 1 to raise to its reservation value, at which Bidder 2 must drop out – as in QVC’s bid for Paramount.

<sup>148</sup> See Interview E, notes at 1 (“It’s a consolation prize, but I try to insist on it if I’m on the buy side.”); Interview B, transcript at 4 (“If someone takes the deal away, I at least want something coming back. I’m not in it for the breakup fee, but it’s a form of insurance.”).

<sup>149</sup> See Interview D, transcript at 1 (“It’s generally about deal protection.”).

to their endowment.<sup>150</sup> The endowment effect is a manifestation of loss aversion, a psychological phenomenon that refers to the widespread tendency of people to place greater weight on losses than on gains of equal magnitude. Thaler's powerful conclusion: the value of gaining an object for an individual who does not possess it is usually less than the value of not losing the object for an individual who does possess it and has adapted to such possession.<sup>151</sup>

Developed in the consumer arena, the endowment effect is translatable to the corporate control context in which a merger, once announced, creates an endowment for acquirer managers. One critical question with respect to M&A deals is whether managers of Bidder 1 adapt to possession of the target after announcement or after consummation of the deal. Clearly, attempting to build a psychological understanding of CEO's and other top managers is a difficult game. Still, as anecdotal evidence, it is interesting to note that champagne toasts and (sometimes decadent) celebratory dinners accompany the signing of the merger agreement,<sup>152</sup> while consummation of the merger typically takes place with much less fanfare. Press coverage, employee communications, and public relations activities all emphasize announcement more than consummation. Bidder managers frequently speak to the press shortly after deal execution using language that suggests that the deals had already closed. Anecdotes abound about bidder managers descending upon target companies during the pre-closing period, organizing planning teams, disrespecting target managers that they expect to be laid off, and generally acting as if the deal has already closed. Empirically, these behaviors are well-founded, in that 87% of the deals in our sample were consummated, once signed (see Table 5 below). These qualitative findings suggest that managers perceive an endowment at the time of announcement, which, in turn, will lead to an endowment effect if they face the prospect of losing the target to a competing second-bidder.

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<sup>150</sup> See Richard Thaler, *Toward a Positive Theory of Consumer Choice*, J. ECON. BEHAV. AND ORG., 1, 39-60 (1980).

<sup>151</sup> Some research suggests that the endowment effect increases with time of ownership. See Michal A. Strahilevitz & George Loewenstein, *The Effect of Ownership History on the Valuation of Objects*, 25 J. CONS. RES. (1998). This result, if translatable to the corporate control context, would suggest that (as with switching costs) the "endowment cost" of losing a deal increases as time from announcement increases.

<sup>152</sup> See Robert E. Spatt, *The Four Ring Circus – An Updated View of the Mating Dance Among Announced Merger Partners and an Unsolicited Second or Third Bidder*, Simpson, Thacher & Bartlett Working Paper (Jan. 12, 1998).

Will Bidder 1 really succumb to these psychological costs? The endowment effect is the only buy-side distortion among the five identified that would not exist in a world of full rationality. Certainly the image of the typical CEO and his advisors is one of pure profit-maximization, devoid of emotional attachment and overwhelmingly rational. Research shows that no endowment effect appears in situations where goods are held for resale rather than for use.<sup>153</sup> This finding suggests that financial buyers may experience less of an endowment effect than strategic buyers. Outside this narrow realm, however, experimental evidence strongly suggests that the phenomena of loss aversion and endowment effects are strikingly robust, appearing in a variety of setting and with a range of subjects.<sup>154</sup> In addition, agency costs may prevent the otherwise hard-boiled qualities of a CEO from fully displacing the effect that endowment effects might otherwise have; it is, after all, not in fact his money that he would forego by continuing to bid rather than taking a lockup payout.

Taken together, these five buy-side distortions create a significant asymmetry in the way that Bidder 1 and Bidder 2 view the economic payoff of the lockup. Nevertheless, if the value of the target were known with certainty and this value were common knowledge,<sup>155</sup> it would be difficult for Bidder 1's management to move its bid upward in response. In reality, however, there is considerable uncertainty in the valuation of the target. Managers therefore have the room to move their valuation of the target toward the upper end within their range of possible valuations, in response to the buy-side distortions that we identify. In effect, it is the uncertainty inherent in the valuation that translates the buy-side distortions into a higher reservation value for Bidder 1 and, to a lesser extent, Bidder 2. The next two sections model this increase in reservation values and demonstrate their potential impact on allocational efficiency.

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<sup>153</sup> See Charles R. Plott, *Industrial Organization Theory and Experimental Economics*, 20 J. ECON. LITERATURE (1982).

<sup>154</sup> See Christine Jolls, Cass Sunstein & Richard Thaler, *A Behavioral Approach to Law & Economics*, 60 STAN. L. REV. 1471, 1473 (1998).

<sup>155</sup> It is not sufficient that Bidder 1's managers know the value of the target with certainty because they could still be influenced by buy-side distortions if this information is not common knowledge.

## B. Modeling buy-side distortions for breakup fees

For breakup fees, buy-side distortions have a relatively simple effect: they cause the reservation values of Bidder 1 and Bidder 2 to fall less than the full economic value of a breakup fee.<sup>156</sup> If the only buy-side effect were buy-side agency costs, then the effect of breakup fees predicted by our model would vary depending on the relative size of buy-side agency costs as between Bidder 1 and Bidder 2.<sup>157</sup> Because Bidder 1 can be expected to encounter information effects, switching costs, reputational effects, and endowment effects as well, which Bidder 2 will not, Bidder 1's reservation value can be expected to exacerbate any higher level of agency costs (or ameliorate any lower level of agency costs) for Bidder 1 as compared to Bidder 2. Thus, even if agency costs were evenly distributed across bidders, these other buy-side distortions would result in a larger number of lockups being effectively foreclosing than would be predicted by the Ayres model. As a result, Bidder 1 will acquire the target even though Bidder 2 is the higher-value bidder: buy-side distortions will result in lockups affecting bid outcomes. Assuming that transaction costs are significant enough to prevent "resales" or "presales" of the sort envisioned by Fraidin & Hanson, buy-side distortions can result in lockups reducing allocational efficiency.

## C. Modeling buy-side distortions for stock lockups

Because the value of a stock lockup increases with the bids, the effect of buy-side distortions is slightly more complicated for stock lockups. Although the bottom line is generally the same – buy-side distortions result in stock lockups affecting bid outcomes – it is worth exploring more precisely how they interact with stock lockups to see if

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<sup>156</sup> For simplicity we assume that buy-side distortions are fixed, independent of bid size. In fact it is likely that at least some of the distortions that we identify are a function of bid size. Most clearly, switching costs will increase as the target gets larger. Agency costs, reputational effects, and endowment effects may also be correlated with bid size, because a small deal will not increase bidder size as much as a large one, and a small deal that is not covered in the *Wall Street Journal* may have a smaller reputational effect and create less of an endowment than a large deal that is. Our assumption regarding fixed buy-side distortions could easily be relaxed, with no change in the overall conclusions.

<sup>157</sup> More precisely, if Bidder 1's agency costs are greater than Bidder 2's, a fee would be foreclosing more often than predicted by the Ayres model, because Bidder 1 would continue to bid even when the



anything can be said about whether buy-side distortions have a larger or smaller impact in the breakup fee or stock lockup context.

We derive Bidder 1's reservation value after the lockup is granted by setting Bidder 1's profits from winning the target equal to Bidder 1's profits from losing the target:

$$(V_1 - B_1)N = (B_2 - P)T - C$$

where (as before)  $V_1$  is Bidder 1's pre-lockup per-share reservation value,  $B_1$  is Bidder 1's bid,  $N$  is the number of outstanding target shares,  $B_2$  is Bidder 2's bid,  $P$  is the strike price for Bidder 1's lockup,  $T$  is the number of share optioned, and  $C$  (a new variable) is the total buy-side distortion, net of Bidder 2's agency costs.

