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Regulating Post-Bid Embedded Defenses: Lessons from Oracle versus PeopleSoft

Jennifer Arlen*

This article shows that courts should not adopt a rule of strict shareholder choice that requires managers to obtain shareholder consent for actions taken post-bid that could deter a hostile acquisition. Managers need to be able to act unilaterally to protect the target when a hostile bid threatens its value. Such threats require managerial action, unfettered by a shareholder approval requirement, when the target needs to be able to respond quickly. The conclusion that shareholders can benefit from granting managers unilateral authority to adopt some takeover defenses, even when shareholders are well-informed, is well-illustrated by the Oracle-PeopleSoft contest. PeopleSoft's shareholders would have been worse off had their managers not been able to defend the firm from the threat posed by Oracle's bid because PeopleSoft's shareholders could not have acted sufficiently quickly to preserve the firm's value. In addition, this article shows that shareholder choice proponents cannot remedy the over-regulation problem by amending the rule to grant managers authority to adopt some post-bid defenses. Such a rule would create a zone of weakly regulated low-cost defenses within a strict shareholder choice regime, thereby encouraging managers to employ substitute defenses that may be more costly for the firm than are traditional takeover defenses.

Most corporate law scholars agree that managers should not enjoy unfettered discretion to use takeover defenses to interfere with target shareholders' ability to accept (or reject) a hostile acquisition. Managers should not retain their normal authority over the firm – even though they are the best informed decision-makers – because they cannot be relied on to use their superior information to benefit shareholders once a hostile bid has been made. Faced with the threat of being fired should a hostile bid succeed, managers often intervene to resist a hostile acquisition even if the deal would benefit the targets' shareholders. Managers also use their power to get substantial private benefits from acquirers, at shareholders' expense. Indeed, the desire to survive is so fundamental to human nature, that it would be unusual if managers did not protect themselves from a threat to their livelihood.¹ Managers, thus, cannot be given – and are not given – unfettered authority to determine the success of a hostile bid.

Yet the question remains, should managers retain any authority at all? Some scholars argue that the answer is no: shareholders, not managers, should determine whether the firm should accept or reject a hostile offer. These scholars argue that

* Norma Z. Paige Professor of Law, New York University School of Law. I would like to thank the following people for helpful discussions about or comments on this article: Marcel Kahan, Victor Lewkow, Robert Lee Hotz, Vice Chancellor Leo Strine, Jr., Guhan Subramanian, Eric Talley, and participants at the Harvard Law School symposium on Deal-Making and Strategic Negotiation. I would also like to thank my research assistant, Xin Yu.

¹ See, e.g., James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. Fin. Econ. 63, 88-94 (1994) (offering empirical support for the claim that managerial resistance to tender offers appear to be driven by managers' self-interest, rather than shareholders' interests); see also Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. Fin. 671, 677 (1991) (“The dramatic increase in the turnover rate of top managers following takeovers...indicates that takeovers are an important device for altering the top management of target firms...”).

shareholders can best be protected by a rule of strict shareholder choice that requires managers to obtain shareholder consent for any action they want to take or maintain post-bid that could deter a hostile acquisition, even if the board could undertake the action unilaterally absent a hostile bid.² This rule appears to be finding increasing favor with institutional investors, who are offering a growing number of shareholder proposals aimed at curbing managers' authority over acquisitions.

But absolute shareholder choice is not the answer to the problem of managerial self-interest because target managers are not the only people who threaten the welfare of target shareholders during a contest for control. Acquirers also can act in ways that undermine the target's value. In these situations, target managers may be the only people able to protect the target. Target shareholders could be hurt if courts precluded managers from acting quickly to defend the firm from a hostile bid. Accordingly, the existence of post-bid defenses that potentially serve legitimate business purposes (hereinafter, post-bid embedded defenses) undermines the claim that strict shareholder choice necessarily improves shareholders' welfare.

Moreover, post-bid embedded defenses present a challenge for strict shareholder choice whether or not courts modify the rule to permit managers authority to adopt post-bid defenses that protect the target from the bidder. Indeed, modified strict shareholder choice would likely be more costly for shareholders than the more absolute rule. All strict shareholder choice rules are potentially costly for shareholders, because they encourage managers to substitute out of regulated defenses and into weakly regulated embedded defenses that may be more costly for the firm.³ But modified strict shareholder choice is even more costly than its stricter cousin because modified strict shareholder choice opens up a zone of weakly

² The strongest arguments against board authority to adopt takeover defenses can be found in a series of articles by Lucian Bebchuk, e.g., Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (hereinafter, Board Veto); Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (hereinafter, Shareholder Power). Other arguments for shareholder choice include Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 559-63 (2002) (arguing that managers should be allowed to "Just Say No" to a bid subject to a shareholder veto at the next meeting, but should not maintain a defense that allows it to "Just Say Never"); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1194-1204 (1981) (arguing that managers should be completely passive in the face of a bid); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 848-65 (1981) (arguing for shareholder authority over tender offers).

³ Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 UNIV. PENN. L. REV. 577 (2003). Other articles discussing defenses that can be characterized as "embedded defenses" include Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 954 (1993) (discussing managers' defensive use of debt covenants with change of control puts triggered only by a hostile offer prior to Delaware's embrace of "Just Say No"); Lucian Ayre Bebchuk et. al., *Stock Pyramids, Cross Ownership, and Dual Class Equity: The Mechanism and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck, ed. 2002) (showing how managers can use pyramids, cross-holding structures, and dual class stock to deter hostile tender offers); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 1006-07 (1994) (discussing managers' ability to use the issuance of preferred stock to those friendly to corporate insiders to defend against a hostile offer).

regulated post-bid embedded defenses. Post-bid embedded defenses are a far more tempting target for strategic defense substitution than are pre-bid embedded defenses because they allow managers to deter a hostile bid without reducing the likelihood of a friendly deal.⁴ Managers do not want to deter friendly deals because these deals give managers substantial private benefits. Accordingly, all else equal, managers are more likely to adopt costly substitute defenses under a modified strict shareholder choice than under a strict shareholder choice rule because the latter enables them to target defenses at hostile bids, without burdening friendly ones. These defenses may be worse for shareholders than pure defenses -- even if they are less effective at deterring a hostile bid -- because they impose costs on the firm even if the target eventually decides to accept the acquisition.

To see the twin challenges for strict shareholder choice created by the existence of post-bid embedded defenses we need look no further than the contest between Oracle and PeopleSoft. The Oracle-PeopleSoft contest demonstrates the direct cost of strict shareholder choice because, in that case, Oracle's bid likely would have harmed PeopleSoft had PeopleSoft's managers not enjoyed unilateral authority to adopt defenses designed to preserve the value of the firm. Oracle's bid for PeopleSoft threatened PeopleSoft's ability to obtain new customer contracts because customers were concerned that PeopleSoft would not honor its implicit long-run commitment to update its product and provide high quality service if Oracle gained control of PeopleSoft. These customers threatened not to contract with PeopleSoft in the shadow of Oracle's bid. The resulting reduced sales would have depressed PeopleSoft's share price. To avert this disaster, PeopleSoft adopted a "Customer Assurance Program" (CAP) that offered customers a refund worth many times the value of the contract, in the event of certain adverse events following an acquisition of PeopleSoft. As a result of the CAP, PeopleSoft had a successful quarter. PeopleSoft's managers were then able to induce Oracle to increase its bid by more than 60%.

PeopleSoft could not have protected itself from the threat posed by Oracle had its managers been prevented from taking unilateral action to defend the firm. PeopleSoft needed its managers to act quickly in order to guarantee strong quarterly earnings during the contest for control. It could not have achieved this goal had it been forced to delay its response in order to obtain shareholder approval.⁵ Application of a rule of strict shareholder choice to PeopleSoft's managers would have harmed PeopleSoft's shareholders more than they were harmed by any ill-advised actions managers took in an effort to save their jobs.⁶

⁴ Beyond this, pre-bid embedded defenses are available only to those managers who anticipated a bid. By contrast, managers employing post-bid defenses do not have to anticipate a hostile acquisition in advance.

⁵ Compare with Bebchuk, *supra* note 2 (arguing that managers should submit post-bid actions, such as mergers with White Knights, to shareholder vote).

⁶ This conclusion is not inconsistent with Arlen & Talley, *supra* note 3, at 622-23. Arlen & Talley presented PeopleSoft's change of control provisions as an example of an embedded defense, but then acknowledged that, under a strict shareholder choice rule, this post-bid embedded defense would be more vulnerable to challenge than would a pre-bid embedded defenses because shareholder choice encourages courts to exercise more authority over post-bid defenses. By contrast, a similar provision adopted pre-bid would likely get business judgment protection (if applicable to any change

Accordingly, the PeopleSoft case reveals that courts cannot adopt a rule of strict shareholder choice without harming target firm shareholders in some circumstances. The rule is particularly likely to be detrimental when the bid threatens the target's value unless the firm is able to respond quickly. For example, managers must have unilateral authority to offer third parties financial assurances when a potential acquisition undermines the target's ability to enter into long-term relational contracts with third parties.⁷ Accordingly, strict shareholder choice would harm some target's shareholders by preventing managers from using such measures even when they serve legitimate value-enhancing purposes.

In addition, the Oracle-PeopleSoft contest illustrates why shareholder choice proponents cannot remedy the over-regulation problem associated with strict shareholder choice by amending the rule to grant managers authority to adopt some post-bid defenses. Permitting this zone of weakly regulated defenses within a strict shareholder choice regime would create a tempting opportunity for defense substitution that would be costly for shareholders. Even a legitimate post-bid defense, such as PeopleSoft's CAP, is likely to be abused if managers have little other recourse. While PeopleSoft's initial CAP appears to have been primarily motivated by a desire to protect its customer relationships, it is likely that PeopleSoft managers were largely motivated by entrenchment concerns when they amended the CAPs to increase Oracle's potential liability to their customers. Moreover, although PeopleSoft in the end was unable to use its CAP to block Oracle's bid, PeopleSoft's arguably legitimate use of its CAP opens the door for other managers to use similar, potentially more effective, measures to fend off an acquirer.⁸ In addition, managers with legitimate reasons for using such measures would be likely to distort them to serve the additional goal of entrenchment if precluded from using other less costly defenses. Indeed, PeopleSoft's managers appear to have responded, over time, to their own inability to use traditional defenses by distorting CAPs to push the penalties beyond the amounts needed to serve PeopleSoft's legitimate interests in protecting customers.⁹

Accordingly, absolute shareholder choice is not the answer to the problem that managers may act to protect themselves when threatened with a hostile bid. While managerial agency costs are substantial, managers are not the only threat that target shareholders face. Some times the bidder is the threat. Given this, strict

of control), whereas this post-bid provision would get closer scrutiny (as in fact happened). Arlen & Talley did not address the issue of whether courts would benefit or harm shareholders if they regulated the type of post-bid embedded defenses at issue in the PeopleSoft case. This article examines this issue.

⁷ Courts cannot aggressively regulate such measures because such target firms cannot obtain the benefit of such assurances if they fear that courts will invalidate them whenever they deter a hostile bid. Similarly, courts cannot rely on a shareholder approval requirement to regulate them, because firms cannot get the benefit of these measures unless they can adopt them quickly.

⁸ While in the end, PeopleSoft and Oracle did agree to a friendly deal, the contest highlights the potential that CAPs and other such measures could have to deter deals (or challenge value to third parties), especially if designed by managers intent on so doing (instead of by a sale department intent on preserving its customer base).

⁹ Although PeopleSoft was not subject to a rule of strict shareholder choice, its managers were not able to utilize pure defenses effectively because of poor pre-bid planning.

shareholder choice may harm shareholders by precluding managers from acting quickly and unilaterally to defend the target from the consequences of the hostile bid. Yet courts also could harm shareholders by slightly modifying the rule to accommodate certain post-bid defenses because this would induce many managers to employ substitute defenses that impose greater burdens on the firm than do standard (pure) defenses.¹⁰

This analysis suggests that there does not exist a uniform optimal rule to govern takeover defenses because the costs and benefits of managerial authority (and its regulation) vary widely across firms.¹¹ Thus the best solution to the takeover defense problem may lie in more permissive judicially-imposed rules governing managerial authority coupled with legal reforms to facilitate optimal contracting between managers and shareholders over the proper allocation of authority over tender offer defenses for any given firm.

This article is organized as follows. Section I shows that strict shareholder choice can harm target shareholders. The strictest version would harm targets by precluding managers from adopting value-enhancing defenses that only managers are capable of adopting effectively. The modified version would harm targets by inducing managers to make excessive use of post-bid embedded defenses to the detriment of shareholders. Section II uses the Oracle versus PeopleSoft contest to demonstrate both the existence of time-dependent value-enhancing defenses and the defense substitution danger presented by such defenses should courts prevent managers from using pure defenses.

I. THE COSTS OF STRICT SHAREHOLDER CHOICE

This section presents the central argument for strict shareholder choice and then shows that this rule can harm shareholders because there exist circumstances where firms benefit from managers' ability to adopt post-bid embedded defenses unilaterally. Post-bid embedded defenses present one of two problems for shareholder choice. One problem can be characterized as a problem of over-regulation: shareholder choice would harm some firms by precluding managers from adopting defenses for legitimate shareholder-regarding reasons that shareholders cannot adopt themselves. The other is a problem of under-regulation. To the extent that courts modify shareholder choice to allow managers to adopt post-bid embedded defenses, shareholder choice could harm firms by inducing managers to substitute out of the relatively low cost pure defenses that they favor today and into defenses that may be more costly for the firms.

A. THE CASE FOR ABSOLUTE SHAREHOLDER AUTHORITY OVER TENDER OFFERS

¹⁰ Unregulable defenses may be more costly because they deter friendly and hostile deals alike, or because they channel some of the benefits of the deal to third parties.

¹¹ Arlen & Talley, *supra* note . This suggests that the current effort by institutional shareholders to adopt firm-specific limitations on defenses may be preferable to a court-adopted rule of absolute shareholder choice.

A central premise of corporate law is that shareholders must grant managers unfettered authority to make business decisions on behalf of publicly held firms in the ordinary course of business. Managerial authority serves shareholders by ensuring that business decisions are made by experts, free from interference by shareholders (or courts), who are less informed about the firm. Shareholders have neither enough information about the firm nor enough expertise in the field to manage a publicly held firm effectively. Firms managed by shareholders also would be harmed by the inevitable delay associated with shareholder voting. Given this, most scholars accept that shareholders benefit when they delegate management to more expert professionals, who can make decisions expeditiously, notwithstanding the fact that these managers' preferences may not be perfectly aligned with those of shareholders.¹²

Nevertheless, while most corporate law scholars agree that managers should enjoy broad authority to manage the firm in the ordinary course of business, many argue that this authority should not extend to a right to take actions that would deter (or increase the cost of) a hostile takeover bid.¹³ Managerial authority to adopt takeover defenses can harm shareholders because managers are only human. Tender offers often presage managers' termination. Faced with such a threat, managers are likely to use any means available to them to either fend off the bid altogether, or transform the bid into a friendly deal that grants them large benefits. Managers may intervene to deter (or alter) the deal even when their actions harm shareholders. Managers have many tools at their disposal to enable them to fend off a hostile bid and can implement such measures without first seeking shareholder approval. Shareholders have limited ability to seize authority over takeover decisions absent court intervention.

The question is, how aggressively should courts intervene to limit managers' authority to adopt or maintain takeover defenses once a bidder announces a hostile bid. Courts and scholars have long debated this question. The issue has proven intractable because interfering with managers' prerogative to run the firm is far from costless. One problem courts face is that the set of actions that managers might take to defend against a bid includes not only pure defenses (whose only purpose is to deter a bid) but also measures that both serve legitimate business purposes and

¹² E.g., Bebchuk, Board Veto, *supra* note 2, at 996. Indeed, the central premise of Delaware 141(a) is that management should have unfettered authority to make business decisions, free from interference by shareholders. In order to ensure that shareholders have the benefit of informed centralized management, Delaware law disables shareholders from managing the firm. Shareholders cannot draft bylaws that grant them the right to veto major contracts. They have no right to be informed about, or advise the board, on most major business transactions (other than a few firm altering decisions, such as mergers and a sale of substantial assets). Consistent with this, the Business Judgment Rule effectively precludes shareholders from interfering with management decisions after-the-fact, by precluding suits that only allege a given business decision was harming the firm. In the case of ordinary business transactions, it is assumed that shareholders are better off attempting to regulate agency costs indirectly, through incentive contracts, voting and the market for corporate control.