Solving for Bidder 1's reservation value we get:

$$B_1 = (V_1N + PT + C) / (N + T)$$

The change in Bidder 1's bid from the Ayres model to the buy-side model is:<sup>158</sup>

$$\Delta B_1 = C / (N + T)$$

Assuming that  $C$  and  $N$  are fixed, this last result leads to an interesting conclusion: Bidder 1's bid increases the most when the number of shares optioned is zero ( $T = 0$ ), i.e., when the lockup is a breakup fee rather than a stock lockup. For example, setting  $T = 0.2N$  (following Figure 4),  $\Delta B_1$  is 17% less for a stock lockup than for a breakup fee. As we will see in Part V below, this difference can have a substantial impact on the outcome of a takeover contest.

What is the intuition behind this result? When the bids go up by one dollar, a stock lockup provides incremental value to Bidder 1 that partially compensates for the costs of losing the bid. With a breakup fee, there is no offsetting benefit when the bids increase by a dollar. Thus Bidder 1 will increase its bid to compensate for the full impact of the buy-side distortions. Colloquially, in the breakup fee situation  $\Delta B_1$  must do all the

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opportunity cost of winning exceeded any gain from winning; conversely, if Bidder 2's agency costs are greater than Bidder 1, a fee would be foreclosing less often than predicted by the Ayres model.

“work” of getting back to Bidder 1’s valuation line; there is no “help” from the second bid.<sup>159</sup>

We are now ready to “cross the T.” As described in Part II, Delaware case law has made breakup fees preferable to stock lockups. Although stock lockups have not disappeared after *Paramount* (as asset lockups did after *Revlon* and *Macmillan*), they appeared in less than half as many deals as did breakup fees in 1999.<sup>160</sup> Part IV.A demonstrated that buy-side distortions make it possible for lockups to influence the outcome of a bidding contest, even between bidders who have already entered. Part IV.C demonstrated that a breakup fee will have a larger impact than a stock lockup of equivalent expected value on Bidder 1’s reservation value. Thus, the type of lockup that is most common in deals today is also the type of lockup that is more likely to have an impact on allocational efficiency once buy-side distortions are factored in.

## V. Testing the Model

Among the many articles written on lockups in corporate control transactions, none have attempted to test theory against real-world evidence. At best, some have offered anecdotal evidence or case studies to support their arguments. In order to provide a more rigorous validation, this Part tests the buy-side theory of lockups against the available empirical data.

### A. Methodology

The most direct test for the buy-side model expounded in Part IV would be an empirical examination of its first-order prediction: Do bidders continue to bid after the profit from their lockup exceed the profit from the deal? Unfortunately this question is

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<sup>158</sup> This is seen by setting  $C = 0$  (*i.e.*, no buy-side distortions), setting  $C > 0$ , and comparing the difference.

<sup>159</sup> As Richard Zeckhauser suggested to us, a “topping fee” could be designed to function like a stock lockup with a cash payout, which would have equivalent benefits to those described in the text for stock lockups. Such a fee would not be a percentage of the initial deal size, as with breakup fees, but a (larger) percentage of the amount by which any bust-up bid exceeded the initial bid.

<sup>160</sup> Stock lockups appeared in 22.5% of deals in 1999 compared to 51.1% for breakup fees. *See* Figure 1.

nearly impossible to test using real-world data because we rarely, if ever, know parties' reservation values.

Instead, two second-order effects from our buy-side model are more readily testable. First, if buy-side distortions are indeed greater on average for Bidder 1 than for Bidder 2, and Bidder 1's management considers these buy-side distortions in setting its reservation value, then deals with lockups should succeed more often than deals without lockups. Second, among deals with lockups, deals with breakup fees should succeed more often than deals with stock lockups because a breakup fee increases Bidder 1's reservation value more than a stock lockup does.

We can also test some of the specific buy-side distortions that we predict. For example, among deals with lockups of any kind, deals involving public company bidders with lockups should succeed more often than deals involving private company bidders with lockups, because the latter will on average have lower agency costs and be more likely to accept lockup payouts. Also, acquirers who repeatedly use lockups should have larger reputational costs and therefore should succeed more often than infrequently make acquisitions or use lockups.

## B. Results

We test these hypotheses by modeling the success rate for first bidders. As in Part II, the sample starts with all friendly M&A bids in the United States greater than \$50 million in market value that were announced after January 1, 1988 and were either consummated or withdrawn before October 1, 1999 ( $n = 2567$ ).<sup>161</sup> As a very simple starting point we can examine the aggregate success rate for first bidders grouped by what forms of deal protection are in place:

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<sup>161</sup> This sample is smaller than in Part II ( $n = 3254$ ) because here we exclude deals that are still pending.

<b>Stock Lockup?</b>	<b>Breakup Fee?</b>	
	<b>No</b>	<b>Yes</b>
<b>No</b>	75.7%	93.4%
<b>Yes</b>	94.6%	94.7%

n = 2567: Percent of all friendly deals >\$50 million that were announced after January 1, 1988 and completed before October 31, 1999 involving majority acquisition or merger of public company targets that lack a controlling shareholder

Even in this simple table the results are striking. Likelihood of success for deals with neither a breakup fee nor a stock lockup is only 76%, compared to 87% overall and 93+% for deals with one or both types of lockups. Interestingly, from a deal protection perspective, using both a stock lockup and a breakup fee may be a “belt and suspenders” approach, since the likelihood of success does not change significantly from including just one or the other.

Consistent with our approach in Part II, we ran four logistic regressions to more rigorously test our model. The results are shown in Table 6. In each regression, the dependent variable is OUTCOME, set to 1 if the Bidder 1 successfully completes an announced acquisition of the target. We again include, as controls, variables involving deal characteristics (12 variables), acquirer characteristics (3 variables), and target industry effects (4 variables).

Table 6: Success Rate for First Bidder (Tobit regressions)