¹³ The strongest arguments against board authority to adopt takeover defenses can be found in a series of articles by Lucian Bebchuk, e.g., see *supra* note 2. Another, more moderate, proposal to cabin managers' authority to adopt takeover defenses is presented in Black & Kraakman, *supra* note 2.

potentially deter bids (hereinafter “embedded defenses”).¹⁴ Embedded defenses include actions such as friendly mergers with alternative bidders and corporate restructurings that managers claim enhance firm value more than would selling the firm to the hostile bidder. Proponents of managerial choice argue that managers’ superior expertise justifies granting them authority to defend the firm whenever they believe doing so enhances long-run value.¹⁵

Proponents of strict shareholder choice argue that managers should not be granted authority to adopt any defenses – not even embedded defenses – because the announcement of a hostile bid both reduces the benefit of managerial authority and increases shareholders’ ability to assert authority over the firm themselves. In the shadow of a tender offer, the benefit of managerial authority plummets because managers faced with a hostile offer that presages their termination cannot possibly evaluate the offer purely based on what is best for shareholders. They cannot help but try to either prevent a deal that would cost them their jobs or make sure that they obtain huge private benefits if the deal goes through. Either course would reduce the gains to shareholders. Thus, in the takeover context, managers cannot be relied upon to act in shareholders’ best interests.¹⁶

Moreover, a hostile bid not only reduces the benefit of managerial authority, it also increases the likelihood that shareholders will be able to decide matters for themselves. Although shareholders have neither the requisite incentives to become sufficiently informed to manage the firm nor the expertise needed to do so in the ordinary course of business, shareholders arguably may have both the incentives and expertise needed to determine what course of action is best for the firm once a hostile bid is announced. A tender offer is a rare event with enormous consequences for shareholders. The magnitude of the stakes are large enough to give sophisticated individual and institutional shareholders ample incentives to acquire the information needed to evaluate both the proposed deal and any alternative business plans that the target’s managers prefer.¹⁷ Moreover, because many takeover contests entail

¹⁴ Arlen & Talley, *supra* note 3 (defining the terms pure and embedded defenses).

¹⁵ Martin Lipton was one of the earliest proponents of the view that board authority over takeovers benefits shareholders by, for example, allowing boards both to pursue long run profits (over short run stock price) and to negotiate effectively with bidders in the firm’s best interests. Martin Lipton, *Takeover Bids in the Target’s Boardroom*, 35 BUS. LAW. 101 (1979). Others who suggest that director authority may benefit shareholders include Marcel Kahan & Edward Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 463, 484-88 (2003) (boards are better able to implement a selling strategy than are shareholders); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); see also Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 171-76 (1987) (finding that certain antitakeover provisions may benefit small shareholders).

¹⁶ For a discussion of how shareholders may be able to use contractual mechanisms, such as options, to mute this agency cost see Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 896-97 (2002) (arguing that managerial choice is less costly than many assert because shareholders have employed adaptive mechanisms, such as executive incentive compensation, to mute the agency costs associated with managerial choice).

¹⁷ E.g., Bebchuk, *supra* note 2, at 991-94, 1003; Gilson, *supra* note 2, at 845-48 (1981) (managers should not be able to block hostile offers); see Black & Kraakman, *supra* note 2, at 524-25

considerable delay – and likely require a shareholder vote if successful¹⁸ -- little is likely to be lost by introducing the delay associated with shareholder voting over whether to accept or defend against a hostile bid, it is argued.

Faith in shareholders' ability to manage firms post-bid has prompted a number of leading scholars to call on Delaware to place greater limits on managers' ability to unilaterally adopt or maintain anti-takeover defenses post-bid. The strongest of these shareholder choice proposals calls on courts to require managers to submit any and all hostile bids to shareholders for a vote (along with any post-bid measures that would impede the bid), even when the board is not putting the firm up for sale.¹⁹ Under this approach, a board could not maintain a defense – such as a poison pill – in the face of a hostile bid without shareholder approval. Moreover, managers would be precluded from taking any action post-bid that potentially deters the bid without shareholder approval. For example, managers seeking to pursue a friendly acquisition of one firm, instead of a hostile deal with another, would have to obtain shareholder approval before completing the acquisition, if doing so would deter the hostile bid. It is argued that this rule would benefit shareholders by encouraging hostile bids – which discipline managers. It also would increase the gain to shareholders of successful deals by reducing managers' ability to use their authority to reap private benefits. The cost of this rule would be small.²⁰

Yet the cost of requiring shareholders to assume ultimate authority over tender offers is not as low as shareholder choice proponents claim. Indeed, for some firms the costs may be significant. Strict shareholder choice presents two potential problems for shareholders. First, strict shareholder choice would preclude managers from taking value-enhancing actions that shareholders cannot take. Second, it could increase the cost to some shareholders of managers' quest for entrenchment by inducing managers to substitute into unregulated (or weakly regulated) defensive measures that impose higher costs on the firm. The problem of defense substitution is omnipresent but is enhanced if courts attempt to ameliorate the problem of over-regulation by allowing managers discretion to adopt some measures post-bid.

B. OVER-REGULATION OF VALUE-ENHANCING POST-BID EMBEDDED DEFENSES

Leading shareholder choice proponents assume that shareholders have little reason to delegate authority to managers once a bid is announced because, in that situation, shareholders can and will obtain the information they need to make

(2002) (more shareholder authority over tender offers is preferable to an approach that allows managers to act unilaterally to deter a bid in order to obtain long-run profits).

¹⁸ Successful tender offers are often followed by a merger which requires a vote of the shareholders of the target. In addition, some acquirers may need their shareholders to approve any acquisition.

¹⁹ For a defense of this position see Bebchuk, *supra* note 2.

²⁰ Shareholders may fare better under hostile bids than friendly deals, because managers pursuing friendly deals can negotiate lucrative side arrangements which reduce the amount bidders are willing to pay to shareholders. Bebchuk, *supra* note 2. But see Kahan & Rock, *supra* note 16 (arguing that managerial choice may enhance returns to shareholders by enabling managers to precommit to a selling strategy).

decisions on behalf of the firm.²¹ Accordingly, they claim that shareholders have nothing to lose, and everything to gain, from a rule that requires managers to submit every hostile bid, along with every alternative post-bid action that managers would prefer, to shareholders for a vote.²²

Yet, even when shareholders and managers are equally informed, shareholders may benefit from granting managers some authority to adopt tender offer defenses because managers are able to undertake actions to benefit the firm whose benefit would be lost if shareholder approval were required. Shareholders' and managers' relative decision-making capacity is not the only issue involved in the choice between managerial and shareholder authority over post-bid takeover responses.²³ Managers often are better able than shareholders to respond to a takeover bid, even when both groups are equally well informed, because managers can act much more quickly than can shareholders, and at considerably lower cost.

Managers may need to act to protect the target because target managers are not the only people who threaten the welfare of target shareholders. Bidders also can threaten their welfare. Moreover, not all threats take the form of openly coercive bids which arguably are subject to regulation by courts. A hostile bid can threaten to reduce the value of the target, even if it is an ostensibly non-coercive all cash/all shares bid, if it undermines the targets' ability to operate effectively during the takeover contest. For example, a bid can threaten the target by undermining its ability to enter into new contracts if customers or suppliers are reluctant to contract with a firm whose ownership is likely to change dramatically. When the bid threatens the value of the target unless the target acts immediately, shareholders obtain little benefit from their ability to sell the firm unless someone is able to act quickly and effectively to preserve the value of the target.²⁴ In this situation, managers must have authority to take unilateral action to defend the firm from the threat posed by the bid.²⁵

²¹ Bebchuk, *supra* note 2, at 1003. See Black & Kraakman, *supra* note 2, at 529 (discussing the view that shareholders are well-informed because disclosure gives them reasonably good information about firm value; they also often benefit from greater industry expertise and better comparative information about other companies). But see Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 814-17 (2005) (institutional shareholders are more informed than individual shareholders but are less informed than corporate managers because they are not directly involved in corporate operations).

²² See Bebchuk, *supra* note 2.

²³ This article focuses on one advantage to shareholders of managerial authority. For a discussion of another benefit see Kahan & Rock, *supra* note 16

²⁴ When customers care about the survival of the firm, the value of the firm is likely to be higher when managers have authority to adopt defenses, even if there is no takeover bid. Customers will pay more when they feel more secure about the firm's future. K.J. Cremers, Vinay B. Nair, Urs Peyer, *Weak Shareholder Rights: A Product Market Rationale* (April, 2006) (available on SSRN) (Arguing that takeover defenses may boost firm value when customers care about the survival of the firm and showing that, consistent with this, weak shareholder rights have no effect on profitability for firms in competitive markets).

²⁵ To the extent that post-bid embedded defenses benefit shareholders, shareholders would not benefit if courts adopted a rule of strict non-deferential court oversight of such measures. Contracting parties will not be willing to pay for the quality guaranteed by these contractual provisions if these provisions do not, in fact, operate as a guarantee because a court is likely to invalidate them in order to facilitate a hostile acquisition.

Managers are better able to respond to such threats than are shareholders because they can act immediately. Officers can take some actions the same day. The board also can act promptly by calling a meeting that can take place immediately. There are no long or expensive notice requirements. Moreover, if necessary, the board can meet by telephone conference call. By contrast, shareholders cannot act unless managers first call a shareholder meeting. This requires that the firm undertake the time and expense both to obtain regulators' approval for their proxy solicitation of shareholders and to send shareholders the requisite notice of the meeting and to obtain their proxies. This is a time-consuming process. It also is expensive. Accordingly, even when shareholders are informed, they can benefit from granting managers authority because managers can respond promptly to a threat posed by a bidder.

The benefits of managerial authority – and the cost of strict shareholder authority – are enhanced when the target is presented with a dynamic contest which requires the target to adjust its responses on a moment to moment basis in response to new actions by a bidder. While the delay and expense of one shareholder meeting might not be too large, the cost of shareholder authority is enormous once the firm has to hold multiple meetings to obtain approval for new measures necessitated by new actions by the bidder. Thus, even when shareholders and managers are equally competent at determining the correct course of action, shareholders may benefit from managerial authority to adopt defenses when the emergence of a hostile bid necessitates prompt action by the target.²⁶

Accordingly, when shareholders need managers to be able to act quickly, shareholders could be hurt by the adoption of shareholder choice because it would preclude shareholders from getting the benefit of timely managerial action to preserve the value of the firm. Shareholders of such firms may be better off under a rule that gives managers authority to adopt some post-bid defenses – perhaps coupled with private contractual arrangements that encourage managers to accept bids²⁷ – than they would be under a rule of strict shareholder choice.²⁸ This suggests that courts should not adopt a uniform rule of strict shareholder choice for all firms. It also suggests that institutional shareholders must take into account differences

²⁶ If shareholders are informed, prompt unilateral managerial action would not be needed if targets' appropriate responses to takeovers were limited to simply deciding whether to sell the firm or instead to pursue some alternative course of conduct. Yet this is not the only set of management decisions presented to those with authority to govern the firm post-bid. While deciding on the appropriate response to the bid, those governing the target also have to act to ensure that the target's value is preserved after the bid is announced. This may require prompt action by managers when the bid threatens the target's value.

²⁷ See Kahan & Rock, *supra* note 16, 896-97 (2002) (arguing that managerial choice is less costly than many assert because shareholders have employed adaptive mechanisms, such as executive incentive compensation, to mute the agency costs associated with managerial choice).

²⁸ Shareholders may realize this benefit both *ex post* and *ex ante*. Shareholders may benefit *ex ante* if acquirers' knowledge that managers have authority to respond deters them to structuring bids to threaten the target's value. Shareholders may benefit *ex post* if managers succeed in preserving the value of the target, increasing the return to target shareholders of either selling the firm or pursuing the long-run strategy that managers may prefer.

across firms and industries in the costs and benefits of adopting a strict shareholder choice rule in determining whether and when to support such a rule.

C. THE PROBLEM OF DEFENSE SUBSTITUTION

The existence of value-enhancing post-bid embedded defenses presents a challenge for proponents of strict shareholder choice whether courts apply it strictly to all post-bid defenses or adjust it to give managers' authority to adopt certain post-bid embedded defenses (a modified strict shareholder choice rule). Indeed, modified strict shareholder choice would likely be more costly for shareholders, in the aggregate, than would strict shareholder choice. Thus, were courts to attempt to remedy the problem of over-regulation of post-bid embedded defenses by granting managers limited authority over certain post-bid embedded defenses, they would benefit some firms at the expense of burdening many others. Accordingly, defense substitution precludes courts from addressing the over-regulation problem within a strict shareholder choice regime.

Defense Substitution

Any strict shareholder choice rule – that precludes managers from using pure defenses – can harm shareholders by inducing managers to substitute into alternative measures outside the reach of the rule.²⁹ Defense substitution is an unavoidable cost of adopting strict shareholder choice because it is not possible to prevent managers from adopting measures that deter hostile acquisitions. Even under the strongest shareholder choice regime, managers retain authority to structure ordinary business transactions to deter acquisitions. For example, they can agree to change of control provisions that require a large payment to a third party in the event of any change of control, whether friendly or hostile. Courts cannot prevent managers from using these provisions without trammeling on managers' authority because such provisions often are used for legitimate reasons.³⁰ Yet the existence of such unregulated provisions presents a strategic opportunity for managers seeking to deter a hostile

²⁹ Arlen & Talley, *supra* note 3.

³⁰ One available embedded defense is change of control provisions that protect third parties from the consequences of a change of control by granting the third parties a financial payoff in the event of a change of control. These penalty change of control provisions often are used to enhance firm value. Thus, any effort to expand shareholder choice to eliminate the use of such change of control provisions could be very damaging to those firms who use them to assuage legitimate concerns of third parties, in situations where third parties' interests cannot be adequately protected by contract. Arlen & Talley, *supra* note 3.

Nevertheless, penalty change of control provisions can be used improperly, to ward off hostile deals. Shareholders would be harmed should managers substitute into these provisions, instead of pure defenses, because, in order to avoid the restraints of strict shareholder choice, managers would need to write them broadly, to apply to both friendly and hostile deals. These broad provisions would harm shareholders by deterring the friendly deals from which shareholders currently derive considerable benefit. See Arlen & Talley, *supra* note 3, at 628-632 (discussing circumstances under which managers may respond to a strong shareholder choice regime by adopting embedded measures that deter friendly and hostile deals alike).

bid. It can be expected that managers subject to strict regulation of pure defenses would substitute into available embedded defenses not regulated by the rule.³¹

Defense substitution can be costly for shareholders because many impose greater costs on the firm than do pure defenses. Although pure defenses deter hostile bids, they do not otherwise reduce firm value and do not deter friendly deals.³² By contrast, most embedded defenses harm the firm whether or not a hostile bid emerges. For example, many reduce the expected probability, and gains to shareholders of, all changes of control – including the friendly deals that are the leading form of corporate combination and from which shareholders currently derive considerable benefit.³³ Accordingly, any strict shareholder choice rule could harm shareholders by inducing managers to employ substitute embedded defenses that are more costly for shareholders.³⁴

Implications for the Regulation of Post-Bid Embedded Defenses

While all strict shareholder choice rules encourage some defense substitution, the expected cost of defense substitution is greater under modified strict shareholder choice rules – that grant managers authority to adopt some post-bid embedded defenses – than under strict shareholder choice. Defense substitution is a problem because courts cannot reliably distinguish managers' legitimate from illegitimate post-bid embedded defenses. Thus, any effort to give some managers' authority to adopt value-enhancing post-bid embedded defenses would enable others to adopt defenses post-bid purely to deter a hostile bid. Accordingly, modified strict shareholder choice would exacerbate the cost of defense substitution because it would give managers the same incentives to substitute as a rule of strict shareholder choice, but expand the zone of unregulated defenses to include post-bid embedded defenses.³⁵

Modified strict shareholder choice is particularly likely to be costly for shareholders because managers are more likely to use substitute defenses when they can adopt them post-bid. All else equal, managers prefer post-bid embedded defenses to pre-bid embedded defenses because managers want to deter hostile deals without burdening the friendly ones that afford managers substantial private

³¹ See Arlen & Talley, *supra* note 3, at 605-628 (discussing available embedded defenses in more detail).