Model	(1)	(2)	(3)	(4)
Sample	Full	Full	Partial	Partial
Deal Protection Variables	Incidence	Magnitude	Incidence	Magnitude
<b>Deal Characteristics:</b>				
Merger of Equals?	<b>-0.98 (0.39)</b>	-0.95(0.39)	1.23 (1.19)	0.67 (1.15)
Log (Deal Value in Real Dollars)	-0.21 (0.12)	-0.14 (0.12)	-1.06 (0.49)	-0.38 (0.46)
Unsolicited?	<b>-1.67 (0.59)</b>	-1.70 (0.59)	1.18 (1.95)	1.19 (1.84)
Litigation?	<b>-0.64 (0.22)</b>	<b>-0.62 (0.22)</b>	0.21 (0.54)	0.30 (0.52)
Tender Offer?	<b>2.14 (0.24)</b>	<b>2.21 (0.24)</b>	<b>2.74 (0.61)</b>	<b>2.75 (0.61)</b>
Months to Close/Withdrawal	<b>0.11 (0.02)</b>	<b>0.11 (0.02)</b>	<b>0.21 (0.07)</b>	<b>0.19 (0.07)</b>
Deal Activity	<b>0.02 (0.01)</b>	<b>0.02 (0.01)</b>	-0.02 (0.02)	-0.02 (0.02)
Premium (%)	0.01 (0.15)	0.01 (0.15)	0.20 (0.62)	0.39 (0.62)
All Stock?	0.38 (0.21)	<b>0.38 (0.21)</b>	-0.31 (0.95)	-0.04 (0.93)
Part Stock?	<b>0.33 (0.21)</b>	<b>0.38 (0.21)</b>	<b>0.15 (0.79)</b>	<b>0.63 (0.78)</b>
Pooling of Interests?	<b>0.35 (0.21)</b>	<b>0.37 (0.21)</b>	<b>0.78 (0.99)</b>	<b>0.51 (1.02)</b>
Same Industry?	0.35 (0.14)	0.34 (0.14)	<b>0.84 (0.52)</b>	<b>0.65 (0.50)</b>
<b>Acquirer Characteristics:</b>				
Public Acquirer?	0.35 (0.20)	0.23 (0.19)	0.77 (0.87)	0.01 (0.77)
Public Acquirer * Lockup?	0.38 (0.27)	<b>0.69 (0.22)</b>	-0.92 (0.97)	0.16 (0.84)
Other Lockups? <sup>162</sup>	<b>0.20 (0.05)</b>	<b>0.19 (0.05)</b>	-0.17 (0.19)	-0.12 (0.18)
<b>Target Characteristics (Industry Effects):</b>				
Banking	0.14 (0.21)	0.18 (0.22)	<b>2.64 (0.96)</b>	<b>2.46 (0.90)</b>
Telecommunications	-0.30 (0.39)	-0.30 (0.39)	1.78 (1.52)	1.59 (1.45)
Utility	<b>-0.91 (0.38)</b>	<b>-0.89 (0.38)</b>	-0.30 (1.48)	-0.35 (1.44)
High Tech	-0.27 (0.38)	-0.27 (0.38)	-0.23 (1.56)	-0.90 (1.78)
<b>Deal Protection:</b>				
Breakup Fee?	<b>0.93 (0.21)</b>		<b>2.13 (0.69)</b>	
Stock Lockup?	0.43 (0.25)		0.76 (0.69)	
Breakup Fee (% of deal value)		<b>0.24 (0.06)</b>		<b>0.34 (0.14)</b>
Stock Lockup (% of deal value)		0.03 (0.05)		-0.01 (0.12)
<b>Constant</b>	-0.24 (0.35)	-0.30 (0.36)	-1.34 (1.48)	-2.28 (1.50)
Number of Observations (n)	2564	2564	150	150
Pseudo R-sq	19.6%	19.5%	35.3%	33.3%

Notes:

Standard errors in parentheses; coefficients significant at 95% confidence in bold.

<sup>162</sup> Breakup fee or stock lockup

We test the hypothesis that deal protection affects deal outcome by including four deal protection variables, two in each regression. The first two regressions test lockup effect on outcomes in the full dataset of deals, and so measure the combined effect of buy-side distortions and lockup foreclosure (in Part III.C, recall, we argue lockup foreclosure is plausible given the size of lockups in our sample). The third and fourth regressions test lockup effect on outcomes in a subsample of deals (n=150) in which second bidders emerged prior to completion of the initial deal, and so measure solely buy-side distortions (if a lockup were foreclosing at grant, these bidders by definition would not have appeared).<sup>163</sup>

In the first and third regressions, our explanatory variables are two dummy variables – BREAKUPFEE? and STOCKLOCKUP? – set to 1 if a fee or stock lockup is present, to test whether the incidence of these devices increase the likelihood of success for Bidder 1, as predicted by the buy-side model. In the second and fourth regressions, our explanatory variables are continuous variables (truncated at zero) – BREAKUPVAL, and STOCKLOCKUPVAL – which test if deals with larger breakup fees or larger stock lockups induce larger buy-side distortions and increase the likelihood of success for Bidder 1, as the buy-side model predicts.<sup>164</sup>

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<sup>163</sup> In some instances, SDC characterizes a second bidder as a new first bidder, especially if Bidder 2 formally appeared in the deal only after Bidder 1 had withdrawn its bid. We adjust the SDC characterization of these subsequent bidders in the following way: any bidder who acquires a target within 180 days of a prior bid for the same target being withdrawn is re-characterized as a second bidder in the original deal. This recharacterization does not change our qualitative results.

<sup>164</sup> We calculate the dollar value of the stock lockup as the number of optioned shares multiplied by the difference between the average overbid from successful third-party bidders (14.9%, from the data set) and the strike price of the option. We used this valuation methodology rather than a Black-Scholes valuation because the volatility of the target's shares is much higher in the context of a takeover bid, and, in fact, is so much higher that it is generally regarded as being unknowable. [cite] Where the strike price is not specified in the data (173 observations), we used the deal price as the strike price. While not perfect, Figure 3 shows that almost three-quarters of stock lockups (72%) are granted within 10% of the deal price, so using deal price as the strike price when actual data are lacking seems reasonable. In situations where the number of shares is not specified in the data (13 observations), we assume a 19.9% option, again consistent with the modal result from Figure 4. In each case, dropping observations with missing data does not change our qualitative results.

To handle capped stock options, we make the simplifying assumption that any stock lockup after *Paramount* is capped at 5% of deal value. *Paramount* sparked widespread use of capped stock lockups by criticizing the lack of a cap in that case. See *Paramount* at 39 (“Because 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)

To test one aspect of the buy-side model more precisely, we include PUBLICACQUIRER? and an interaction term between PUBLICACQUIRER? and the deal protection variables. PUBLICACQUIRER? on its own tests the hypothesis that public bidders have larger agency costs and therefore will continue to bid beyond their reservation values.<sup>165</sup> The interaction variable between PUBLICACQUIRER? and the lockup variables is included to distinguish between public bidders who win because they simply overpay relative to private bidders and public bidders who value the lockup payment less highly than private bidders. This variable allows us to isolate the second effect as the one that is most relevant for testing the buy-side model. We also include OTHERLOCKS to test the hypothesis that repeat players may rationally bid higher in order to preserve their reputation in future rounds. OTHERLOCKS provides a rough proxy for this reputational effect by counting the number of total lockups received by Bidder 1 in the data set.<sup>166</sup>

Table 6 confirms the predictions of the buy-side model. In all four regressions, breakup fees have a strong, positive and statistically significant effect on Bidder 1's likelihood of successfully completing its deal. In the full sample, the mere presence of a breakup fee (regardless of size) increases the recipient's likelihood of closing (+0.93,  $p < .0001$ ), and larger fees have a larger impact (+0.24,  $p < .0001$ ). Conditional on a second bidder emerging, the effects are even stronger, and highly statistically significant (although, given the smaller sample size, predictably less so): fees of any size increase

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unreasonable levels.”). Before *Paramount*, options were rarely capped; since, practitioners have taken the none-too-subtle hint, and uncapped stock lockups have become rare. See Interview I, transcript at 5 (“Current practice tends to be that if you’re going to have both the stock option and the breakup fee you cross-cap them. The days of getting 3% in the breakup fee and an unlimited theoretical upside in the option, additive, have kind of gone away.”). Although our approach is admittedly rough, we believe it adequately reflects the shift to capped stock lockups. As a check, we re-ran our regressions, dropping all deals after *Paramount*, leaving 732 observations, and our qualitative findings were unchanged.

<sup>165</sup> Unfortunately SDC does not collect data on the ownership status of third-party bidders, so we make the simplifying assumption that public first bidders face approximately the same mix of third-party bidders (public and private) as private first bidders. Put another way, we make the assumption that whether a third-party bidder is public is not correlated with whether the original bidder is public.