³² For an empirical analysis of the effectiveness of the poison pill when used with an “effective classified board,” see Lucian Bebchuk, John C. Coates IV, & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 *Stan. L. Rev.* 887 (2002).

³³ Pure defenses are easily identified as such in part through provisions that allow the board to retain control over the tender offer process. (For example, the redemption provision in poison pills). Consequently, regulation of pure defenses would require boards to adopt defensive measures that do not appear to be a pure defense, but instead appear to serve legitimate interests.

³⁴ Defense substitution presents a challenge for shareholder choice even when managers cannot avail themselves of post-bid embedded defenses, because managers almost always have available to them pre-bid embedded defenses. For a thorough discussion of the issue of defense substitution see Arlen & Talley, *supra* note 3.

³⁵ By contrast, managers who adopt pre-bid embedded defenses generally burden hostile and friendly deals alike. A strict shareholder choice rule in theory leaves pre-bid embedded defenses unregulated while regulated most post-bid embedded defenses. By contrast, a modified strict shareholder choice rule leaves unregulated both pre-bid embedded defenses and a class of post-bid embedded defenses.

benefits.³⁶ Accordingly, all else equal, managers are more likely to adopt a substitute defense if they can do so post-bid, because post-bid defenses can be targeted directly at hostile deals, whereas pre-bid embedded defenses usually burden hostile and friendly deals alike.³⁷

Taxonomy of Takeover Defenses

	Pre-Bid Actions	Post-Bid Actions
Pure Defenses: Affect Only Hostile Bid	Poison Pill Hostile-bid Trigger Poison Puts in Debt Contracts	Poison Pill Blank Check Preferred
Embedded Defenses: Non-defensive Justification for Action	Penalty Change of Control Provisions in Third-Party Contracts	Defensive Acquisitions Customer Assurance Program

This substitution can harm shareholders. Although post-bid defenses are less costly than pre-bid defenses, they nevertheless can be more costly than pure defenses (especially when managers' compensation agreements provide them some incentive to sell the firm). Many post-bid embedded defenses are costly because, once adopted, they impose costs on any change of control, even if managers eventually decide to agree to it. This is in contrast to pure defenses which managers can agree to rescind. As a result, relative to pure defenses, post-bid embedded defenses reduce the likelihood that the target's managers will be able to eventually negotiate a friendly deal; they also lower the value to target shareholders of any deal that does occur.

Modified shareholder choice, thus, does not solve the problem of value-enhancing post-bid embedded defenses. This rule would benefit those firms that

³⁶ Of course, this cost of pre-bid defenses may be less than it might seem. In a prior article, Eric Talley and I showed that one effect of a rule of absolute shareholder choice would be to reduce the benefit to managers of friendly deals. Managers gain less from friendly deals under absolute shareholder choice because raiders would now need to court shareholders, not managers, since shareholders would have all the power. In this case, a strong shareholder choice regime would eliminate the main factor deterring managers from using "blanket" embedded defenses that deter friendly and hostile deals alike. See Arlen & Talley, *supra* note 3. Nevertheless, even with a strong shareholder choice regime, managers are likely to enjoy sufficient bargaining power to reap some benefits from friendly deals. These benefits would serve as a potential disincentive to employ blanket defenses. Thus, the threat of defense substitution is heightened when there also exist substitute post-bid embedded defenses.

³⁷ Under a strict shareholder choice rule, managers would have to use pre-bid embedded defenses that ostensibly apply to both friendly and hostile deals because courts will regulate measures limited to all hostile acquisitions because these are unlikely to mimic legitimate measures. Were strict shareholder choice expanded to allow hostile-trigger pre-bid conditions, then managers would use them. For a discussion of the extensive use of hostile-trigger penalty change of control provisions in debt covenants prior to Time/Warner see Marcel Kahan & Michael Klausner, *supra* note 3, at 935-36.

suffer from the over-regulation of post-bid defenses, but only at the expense of all those firms that would be hurt by managers' greater ability and willingness to employ costly substitute defenses to entrench themselves.

D. IMPLICATIONS

Accordingly, aggressive regulation of pure defenses may make shareholders worse off than they would be under a rule that grants managers authority to adopt pure defenses subject to court oversight. Shareholders could be worse off if courts adopt a uniform rule of strict shareholder choice because certain firms benefit when their managers can respond post-bid to a hostile raider. A uniform shareholder choice rule, thus, would threaten to hurt those firms. Yet courts could not remedy this problem by modifying the uniform rule to grant managers discretion over a limited set of post-bid defenses. While this modification would benefit firms hurt by the stricter rule, it would hurt many other firms. Other firms would be hurt because modified shareholder choice would encourage managers to seek substitute defenses that are relatively costless for managers, but costly for shareholders. Managers' embrace of post-bid embedded defenses would harm many firms.

A central problem with strict shareholder choice is its effort to adopt a uniform rule to govern all firms. The analysis above suggests that there does not exist a single shareholder choice rule that is optimal for all firms. Firms differ in their vulnerability to a hostile bid and in their vulnerability to costly defense substitution. This suggests that the best solution to the takeover defense problem may lie in relatively weak mandatory rules limiting defenses coupled with legal reforms that facilitate optimal contracting between managers and shareholders over the proper allocation of authority over tender offer defenses for any given firm.

II. ORACLE VS PEOPLESOFT AND THE PROBLEM OF POST-BID DEFENSES

The preceding claim that strict shareholder choice may harm shareholders depends on the claim that there exist post-bid embedded defenses that cannot be adequately regulated by granting shareholders authority over post-bid corporate actions.³⁸ This section evaluates the Oracle-PeopleSoft contest to show that circumstances do exist where target shareholders are better off when managers have unilateral authority to adopt post-bid defenses. The justifications for managerial action in this contest are likely to be present in other situations as well. This section then shows that modifying strict shareholder choice to grant managers freedom to adopt such defenses would both impose heavy costs on the firm and substantially enhance the likelihood that managers of other firms would use them purely for entrenchment purposes.

A. THE ORACLE PEOPLESOFT CONTEST

³⁸ This claim only depends in part on the existence of unregulable post-bid embedded defenses because, even if these defenses do not exist, pre-bid embedded defenses present a problem for shareholder choice. For a discussion of pre-bid embedded defenses see Arlen & Talley, *supra* note 3.

In June, 2003 Oracle announced that it wanted to pursue a hostile acquisition of PeopleSoft, one of its leading rivals in the enterprise application software business. Bidders truly seeking to accomplish a deal often try to design their bids to be as attractive to the target as possible. Oracle, by contrast, made a bid that was both unattractive and was structured in a way that was potentially damaging to PeopleSoft.

Oracle made its bid for PeopleSoft immediately following PeopleSoft's announcement that it was merging with one of its competitors, J.D. Edwards, to create the second largest firm in the industry.³⁹ Moreover, Oracle's bid was, by all accounts, a very low bid. Oracle's initial bid of \$16 was barely above the current market price, and was in fact below the 30-day average trading price.⁴⁰ Oracle's design to enter with a low bid introduced prior to the completion of PeopleSoft's merger appeared to be designed to damage PeopleSoft, by potentially undermining its deal with J.D. Edwards.⁴¹

Beyond its threat to PeopleSoft's recently announced merger, Oracle's bid threatened to reduce the value of PeopleSoft itself, by undermining its customers' willingness to enter into new contracts with PeopleSoft. Oracle's bid for PeopleSoft affected the market for PeopleSoft's products because PeopleSoft did not simply sell a product; it sold a long-run relationship whose value depended largely on its commitment to support its product. This was a commitment that Oracle did not appear to share. Customers purchasing enterprise software generally enter into long-run relational contracts with sellers, paying large amounts in return for the seller's promise to provide regular product updates and customer support in the future. These contracts usually do not impose precise obligations on the seller, because it is too difficult to contract over all the circumstances where an update might be needed. It also is difficult to specify adequate support. Instead, producers and customers rely on long-run relational contracts that are supported by the producers' reputation for quality.⁴² PeopleSoft had a strong reputation for good customer service and, in fact, derived substantial revenues from the fees its customers paid for both customer support and for the right to receive periodic updates. Customers depended on the

³⁹ Lynn Paine, Guhan Subramanian, and David Millstone, *Oracle vs. PeopleSoft (A)*, Harvard Business School Case Study N9-306-058 (October 31, 2005).