<sup>166</sup> We could have used the number of subsequent lockups rather than number of total lockups in the data set. Although this adjustment would more accurately capture the forward-looking nature of the reputational effect, we assume that our data set captures a snapshot, over twelve years, of a bidder's steady-state acquisition program. Therefore looking over a longer time period gives a more accurate indication of how frequently the bidder receives lockups in the M&A marketplace. To take the extreme example, a very recent bidder in the data set may have no subsequent lockups but may in fact be a regular acquirer. Looking at total lockups in the data set avoids this problem.

the recipient's likelihood of success (+2.13,  $p < .001$ ) and larger fees have a larger impact (+0.34,  $p < .04$ ). In sum, the evidence supports the view that buy-side distortions can cause breakup fees to affect bidding outcomes. In addition, because breakup fees continue to exert influence even after a second-bidder has emerged in the regressions (3) and (4), buy-side distortions appear to be a lockup-related cause of deal success, rather than lockup foreclosure alone. Contrary to the Ayres model, breakup fees do not appear to reduce the reservation values of recipient bidders as much as they reduce those of bust-up bidders, and contrary to the Fraidin & Hanson model, breakup fees do appear to affect bid outcomes.

Stock lockups, by contrast, have some effect, but it is smaller, as predicted by the buy-side model. Only in regression (1) do stock lockups have a statistically significant effect on deal outcomes, and it is only about half as large as the effect of a breakup fee. The stock lockup effect does not persist in regression (3), so that whatever effect stock lockups have may be due more to foreclosure,<sup>167</sup> consistent with our argument in Part III.C, and less to buy-side distortions, consistent with our analysis in Part IV (where we show that the effect of buy-side distortions on bidders should be ameliorated by stock lockups). In neither regression (2) nor (4) does stock lockup magnitude appear to affect bid outcomes. Although this reinforces the general conclusion that stock lockups are less powerful than breakup fees of equivalent size, it may also simply reflect the fact that there is considerably less dispersion in stock lockup magnitude than in breakup fee magnitude (as reflected in Figures 2-4).

To get a more intuitive sense of the relative impact of breakup fees of different sizes and of stock lockups, we use the method of recycled predictions to predict the effect of different types of lockups. The presence of an average breakup fee (2.9% in the full sample) increases likelihood of deal success by 10.0%, and the presence of a stock lockup increases likelihood of deal success by 4.3%. For each percentage increase in the size of the breakup fee above 2.9%, the likelihood of deal success increases by 2.1%, so that a

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<sup>167</sup> This may be especially likely if, as practitioners assert, the effect of stock lockups on pooling has special importance. Pooling accounting, it should be noted, has an independent, positive and significant effect on the likelihood of deal consummation in our model, even after controlling for stock consideration (required in poolings), lockup incidence and industry effects. [test interaction of pooling and stock lockup]



fee at the 75<sup>th</sup> percentile of the sample (3.9%) would increase likelihood of deal success by a total of 12.1%.

The agency cost version of the buy-side model finds mixed support in the data. Consistent with general academic views, we hypothesize that public bidders have larger agency costs than private bidders, which will affect both willingness to bid aggressively and reluctance to take a lockup payout in lieu of winning. Indeed, coefficients on PUBLICACQUIRER? are positive in regressions (1), (2) and (3), suggesting that public bidders bid higher than private bidders, but none of the results are statistically significant. More importantly for the buy-side model, PUBLICACQUIRER? interacted with lockup incidence is positive in regressions (1), (2) and (4), and statistically significant in regression (2) (+0.69,  $p < .002$ ). These results suggest that larger lockups amplify buy-side agency costs, but precisely how much is less clear, given the lack of strong results in the other regressions.

Reputational effects also find qualified support in the regression results. The coefficient on OTHERLOCKS is positive and statistically significant in regressions (1) and (2), suggesting that bidders who use lockups frequently are less likely to walk away from the current deal. However, OTHERLOCKS loses its statistical significance (and in fact has the wrong sign) in the smaller sample of deals that were contested, precisely when the reputational cost of walking away from the deal would be greatest.

Taken together, these results provide strong support for the buy-side model. Breakup fees of any size provide strong protection for a deal, contrary to what the Ayres and Fraidin & Hanson models would predict, and larger fees provide increasingly stronger protection. This is true generally, and conditional on the emergence of a competing bidder. Breakup fees offer more protection than stock lockups, which reduce buy-side distortions, and larger stock lockups provide no more protection than smaller ones. More specifically, the agency cost effect and the reputational effect find some support in the data as well, but the absence of strong support for these specific versions of the buy-side model suggests that the other versions of the model (switching costs, information effects and endowment effects) may be just as if not more important in explaining our overall results.

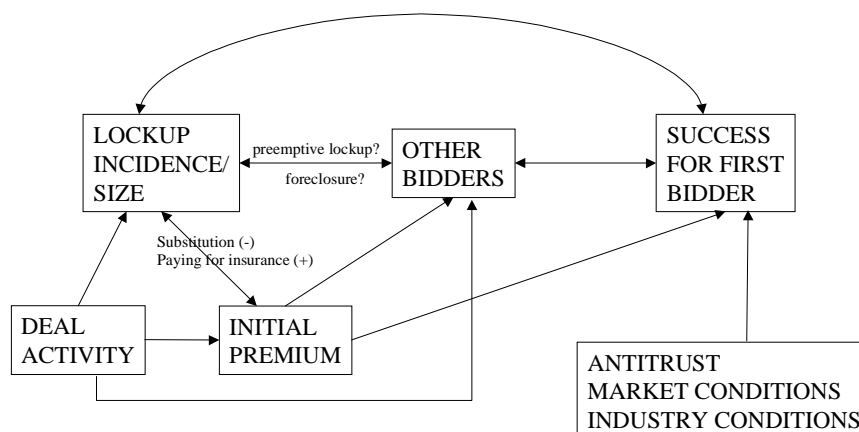
In closing this section, we briefly note other results from Table 6. Unsurprisingly, deals that take longer or encounter litigation are less likely to succeed. More interestingly, friendly deals executed by tender offer are more likely to succeed, even after controlling for time between announcement and closing, suggesting that “pressure to tender” exerts an independent force in many deals. In fact, the tender offer is a powerful tool for ensuring deal success – more successful than even a breakup fee (2.14 vs. 0.93, from Column 1 of Table 6). To have an effect equivalent to that of a tender offer, a breakup fee would have to be over 9% of deal size (2.21 vs. 0.24, from Column 2 of Table 6). Deals involving higher premiums, by contrast, are no more likely to close, reinforcing the impression from Part II that bidders pay more for lockups, rather than using both higher premiums and lockups to deter bust-up bids. MOE’s are less likely to succeed overall, even after controlling for stock consideration, merger-vs.-tender-offer structure, and accounting treatment, and industry overlap, but are not less likely to be completed when another bidder is present, suggesting that MOE failure may have as much to do with unhappiness among existing investors as with bust-up bids.

Finally, we note some industry effects: utility deals are less likely to close, even after controlling for the longer time frame required to achieve regulatory approval; and bank deals, though not statistically different in the full sample, are more likely to close when compared to the set of deals with other bidders present. On the surface this last result would seem to suggest that competitors to bank deals are less effective than competitors to deals in other industries, though this finding clearly requires further research in order to test this hypothesis.

### C. Other Potential Interactions

As with any regression analysis, the previous section has demonstrated a correlation between deal protection and deal success, but not necessarily causation. Figure 6 illustrates the complexity inherent in our story:

Figure 6: Potential Causal Relationships



The buy-side model predicts a causal link between lockup incidence/size and the success rate for first bidder. But as Figure 6 illustrates, there may be a causal relationship in the other direction as well: in addition to (or even instead of) deal protection leading to higher deal success, it is possible that higher likelihood of deal success leads to greater deal protection. For example, if it is certain the deal will succeed, a lockup might be viewed as costing nothing for a target to give.<sup>168</sup> A lockup may be more likely precisely because the target is confident that the deal with Bidder 1 will be consummated. Deal success, in turn, may be affected by the size of the initial premium, the appearance of other bidders, antitrust barriers, market conditions, and general industry conditions. In the remainder of this Part we explain why we believe that the causation does in fact run from deal protection to deal success, and not *vice versa*.

Because we cannot measure the likelihood of deal success directly, our approach is to examine several (measurable) variables that might influence deal success – OTHERBIDDER, SAMEINDUSTRY?, BETWEEN, and PREMIUM – and test the relationship between these variables and both deal protection and deal success. We start with other bidders. If both bidder and target have the same expectations regarding the

<sup>168</sup> In fact, even in this limiting case, legal risk should bias against a lockup. Part II shows that lockups have encountered judicial criticism. Even if no bust-up bid appears, target shareholders (or, more precisely, law firms nominally representing target shareholders) may sue target directors for granting a lockup. Directors concerned about liability have an incentive to resist requests for lockups even where bust-up bids are unlikely. Bidder directors, by contrast, face little legal risk for not insisting on lockups. Legal risk should make lockups not more but less likely where they are unneeded.

likelihood of a subsequent bidder, and if that likelihood is not zero, then the incidence (and magnitude) of a lockup should not be influenced by the likelihood of a subsequent bidder. The reason is the lockup negotiation is a pure value-claiming exercise between the target and the bidder: a larger lockup benefits the bidder, and a smaller lockup benefits the target. Therefore, precisely in the situation where the lockup is cheap for the target to give, it is of low value for the bidder to receive. In the opposite situation – where both bidder and target believe another bidder is highly likely – the target will resist giving the lockup but the bidder will insist on receiving it as well.<sup>169</sup> Assuming equal bargaining power between bidder and target, the net effect should be the same in both scenarios and independent of the likelihood of another bidder.

Empirical evidence does not reject this analysis. From Table 3, we can use the ex post existence of another bidder as a proxy for the ex ante estimate of the likelihood of another bidder. OTHERBIDDER is not correlated with the incidence of a stock lockup (Column 1) or a breakup fee (Column 2) or both (Column 3).<sup>170</sup> This finding suggests that parties do have equal bargaining power in negotiating lockups, and that competing interests with respect to the lockup effectively cancel each other out over a large number of deals. Therefore we can break the causal link running from other bidders to likelihood of deal success to lockup incidence.

Figure 6 shows a second endogeneity problem, involving the deal premium. The higher the premium, goes the theory, the higher the likelihood of deal success, which in turn increases the likelihood of a lockup. Table 3 shows a larger premium in fact leads to higher incidence of stock lockups (though not of breakup fees), and Table 4 shows a larger premium increases the magnitude of a stock lockup (Column 1) (but, again, not the magnitude of a breakup fee). These results could be read to support a theory that premiums and stock lockups are complements, not substitutes. However, higher

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<sup>169</sup> Some practitioners on the bidders' side seem to view a lockup as a non-negotiable prerequisite to the deal. *See, e.g.*, Interview K, transcript at 1 (“I would advise him to make it a principal term. Not to get into great detail, but to say, ‘here’s the price, here are the social issues, and among the other issues, we have to have whatever we want in that area [deal protection].”); Interview D, transcript at 1 (“[Deal protection] is a condition of the deal.”).

<sup>170</sup> We also ran but do not report a regression model in which OTHERBIDDER is the dependent variable and the various deal protection terms are the independent variables. This model leads to the same conclusion, namely, that deal protection is uncorrelated with the presence of other bidders.

premiums are not correlated with higher likelihood of deal success (Table 6). Premiums thus influence lockup incidence directly (targets are more willing to grant stock lockups if bidders offer higher premiums), but not indirectly through anticipated deal success. Bidders do not appear to push more or less hard for lockups when they anticipate that a higher premium will make deal success more likely. Once again, our results do not reveal any causal chain running from higher premiums to higher likelihood of deal success to higher lockup incidence.

A final endogeneity problem may exist, with causation running from exogenous variables (antitrust, market conditions, and industry conditions) to likelihood of success to deal protection incidence. Deals that are more likely to be blocked or held up under antitrust law, for example, may be less likely to succeed for that reason, but also more likely to produce large synergies if they do succeed, making both bust-up bids and lockups less likely. While we cannot test this hypothesis directly, we can make the same *a priori* arguments made above (*i.e.*, if anything target bargaining power and legal risk may bias against lockups where deals are less likely to succeed for reasons other than bust-up bids), and we can test for this sort of endogeneity using two proxies in the model. SAMEINDUSTRY?, set to 1 if the acquirer and the target are in the same industry, provides a rough measure for potential antitrust obstacles. BETWEEN provides a proxy for likelihood of deal success – the longer the time between announcement and closing, the less likely the deal will be to succeed. Interestingly (and counterintuitively), neither is more than marginally significant in predicting deal protection incidence (Table 3) or deal protection magnitude (Table 4).<sup>171</sup> Although less compelling than our (more direct) test of other bidders, these results cast significant doubt on the proposition that exogenous variables influence lockup incidence through their influence on likelihood of deal success.

To summarize this point, we cannot examine likelihood of deal success directly, but we can examine other variables that might influence deal success, which, in turn,

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<sup>171</sup> As a more sophisticated measure of potential antitrust concerns (though arguably less accurate), we also used the number of overlapping SIC codes between target and acquirer divided by the total number of SIC codes for the target. *See* R. Morck, A. Shleifer & RW. Vishny, [cite]. This independent variable also was not significant.

might influence deal protection incidence. In doing so we find little evidence that these variables influence deal protection, suggesting that any causal link from likelihood of success to deal protection incidence is weak at best. For the one variable that does influence deal protection incidence (PREMIUM), we have a straightforward and direct link between premiums and deal protection (namely, bidders pay for deal protection through a higher premium) which does not implicate likelihood of success, and no evidence that higher premiums in fact affect deal outcomes. These findings support the buy-side model's proposition that deal protection influences likelihood of success, and not *vice versa*.

## **VI. Implications\***

In Part II we offered an empirical profile of lockups and the effect of law on lockup incidence and design; in Parts III and IV we set out the prior theoretical model and our extension of it; and in Part V we tested our theory against the available data. We now shift from the descriptive to the prescriptive to make a case for changing the way lockups should be viewed, both by courts and by corporate boards of directors. Our analysis has three normative implications: (1) lockups do affect bid outcomes, and policy concerns about lockups should not be treated lightly on the ground that they do not; (2) lockups may affect bid outcomes by exacerbating buy-side inefficiencies, but may also serve useful purposes, so that courts evaluating a given lockup should be attuned to the nature of the bidder, target and deal; and (3) different types of lockups affect outcomes differently, so that courts should also be attuned to the particular characteristics of the lockup being evaluated. In addition, we note several implications for boards and practitioners facing lockup decisions.

### A. Implications for Courts

An important theme in academic theory on lockups has been that “lockups can’t hurt but may well help.”<sup>172</sup> Our theoretical model shows ways that lockups may prevent

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\* This Part remains particularly preliminary.

higher-valuing second bidders from acquiring a target, and the empirical data provide strong support for our buy-side model of lockups. Simply put, lockups influence bid outcomes. This is true even of modest lockups, much smaller than the “foreclosing” type of lockup identified by Ayres as potentially affecting bid outcomes. This – together with the undeniable existence of transaction costs that impair Coasian bargaining – raises the specter that lockups may “hurt” by preventing assets from moving quickly or securely to their highest-value use. In this way, lockups are similar to other defense mechanisms, such as poison pills, the potential adoption of which (together with effective classified boards) may impede the flow of assets in the market for corporate control.<sup>173</sup> Thus, contrary to the conventional wisdom, lockups may well “hurt,” regardless of whether (as Kahan & Klausner argue) lockups enable disloyal behavior by target managers, or reduce the disciplinary force of the takeover market.