⁴⁰ *Id.* at 4. David Millstone & Guhan Subramanian, *Oracle v. PeopleSoft: A Case Study*, HARV. NEG. L.J. [p. 5 in draft] (2006)

⁴¹ The PeopleSoft/J.D. Edwards deal was vulnerable to a fall in the value of PeopleSoft stock because the deal contemplated J.D. Edwards' shareholders getting PeopleSoft stock in a fixed exchange ratio. A fall in the value of PeopleSoft shares would operate to the detriment of the J.D. Edwards shareholders, and could harm that deal. Cf. Millstone & Subramanian, *supra* note 40, at [5] (a large PeopleSoft investor stated that Oracle's announcement of its bid made Oracle sound like they had a "Machiavellian strategy" to destroy a competitor).

⁴² Customers depend heavily on the provider living up to its terms. Once a customer has committed to particular enterprise software it cannot easily switch. Installation and training often costs ten times the amount of the actual software; once a firm has organized its systems around one platform it cannot easily switch.

implicit understanding that PeopleSoft would undertake those updates and revisions that were needed. Without it, PeopleSoft's product was much less valuable to them.⁴³

Oracle's bid caused many potential customers to conclude that PeopleSoft would not provide them its traditional quality of service if Oracle gained control of PeopleSoft. While Oracle could have allayed these concerns if it had made strong public pronouncements that it would continue to invest in, upgrade and maintain the PeopleSoft platform, it chose not to do so. Indeed, Larry Ellison, Oracle's founder, chairman and co-President, announced that Oracle would "support but not actively market" PeopleSoft.⁴⁴ This statement left customers uncertain about whether Oracle would invest in updating and supporting PeopleSoft's product. Customers' concerns were heightened by statements of Oracle employees that Oracle's software, and not PeopleSoft's software, would be the surviving platform if Oracle acquired PeopleSoft.⁴⁵ Some analysts reported that Oracle would not support the PeopleSoft platform following the acquisition.⁴⁶ As a result, following Oracle's bid, many customers indicated their inclination to either purchase from another provider or delay their purchase, beyond the close of PeopleSoft's current quarter. This threatened fall in sales would have depressed PeopleSoft's share price, thereby hurting PeopleSoft's ability to either remain independent or bargain for a higher price.

⁴³ Millstone & Subramanian, *supra* note 40, at [5]. PeopleSoft's product, enterprise applications software, is extremely expensive. The product alone costs many customers hundreds of thousands, and some over a million, dollars. In addition to this, customers often must spend ten times this amount to install the product and integrate it into their systems. Firms that switch platforms cannot recover most of these costs. Thus, firms undertake these expenditures anticipating a medium-to-long run relationship with the supplier. The value – and indeed feasibility – of this long run relationship depends on the software vendor's willingness both to provide high quality customer support and to undertake regular software updates over a substantial period of time (5-10 years). E.g., Transcript of Testimony of Ken Harris, *Oracle v. PeopleSoft*, Del. Chanc. Ct 20377 (Trial Transcript Vol IV (10/7/04) p. 1043). Indeed, PeopleSoft derived substantial revenues from the fees its customers paid for both customer support and for the right to receive periodic updates. This latter contract (for updates) was, necessarily, incomplete in that it did not contractually obligate PeopleSoft to provide updates or to fix problems with the software. Customers depended on the implicit understanding that PeopleSoft would undertake those updates and revisions that were needed.

⁴⁴ Margaret Kane and Mike Ricciuti, *PeopleSoft Calls Oracle Bid Atrocious*, ZDNetNews, June 6, 2003, http://news.zdnet.com/2100-3513_22-1013893.html. See Plaintiff's Pre-Trial Brief, at 19 *Oracle v. PeopleSoft* (Del Ch.) (No. 20377).

⁴⁵ Indeed, on December 16, 2004, the California Superior Court concluded that PeopleSoft had presented admissible evidence that, immediately following its tender offer, Oracle announced that it planned to kill PeopleSoft's products and that PeopleSoft's platform would not be the surviving platform in the event of a merger. It also concluded that PeopleSoft had produced admissible evidence that Oracle had made other public statements designed to cause customers to doubt PeopleSoft's continued viability. *PeopleSoft v. Oracle*, Order Denying Oracle's Motion for Summary Adjudication on PeopleSoft's Claim for Intentional Interference with Prospective Economic Advantage, 2004 WL 3266120 (December 16, 2004). By contrast, Oracle claims it was not going to immediately kill PeopleSoft. Nevertheless, it did state that they were not going to actively market the product, which raised reasonable concerns about how much they would invest in both updating and supporting PeopleSoft's platform.

⁴⁶ *Oracle Corporation v. PeopleSoft, Inc.*, Plaintiff's Post-Trial Brief Concerning the Customer Assurance Program (Civil Action No. 20377 NC) (Public Redated Version) p. 6 & notes 5 & 6.

PeopleSoft thus found itself faced with a low-ball bid that appeared to be primarily intended to spoil PeopleSoft's own deal with J.D. Edwards. In addition, whether or not the bid was made in good faith, it presented a threat to PeopleSoft because PeopleSoft could neither defend against the low bid nor negotiate for a higher price unless it could demonstrate its ability to keep operating to the market.

PeopleSoft's managers responded to the threat presented by Oracle's bid by adopting a measure, called a "Customer Assurance Program" (CAP), that was designed to attract new customers by reassuring them that they would get the full value of PeopleSoft's product. PeopleSoft's CAP promised customers a refund worth many times the value of the contract, in the event of certain adverse events following an acquisition of PeopleSoft.⁴⁷ The potential liability on these contracts – if every customer exercised its right to be paid on them – eventually reached over \$2 billion.⁴⁸

The CAPs had their desired effect. PeopleSoft had a very strong second quarter of 2003 – exceeding industry estimates.⁴⁹ PeopleSoft and Oracle eventually negotiated a friendly deal that resulted in Oracle buying PeopleSoft (CAPs and all) for \$26.50 per share – a substantial increase over the initial offer.

B. PEOPLESOFT'S NEED FOR POST-BID DEFENSES

PeopleSoft's CAP is just the type of post-bid embedded defense that would be precluded by a rule of strict shareholder choice. The CAPs are most certainly post-bid embedded defenses targeted directly at a hostile bidder. Moreover, they were adopted unilaterally, without the consent of PeopleSoft's shareholders. Yet courts would not be correct to preclude managers from adopting them unilaterally.⁵⁰ PeopleSoft's shareholders benefited from the CAPs which enabled PeopleSoft both to retain its value and force Oracle to raise its bid substantially. PeopleSoft's shareholders could not have obtained these benefits of the CAPs had their validity turned on a shareholder vote because PeopleSoft needed the protection of the CAPs long before shareholder approval could have been obtained.

⁴⁷ The initial CAP agreements offered to pay customers twice their initial purchase price if two events occurred: (i) PeopleSoft was acquired within one year of the contract and (ii) the acquirer, any time within two years of the contract date, discontinued support services prior to the end of PeopleSoft's normal support term, stopped licensing PeopleSoft's products to new customers, or stopped providing updates or new releases for supportable products. Dawn Kawamoto, *PeopleSoft Guarantees May Be Costly*, ZDNetNews, July 3, 2003, http://news.zdnet.com/2100-3513_22-1023255.html?tag=nl. Over time, the terms of the CAP evolved. Eventually, it was amended so that customers would receive 2-5 times the licensing fee plus the first year's maintenance fee, if the CAP was triggered within a two or four year period, respectively (in the event of an acquisition). The final version was triggered only by an acquisition by Oracle. Millstone & Subramanian, *supra* note 40, at [12].