To this general point, we add two specific reasons why lockups may “hurt”. First, our model suggests that endowment effects may cause bidders with lockups (or bidders with large lockups) to be more likely to “hold onto” the locked-up target than to let a higher-valuing competing bidder win, a result that can be viewed as simply irrational. Second, buy-side agency costs may be exacerbated by lockups. As shown in our model, a bidder can use a lockup to foreclose other bids, making a value-destroying acquisition motivated by empire-building or risk aversion even more likely than in a world without lockups. Should a bust-up bid emerge, the availability of a lockup payout will not mitigate the tendency of an initial bidder afflicted with agency problems to continue bidding, as the Ayres model would suggest. This analysis suggests that courts evaluating lockups should not only be sensitive to the possibility of agency problems and conflicts of interest at the target, but also at the bidder. In particular, public company bidders

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<sup>172</sup> See Fraidin & Hanson, *supra* note 9 at 1745.

<sup>173</sup> Cf. Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 DEL. J. CORP. L. 375 (1998); John C. Coates IV, *An Index of the Contestability of Corporate Control: Studying Variation in Legal Takeover Vulnerability*, Working Paper (July 1999). Takeover defenses are common in firms going public, however, see Robert Daines & Michael Klausner, *Value-Maximizing Charters: An Empirical Analysis of Antitakeover Provisions in Corporate Charters at the IPO Stage*, Working Paper (Jan. 13, 1997), a number of theories exist as to why defense might enhance firm value, see Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. REG. 107 (1992), and no empirical evidence supports the view that defenses harm firm value, see John C. Coates IV, *The Contestability of Corporate Control: A Critique of the Scientific Evidence on Takeover Defenses* (Working Paper July 17, 1999).

(“strategic” bidders) may be more likely to abuse the lockup device than other types of bidders. Courts may also be justifiably more suspicious of lockups granted to bidders in mature industries, where agency costs tend to be higher than elsewhere, or bidders making diversification acquisitions, which may be a direct signal of high agency costs.

On the other hand, our theory also makes a contribution to the other side of the question – do lockups “help”? Four reasons have previously offered for why lockups might “help”: they compensate for the costs of bidding,<sup>174</sup> encourage search,<sup>175</sup> overcome valuation disputes,<sup>176</sup> and allocate risk efficiently.<sup>177</sup> These arguments suggest that lockups may improve allocational efficiency in some situations.<sup>178</sup>

We add two additional justifications, derived from our buy-side model. First, lockups permit a lockup holder to recoup consolidation costs incurred between the announcement of a deal and the loss of the target to a bust-up bidder. This point is similar to points made by Kahan & Klausner, who focus on costs incurred prior to the announcement of the deal. Our focus, however, is on the interaction of a lockup and the

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<sup>174</sup> Kahan & Klausner, *supra* note 12 at 1563. Sunk costs, however, should not be considered: “No loyal target would grant and no bidder could credibly demand a lockup for investments already made in identifying and evaluating the target and its value.” Fraidin & Hanson, *supra* note 9 at 1814.

<sup>175</sup> *Id.* at 1826-28; Kahan & Klausner, *supra* note 12 at 1564. Kahan & Klausner argue that rewarding search is less important for second-bidder lockups because a first bidder has already identified a target as such to the world, and its bid has revealed what it believes is a reasonable valuation for the target. *Id.* at 1556 n.47. Roosevelt argues lockups do not directly reward search, but first-bidder lockups dampen and second-bidder lockups exacerbate the auction-stimulating effect of the Williams Act, which reduces the reward for search, and so agrees with Kahan & Klausner’s policy conclusions. *Supra* note 121 at 1.

<sup>176</sup> Fraidin & Hanson, *supra* note 9 at 1822. The importance of this point was confirmed by M&A practitioners at a presentation of an earlier version of this paper at a workshop sponsored by New York University School of Law. This justification, too, is least powerful in the case of second-bidder lockups, since second bidders and targets negotiate in light of an existing valuation floor created by the initial bid.

<sup>177</sup> Ayres, *supra* note 10 at 698 n.46; Fraidin & Hanson, *supra* note 9 at 1823-26. Kahan & Klausner argue risk allocation via lockup is implausible for second-bidder lockups because the main risk reduced by lockups is whether another bid will emerge. *Supra* note 12 at 1556 n.47. Fraidin & Hanson also note that lockups allow targets and lockup recipients price discriminate to extract surplus from second bidders, at 1823-26. Kahan & Klausner note this may benefit shareholders of targets and lockup recipients, but it does not produce social gains. At 1556 n.47.

<sup>178</sup> In addition, where a target has conducted, or been forced into, a full auction process, a lockup may usefully serve the role of a “gavel” to end the auction, and the promise of such a lockup may help the target commit against opportunistic negotiations after the “end” of the process. See Fraidin & Hanson at 1829; Cramton & Schwartz at 41 & 44; Kahan & Klausner at 1557 n.47. Without such a commitment, bidders may bid incrementally, in the hopes of price discriminating and achieving victory at the second highest reservation value. Such an incremental process, however, may do substantial damage to a target’s franchise. Thus, we agree that courts should defer to target boards in granting auction-ending lockups. *See, e.g., Hecco Ventures v. Sea-land Corp.*, No. 8486 (Del. Ch. May 19, 1986) (upholding stock lockup granted at end of auction to only remaining bidder).



post-announcement consolidation process. To the extent a bidder does not have (or cannot enforce) a lockup, it will be more likely to defer costly post-announcement consolidation of the two companies, or positioning of the two companies for post-closing consolidation. For example, decisions regarding how cost-savings will be achieved involve a beauty-contest among competing divisional or functional management teams inside the bidder and the target; but unless a deal is reasonably safe from bust-up bids, bidder managers will be reluctant to decide or even begin that contest, for fear that it will permanently damage the bidder's own franchise should a bust-bid bidder win the target. Assuming such decisions are necessary before efficiencies from the deal can be achieved, a lockup may allow a deal to produce earlier (and therefore larger) social gains.

Post-signing switching costs may justify lockups for both first- and subsequent bidders, since any bidder will face the same costs of delay in the consolidation process. However, use of a lockup to protect against losing post-announcement switching costs will be most important where the delay between signing and closing of the deal is greatest.<sup>179</sup> As noted in Part II, several sources of variation in deal delay exist: (1) SEC registration procedures if stock consideration is used, as common for public bidders in rising stock markets, and at all times in industries (such as banking) where bidder equity capital is scarce or intentionally kept near a regulatory minimum;<sup>180</sup> (2) special regulatory approvals, such as those required in the banking, utilities or telecommunications industries;<sup>181</sup> and (3) antitrust review, if the deal raises antitrust concerns or will require divestitures to be completed (as is increasingly common). Where these constraints are

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<sup>179</sup> Thus, the bottom line of this point is similar to a point made by Bainbridge, who argues that lockups compensate for risks inherent in the delay between signing and closing. Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, at 241-42. But as Fraidin & Hanson point out, the mere fact of delay does not by itself justify lockups. *Supra* note 9 at 1814-17. By focusing on the post-signing consolidation process as giving rise to special concerns, we specify how and why lockups help compensate for that delay.

<sup>180</sup> Whether recent changes to the Williams Act as applied to exchange offers reduce the additional delay remains to be seen. See Securities and Exchange Commission, *Regulation of Takeovers and Security Holder Communications*, SEC Release Nos. 33-7760, 34-422055 (Oct. 26, 1999) (effective Jan. 24, 2000) (available at <http://www.sec.gov/rules/33-7760.htm>).