⁴⁸ Paine, Subramanian & Millstone, *supra* note 39, at 23.

⁴⁹ Oracle Corporation v. PeopleSoft, Inc., Defense Post-Trial Brief, at 14.

⁵⁰ In analyzing whether the CAPs were seriously vulnerable to challenge, this article focuses on whether the CAPS, by their very structure, were invalid. The article does not discuss the process PeopleSoft used for adopting the CAPs, because the focus of this article is on the relevance of the CAPs to future cases. Boards in future cases, armed with the information provided by the PeopleSoft case, should be able to avoid the procedural problems that afflicted PeopleSoft's managers.

As previously discussed, Oracle's bid threatened PeopleSoft's ability to use its reputation as a bond to guarantee its promise to provide good quality future service, thereby enabling it to enter into contracts for future services that were not precisely specified.⁵¹ Oracle's statement that it was not going to "actively market" PeopleSoft signaled that Oracle did not plan to invest long-term in PeopleSoft. This presented the risk that Oracle could undermine PeopleSoft's reputation for quality without suffering much loss – if it could channel customers to its own products.⁵² Unable to rely fully on its reputation to guarantee its future performance, PeopleSoft needed a substitute credible commitment mechanism. It needed to ensure that Oracle would have a financial incentive to support PeopleSoft's products even if it did not plan to invest in them in the future. PeopleSoft's promise to its customers that it would pay a large penalty if Oracle acquired PeopleSoft and quality fell was an effective way to bond Oracle to PeopleSoft's long-term contracts. This penalty reassured customers that Oracle would invest in their contracts, even if it did not invest in the long-run welfare of PeopleSoft, simply to avoid the penalty.⁵³ The CAPs, in other words, were an effective substitute for PeopleSoft's lost ability to contract based on its reputation.

The magnitude of the penalty PeopleSoft offered was large. Yet this does not necessarily indicate that the CAPs were primarily motivated by illegitimate entrenchment aims. Very large penalties were consistent with the purpose of the CAPs. The CAPs were designed to deter Oracle from reneging on PeopleSoft's long-standing commitments, and not just to compensate customers for future losses. PeopleSoft's customers needed near certainty that they could safely purchase from

⁵¹ Reputation can be a commitment mechanism when the benefits of a good reputation are sufficiently great that the firm cannot benefit from offering a lower quality product in the future, because the cost to it of the resulting decrease in revenues from future customers exceeds the benefit it could obtain from cutting quality on services provided to existing customers.

⁵² Managers of a firm that has received a hostile bid have many legitimate reasons to attempt to continue to maximize the value of the firm by continuing to contract with customers, suppliers and financiers. Shareholders are served when managers strive to maximize firm value whether or not shareholders want the firm sold. Shareholders seeking to sell the firm nevertheless benefit when managers maximize (or at least preserve) firm value because this enhances (or preserves) the firm's share price, which is an important determinant of the amount shareholders will receive. Managers also must continue to maximize firm value against the real possibility that the hostile bid will not result in a consummated acquisition. Finally, managers who genuinely believe that the firm should not be sold, serve their fiduciary duties when they attempt to preserve the long-run value of the firm (in the hope that shareholders will reject the unwanted offer). Managers' concern for preserving firm value may be particularly great when faced by a bid from a rival firm which management fears is bidding simply to hurt the target.

⁵³ The problem of how to credibly commit to provide high quality services when quality is determined post-contract and is non-contractible arises in other areas. A prime example is medical malpractice. For a discussion of the use of liability rules to solve the credible commitment problem in the malpractice context see Jennifer Arlen & W. Bentley MacLeod, *Torts, Expertise, and Authority: Liability of Physicians and Managed Care Organizations*, 36 *RAND Journal of Economics* 494 (2005); Jennifer Arlen & W. Bentley MacLeod, *Malpractice Liability for Physicians and Managed Care Organizations*, 78 *New York University Law Review* 1929 (2003). What is difficult about the PeopleSoft situation is that harm (or breach) was not clearly more easily identifiable *ex post* than it was possible to specify a standard of conduct *ex ante*. This resulted in PeopleSoft offering CAPs with vague terms governing what constitutes satisfactory quality service. PeopleSoft necessarily was relying on both the courts, and reputational pressures on customers, to ensure that the contracts were applied in a reasonable fashion.

PeopleSoft because any future problems would likely mean immediate job loss for the purchasing agent who elected to buy from PeopleSoft in the face of Oracle's bid and the resulting warnings in the press.⁵⁴

Moreover, adopting a CAP was not only a potentially reasonable response, it may have been superior to alternatives such as discounts and rebates. PeopleSoft's managers needed a response that ensured that its second quarter revenues did not suffer as a result of Oracle's bids. While it could have attracted customers through large discounts and rebates, offering such discounts would have adversely affected its profits per customer, both now and over the life of the contract. This could have depressed PeopleSoft's share price (and thus bargaining power).

PeopleSoft's CAP also is better than the alternatives Oracle preferred, such as offering customers source code escrows. These mechanisms do not enable PeopleSoft to compete effectively with its rivals since they do not enable PeopleSoft to commit to provide high quality long-term. They only mitigate the cost of customers, to some small degree, of any decision by Oracle to reduce support for PeopleSoft's products. For many customers, PeopleSoft's financial commitment to continue to support the product over the long-run was more valuable than any promise to share code, because the customer would be unlikely to have been able to use this code to provide the same quality upgrades and support that it could have obtained from PeopleSoft.

Nor can the CAP be presumed to be invalid simply because PeopleSoft did not adopt it until after Oracle made its bid. Prior to Oracle's hostile bid, PeopleSoft had no need for a CAP because it had its strong reputation for quality. Thus, before the hostile bid, PeopleSoft could only hurt itself by adopting a CAP because the CAP required it to define the trigger terms for the penalty, which in turn, required PeopleSoft to contract over quality terms that were, in fact, non-contractable.⁵⁵ As long as PeopleSoft was able to rely on its reputation to provide its customers with the assurances they wanted, PeopleSoft was better off not using CAPs.⁵⁶ Accordingly, there is nothing untoward about PeopleSoft's decision not to adopt a CAP until faced with Oracle's bid and general acquisition strategy.⁵⁷

⁵⁴ An important aspect of the CAPs is that their purpose was not to compensate customers for harms caused, but rather to reassure customers that the harms would not befall them (because the harms would be too expensive for PeopleSoft).

⁵⁵ Indeed, the reason software providers and customers rely on long-run relational contracting in the first place is that it is hard to define, *ex ante*, the software suppliers' obligation to support and upgrade its product.

⁵⁶ Nor should PeopleSoft have simply adopted a CAP to govern in the event of any change of control. PeopleSoft apparently was under no pressure from customers for protection from an unspecified bidder and PeopleSoft's managers would have legitimately wanted to avoid burdening a friendly deal. PeopleSoft did not face pressure from customers until Oracle's bid.

⁵⁷ Moreover, even if it would have been optimal for PeopleSoft to use CAPs pre-bid, their absence in PeopleSoft's earlier contracts would not imply that PeopleSoft did not legitimately need to adopt CAPs once Oracle bid. PeopleSoft failed to adopt many pre-bid defenses that arguably would have been sensible for managers to adopt because it did not obtain the best advice, pre-bid, on how to plan for the possibility of a hostile bid. John Coates, *Blame the Experts: PeopleSoft as a Case Study in Professional Service Market Failure*, [] HARV. NEG. L. REV. [] (2006). See also Guhan Subramanian, *Bargaining in the Shadow of PeopleSoft's (Defective) Poison Pill*, [] HARV. NEG. L. REV. [] (2006) (PeopleSoft had adopted an inadequate poison pill prior to Oracle's bid).

C. IMPLICATIONS FOR STRICT SHAREHOLDER CHOICE

The Oracle-PeopleSoft case reveals that courts cannot adopt a *per se* rule banning all unilateral board actions that deter hostile bids without harming the target shareholders of certain firms. Strict shareholder choice can be inferior to a more permissive rule even when shareholders are well informed, because even informed shareholders sometimes benefit when managers have authority to respond unilaterally to the threat posed by a hostile bid. Informed shareholder voting is, in theory, an effective tool to regulate managers' defensive use of long-run business arrangements,⁵⁸ but shareholder voting cannot be used effectively to regulate business transactions whose value is reduced (or eliminated) by delay.⁵⁹ Strict shareholder choice, therefore, creates an inevitable risk of excessive regulation of managers.