<sup>181</sup> Where regulatory approval is highly likely, but subject to delay, the bust-up risk that the delay might otherwise impose can be reduced by holding the meeting of target shareholders to approve the deal and so end the period of bust-up risk in advance of receiving regulatory approval. But where regulatory approvals may be conditioned on extensive divestitures or other changes in the basic terms of the deal, this technique may not be available.

imposed on the initial deal, a lockup of larger size may be more justified. Lockups in deals involving banks, utilities, *etc.*, not only are, but should be, different.

A second efficiency-enhancing role lockups play in our buy-side model is to reduce the drag of uncertainty on gains from trade. By allowing a lockup holder to infer more information from the fact and size of a bust-up bid, a lockup reduces the size of the discount that an initial bidder would otherwise use in estimating a target's value. This point differs from Fraidin & Hanson's arguments that lockups allow target and bidder to trade on the basis of different estimates of auction outcomes or different risk preferences.<sup>182</sup> Rather, our point is that lockups enable trades on the basis of different estimates of the target's value.<sup>183</sup> To the extent a bust-up bidder can be expected to have private information about common elements of value for the target that are not available or verifiable to either the public or the initial bidder, an initial bidder with a lockup can make a more certain valuation of the target when the bust-up bid appears. As with the switching cost justification, the reactive revaluation justification applies to second-bidder as well as first-bidder lockups, and again, courts inclined to uphold a lockup in part on this ground should be sensitive to the context of a particular deal. Where targets are substantially harder to value with certainty, such as the Internet, biotechnology or other high (potential) growth industries, lockups may be more defensible, but in mature industries where valuation parameters are relatively well-established and stable, lockups may be more suspect.

Finally, both our theoretical model and our empirical analysis supports the view that – contrary to the language of the *Paramount* decision – uncapped stock lockups with strike prices no lower than the initial bid price should be viewed with no more, and perhaps less, suspicion than breakup fees of equivalent size. We have shown that breakup fees are likely to affect bid outcomes more, dollar for dollar, than stock options,

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<sup>182</sup> At 1822-24. Kahan & Klausner touch on valuation uncertainty and seem to acknowledge that it may provide a limited justification for lockups even in the second-bidder context. At 1555 n.43.

<sup>183</sup> The point also differs from Fraidin & Hanson's argument that lockups allow an initial bidder and target to collusively price discriminate against a bust-up bidder. They assume (implausibly) that target and initial bidder intend the lockup to allocate gains from the bust-up bid between them. *Id.* at 1824-26. By contrast, we think it more likely that an initial bidder will seek a lockup in part to force a subsequent bidder to reveal more information about its reservation value, expecting to use that information in deciding whether to

precisely because their value is “capped.” Likewise, a capped stock option, particularly one that is granted with an “in-the-money” strike price, functions more like a fee than a normal stock option, and so does little to overcome buy-side distortions. It is true that an initially out-of-the-money uncapped stock lockup may offer a first bidder a substantial windfall – which, after a bid has emerged may seem to a court in hindsight to have been unduly generous. However, such an option is more likely to overcome the buy-side distortions we have described precisely in those settings where the subsequent bidder is willing to pay considerably more than the initial bidder. Thus, although they may appear egregious ex post, uncapped options are most likely to encourage the lockup holder to take the lockup payout and allow a higher-valuing bidder to acquire the target.

In sum, the foregoing analysis leads us generally to endorse Kahan & Klausner’s recommendation that first-bidder lockups be given greater deference than lockups granted to later bidders.<sup>184</sup> However, because we also view first-bidder lockups as possibly influencing bid outcomes, we do not endorse the highly deferential business judgment rule standard for such lockups. And because we view lockups as possibly justifiable even for second bidders facing significant post-signing switching costs or valuation uncertainty, we do not think that the distinction between first- and second-bidders should be dispositive. Given that lockups may hurt or help depending on other features of the context, courts should give *all* lockups a hard second look. Consistent with the approach now taken under *Revlon*, courts should require that boards – in all contexts – show that some tangible gain was obtained in exchange for a lockup.<sup>185</sup>

When courts review lockups, they should recognize that some lockups are more likely to hurt more than others. Lockup magnitude should matter: in-the-money stock lockups and breakup fees above 3% of deal value should be given a particularly hard

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counterbid. In other words, price discrimination is a side-effect of lockups (and one with no positive effect on efficiency), while reactive revaluation is a direct and common effect (and should enhance efficiency).

<sup>184</sup> We also note a caution: Kahan & Klausner rightly point out that anticipatory lockups are similar in many respects to second-bidder lockups. However, in practice, the degree to which anticipation of a takeover has led to a given lockup is likely to vary along a continuum, rather than be a qualitative feature of many situations (as in *Paramount*, for example), and bright-line rules based on this feature are unlikely to work.

<sup>185</sup> This is not a suggestion that the full *Revlon* standard be extended to all deals. Rather, a court should apply “enhanced scrutiny” to the specific decision to grant a lockup in all deals, as outlined by the Delaware Supreme Court in *Macmillan*, 559 A.2d 1261, 1288 (1989).

look, but courts should not simply assume, as the *Brazen* court seems to have assumed, that a small percentage (even 2%) of deal size is ipso facto a reasonable estimate of bid costs. As deal sizes have grown, lockups have not fallen but grown slightly as a percent of deal size,<sup>186</sup> even though there is no reason to believe that deal expenses have grown at the same rate.<sup>187</sup> Thus the original link between lockup value and deal expenses may have come unhinged in the mega-mergers of the late 1990s.<sup>188</sup> If so, Delaware courts have reason to step in to hinge them back together.

On the other hand, courts should not limit their analysis to out-of-pocket costs. The *Brazen* court's recognition that opportunity costs can be real, and large, seems justified.<sup>189</sup> For first bidders, protection of search costs, although sunk by the time the court evaluates a lockup, provide an inducement for future bids. For all bidders facing substantial delay between signing and closing, post-announcement switching costs can be substantial, and legitimately protected by a lockup. For bidders attempting to value a hard-to-value target, lockups may usefully flush out information that can improve gains from trade. Thus, particularly in regulated or hard-to-value, high growth industries, larger lockups should be more defensible might normally be the case.

## B. Implications for Corporate Boards

We have demonstrated that lockups do in fact put up significant barriers against outsiders overbidding a transaction protected by a lockup. The question for a target board member, then, is whether he or she wants to foreclose potentially higher-value offers by agreeing to a lockup. On the one hand, directors would and should be genuinely concerned about particular bids or bidders (unfinanced bids, bids that violate the antitrust or disclosure laws, bids by felons or looters). Moreover, a full-blown auction can create real costs for the company that board members may legitimately want to avoid. Finally, attractive bidders may legitimately seek some insurance against the

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<sup>186</sup> See Figure 2.

<sup>187</sup> [get SDC data on deal expenses]

<sup>188</sup> See, e.g., Exxon/Mobil merger (\$2.5 billion breakup fee); MCI/Sprint merger (\$2.5 billion breakup fee); Warner-Lambert/American Home Products merger (\$2.0 billion breakup fee).

<sup>189</sup> See note 91 supra.

risk that a higher bid will emerge during the legally required period of vulnerability between signing and shareholder approval, particularly if that period must be longer than usual. Our results show that lockups can protect against unwanted bids, and thus control and manage a sale process to prevent value deterioration. If that is true, lockups are in fact of value to bidders, and should be viewed as an important bargaining tool by target boards. Although it will often be impossible to separate out precisely what a target gets in return for a lockup, no target board should accept the view that a lockup is so “standard” that no quid pro quo should be expected.

On the other hand, the very reason that the law requires a period of vulnerability between signing and shareholder approval – *i.e.*, shareholders and not directors bear the risks and costs of ownership, and retain important veto rights over significant transactions – should indicate the limits of lockups. Barriers that effectively eliminate the likelihood that higher-valuing bidders will even consider making alternative proposals undermine shareholder power, and will both impair the capital markets and make a political or legal backlash more likely. In the context of so-called “pooling-killer” lockups, [Interviewee C] of [firm] describes his counsel to boards of directors as follows:

You [the lawyer] have to tell the board, “Look, this may stop anyone else from coming in and doing an overbid. Even though, as a legal matter, you may argue that you’re not for sale, as a business matter, do you really want to agree to something that’s going to prohibit anyone else in the world who needs to do a pooling deal from coming in and topping it? Is that what you want to do as a business matter for your shareholders? Forget about legal liability.” And I think in those circumstances, the board would basically say, “I’m not doing that. Sure, the lawyers tell me that I can do that, but I don’t want to do that.”<sup>190</sup>

Our theoretical model and empirical data show that the same advice could and should be given to boards of directors facing regular (*i.e.*, non-pooling-killer) lockups as well.

In many circumstances, a corporate board focused on maximizing shareholder value would be hard-pressed to justify granting lockups to second-bidders (at least until the end of a open auction process). We also believe that before granting a lockup of any sort, a well-motivated board would want good evidence of costs the bidder could expect to incur as a result of losing to a higher bid. To be legally useful, the virtues of any lockup will need to be not only real but demonstrable. Boards should only grant such lockups where

doing so does not undermine a process that would otherwise increase shareholder value. Just as the Trans Union board found itself personally liable for approving a transaction (including a lockup) without fully understanding its implications, any target board should assume – regardless of whether courts follow our suggestions above – that courts may view a lockup approved hastily or without adequate rationale with suspicion and skepticism. Bidders, too, must understand the need for process: a lockup shoved down the throats of an unwilling target board will certainly mean ugly depositions in an expensive shareholder lawsuit, and may well mean the lockup will be enjoined – and thus worth exactly what the bidder paid for it.

If a board decides in the end that a lockup is warranted, our model provides some interesting (and somewhat counterintuitive) insights on the structure that minimizes the effect of buy-side distortions. First, as pointed out in Part IV, a stock lockup minimizes the impact of buy-side distortions relative to a breakup fee. All other things being equal, a target board should prefer a stock lockup to a breakup fee of equal value. Second, among stock lockups of equal value, a larger lockup with a higher strike price should be preferred by a target board to a smaller lockup with a lower strike price. This move would shift more of the present value of the lockup from embedded value<sup>191</sup> to value that is contingent on the emergence of a higher-valuing bidder. Alternatively, appropriately structured “topping fees” based not on the initial deal size but on the amount by which a bust-up bid exceeds the initial bid may provide equivalent results. In both cases, the contingent nature of stock lockup and topping fee payouts provides the recipient with appropriate compensation for losing a bidding war and helps overcome the perverse and inefficient effects of buy-side distortions. Such lockup structures, in other words, are better for both target and bidder shareholders.

## **VII. Conclusion**

Some practitioners hesitate to call lockups by that name because the term raises the specter of bid foreclosure, which is anathema to auction proponents and, perhaps

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<sup>190</sup> Interview C, transcript at 5.

<sup>191</sup> Defined as the difference between the strike price and the current market price.

more importantly, may create problems in court.<sup>192</sup> Other practitioners feel comfortable talking about lockups as deal protection,<sup>193</sup> but might characterize them differently in public. As [Interviewee D] of [firm] explains:

You end up with some lawyers who, for example, feel passionately that you've got to make a record that all thinking about termination fees is compensation for lost opportunity cost. And you can't talk about the vernacular of deal protection at all. And there are other lawyers who aren't particularly shook up about that. You've heard about 'Anatomy of a Murder,' where the lawyer coaches his client without actually saying anything.<sup>194</sup>

In a striking consensus of academics and practitioners, several theoretical models have been put forward to explain why lockups cannot and do not protect deals from outside interlopers. This Article first takes on this line of reasoning from the academy, arguing first that foreclosing lockups do exist as an empirical matter, and second, that the theoretical models that have been put forward to date are flawed because they do not incorporate five buy-side distortions. Once these distortions are incorporated into the model, we see how lockups can in fact protect deals from third-party higher-value bidders. We then use empirical data to show that practitioners who argue that lockups cannot prevent higher-value bidders from entering the deal are misestimating the impact that lockups have had.<sup>195</sup> In fact, empirical data from twelve years of M&A activity in the United States shows that lockups significantly increase the likelihood that the initial deal will be consummated.

Lockups should be recognized for what they are – deal protection. Once this conceptual barrier has been crossed, academics can assist courts and boards in responding to them more effectively. In particular, courts should not rubber-stamp lockups under the business judgment rule or rely on bright-line rules of thumb to approve lockups simply because they are a small percentage of deal value. Instead, they should use a *Revlon*-like

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<sup>192</sup> See, e.g., Interview K, transcript at 2 (“I don’t like to use the word ‘lockup’ for a number of different reasons – it’s not a very user-friendly word.”).

<sup>193</sup> See, e.g., Interview D, transcript at 1 (“Q: Do you think about [lockups] in terms of deal protection, or is it simply compensation in the event that the deal falls through? A: No, it’s generally about deal protection.”).

<sup>194</sup> See Interview H, transcript at 1.

<sup>195</sup> See, e.g., Interview B, transcript at 2 (“The others who want to come into the deal will come in anyway.”); Interview E, notes at 1 (“Maybe a 15% lockup would keep somebody out, but 2-3% isn’t going to make much of a difference.”).

analysis to evaluate carefully lockup timing, whether a lockup was necessary to induce a bid, whether the expected value of a lockup is a reasonable measure of pre- and post-bid switching costs (including opportunity costs), and whether (given the nature of bidder, target and their businesses) it is likely the lockup will exacerbate irrational or disloyal bidder behavior. In general, courts should view stock lockups more favorably than breakup fees, contrary to conventional wisdom, to reduce distortions on the buy-side.

Of course, the better place to curtail inefficient lockups is before they reach the courts. Advice from lawyers and bankers that lockups are not “undue impediments” to other bidders is contradicted by the weight of the empirical evidence.<sup>196</sup> Corporate boards of directors should think carefully about whether they want or need to limit themselves to the bidder currently at the table. If so, they should recognize that lockups that comply with the law reduce risk and are worth money to bidders, and that a bidder may be indifferent as between different types of lockups which nevertheless are likely to have better and worse effects on deal outcomes. In all events, target boards should consider how they can get the best value for any lockup they grant.

The net result of these changes would be improved allocational efficiency in the market for corporate control. Such reform is critical as lockups continue to gain popularity in major M&A deals today. Lockups have been misestimated by practitioners and misunderstood by academics. In this Article, we have attempted to shed some light on the debate. To paraphrase Freud, sometimes a lockup is just a lockup.

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<sup>196</sup> See Interview I, transcript at 2 (“It tends to be the lawyers [negotiating lockups], being able to tell the investment bankers, ‘Hey, when you get into the board room, you’re going to have to make sure you tell the board that you don’t think that whatever it is that’s been agreed to would be an undue impediment.’ And that’s something I try to get investment bankers to tell boards, because that is the underpinning under the case law of what it should be. You’ll inform management as to what’s going on, and you’ll ultimately tell the board, and the board will say ‘Is this normal?’ and you’ll say yes.”).