Shareholders are particularly likely to benefit from managerial authority over tender offer defenses when the target firm is vulnerable to uncertainty over control. As the PeopleSoft case reveals, managerial authority to respond post-bid may benefit firms that enter into large long-run relational contracts whose value to the third party (e.g., customer or supplier) could be materially reduced if the firm was acquired by a bidder who did not intend to invest in its long-run reputation.⁶⁰ When third parties value the contract less if the raider succeeds, managers may legitimately conclude that the firm is best off agreeing to change of control provisions, adopted post-bid, that are designed to deter the third party from reneging on the relational contracts between the target and the third parties. In such circumstances, managers may need the authority to adopt post-bid contracts that protect these third party relationships in order to enable it to respond adequately to the bid, whether that response is a defense or a decision to negotiate for a better price for target shareholders.⁶¹ Given this, firm value could be reduced if courts either freely invalidate all such provisions or impair management's ability to adopt them by subjecting them to a time-consuming shareholder vote requirement. Given this, a *per se* rule that in effect

⁵⁸ Bebchuk, *supra* note 2. For a critique of justifications for managerial choice flowing from long term firm value see Bebchuk, *supra* note 2; see also Black & Kraakman, *supra* note 2.

⁵⁹ Courts cannot solve the delay problem by adopting a rule that allows boards to obtain a shareholder vote after the measure is adopted. Third parties will not enter into contracts in reliance on a measure whose validity will not be determined until after a shareholder vote, many weeks hence. Thus, shareholder vote would in effect preclude firms from obtaining the immediate benefits of such measures, even if courts allowed managers to obtain the vote after the measure was adopted.

⁶⁰ Long run contracts cannot cover all contingencies relevant to the parties with sufficient specificity to completely protect contracting parties. Parties thus often rely on common understanding and subsequent negotiations to adjust the contract over time. The value to a third party of this relational contracting depends considerably on the identity of the other party, and thus the third party may care about the identity of management.

⁶¹ Target shareholders can affect whether the board chooses to defend or sell through the compensation package granted to the board. Boards can be motivated to sell through the grant of substantial options that have very long vesting periods normally, but which vest immediately upon a change of control. See Kahan & Rock, *supra* note 16 (discussing how shareholders can use compensation arrangements to affect boards' incentives to sell).

eliminates boards' authority to adopt such measures quickly would not necessarily be in shareholders' best interests.

D. MANAGERS' ABILITY TO MISUSE PEOPLESOFT'S EMBEDDED DEFENSE

Analysis of PeopleSoft's CAP program also shows why proponents of strict shareholder choice cannot ameliorate the problem of over-regulation of post-bid defenses by modifying their proposals to permit managers to adopt post-bid defenses designed to preserve the value of the firm. Indeed, the more permissive form of strict shareholder choice might be worse than the strictest form, so long as pure defenses remain strictly regulated.

As previously discussed, a rule that strictly regulates pure defenses while allowing managers to adopt some post-bid defenses would harm many firms because it would encourage managers to adopt costly substitute post-bid embedded defenses. These costs would affect both firms that benefit when managers have discretion to adopt post-bid embedded defenses and firms that do not necessarily need their managers to employ such defenses. The first type of firm could be hurt because aggressive regulation of pure defenses would encourage those managers who legitimately need to employ a post-bid embedded defense to implement a larger, more costly, measure than is justified because they are precluded from using low-cost pure defenses to protect their own private benefits. The second type of firm could be hurt because, as previously exemplified, modified strict shareholder choice would open up a zone of weakly regulated post-bid defenses. Thus, the adoption of this form of shareholder choice would encourage managers to adopt substitute post-bid embedded defenses that could be more costly for shareholders than pure defenses.

PeopleSoft's approach to its own CAPs provides an excellent example of managers responding to a lack of effective pure defenses by strategically altering an otherwise legitimate post-bid defense to enhance its deterrent capabilities.⁶² The first CAP, which was adopted by managers directly in response to customers' concerns, was relatively modest. The penalty was not enormous and only lasted for a limited period of time. Over time, PeopleSoft expanded the CAP so that it could be triggered if Oracle cut support anytime within four years of the contract and enhanced the penalty to up to five times the purchase price.⁶³ It is possible that this expansion was in response to customer demand for a large CAP. Yet it seems equally likely that PeopleSoft's managers decided to expand the temporal scope and size of the CAP because they realized that it could be designed to serve a secondary goal: deterring Oracle. In pushing the CAP above the level needed to attract customers,

⁶² For a discussion of why PeopleSoft was inadequately protected by the standard pure defenses employed by most firms, see Coates, *supra* note 57; see also Subramanian, *supra* note 57 (discussing deficiencies in PeopleSoft's poison pill).

⁶³ The first CAP that PeopleSoft adopted was relatively modest. It required that an acquisition occur within a year of the contract and only applied for two years after that. In the event that the CAP was triggered, the payment to customers was limited to two times the purchase price. Yet PeopleSoft eventually decided to extend the temporal reach of the CAPs (so that the CAP could be triggered by actions taken within four years of the contract date). It also greatly enhanced the penalty, which eventually could reach as high as five times the original purchase price in the event that the CAP was triggered. See Paine, Subramanian, Millstone, *Oracle vs. PeopleSoft (A)*, *supra* note 39, at 23.

PeopleSoft's managers potentially reduced the value to shareholders of the eventual friendly deal between the two firms.

In addition, the apparently legitimate justifications for PeopleSoft's CAP can be expected to open the door for other managers to employ post-bid change of control provisions primarily to entrench themselves. Moreover, future managers can be expected to design CAPs that are more effective than the PeopleSoft CAP. Just as lawyers in the 1980s were able to seize on the deterrent potential in Unocal's original scorched earth policy and transform it into the poison pill, lawyers will be able to enhance the deterrent potential residing in otherwise legitimate-seeming post-bid change of control provisions, if adequately motivated to do so. While the courts probably can identify and properly invalidate particularly outrageous change of control provisions, well-counseled targets in particular industries will still enjoy considerable leeway to employ such measures defensively. These defenses could harm shareholders if they either deter the hostile bid altogether or reduce the target's ability to extract substantial gains from a friendly deal.⁶⁴

Finally, analysis of the problems presented by embedded defenses raises the possibility that one of Delaware's strengths may lie in the judiciary's refusal to adopt clear bright line rules governing takeover defenses and the concomitant uncertainty over the zone of regulation about which some have complained. The trial transcripts suggest that Delaware judges are cognizant of the problem of substitute defenses and may employ legal uncertainty strategically, to constrain managers and bidders alike. Judge Leo Strine utilized the threat that he could act against either party both to deter each from taking additional value-reducing behavior and encourage each to negotiate a friendly deal.⁶⁵

This strategic use of legal uncertainty presents the possibility that, in a world of unregulable (and noncontractable) defenses, some degree of legal uncertainty may, in fact, be a welfare enhancing response to the problems presented by regulating activities whose purpose and effect are difficult to discern.⁶⁶ To the extent that

⁶⁴ The fact that PeopleSoft's CAP did not prevent the deal (or harm its shareholders) does not imply that managers of other firms would not use the insights from PeopleSoft to design CAP programs that do deter the bidder, to the detriment of their shareholders. Also, it should be noted that PeopleSoft's managers desire to resist Oracle fell, mid-bid, once PeopleSoft's board terminated PeopleSoft's CEO for reasons unrelated to the CAP. Millstone & Subramanian, *supra* note 40, at [17]. This could be expected to make the board more open to a friendly deal with Oracle.

⁶⁵ During the trial, Judge Strine made the following statement to the parties, that appears designed to use his ability to take almost any course of action to motivate the parties to settle the case in a mutually beneficial way:

I sit here in every case as a part of a reason for settlement, right? ... And now you have got the notion that Strine could pull the pill. Strine could not pull the pill. Strine could not pull the pill but enjoy the CAP and declare it invalid. Strine could uphold the CAP in its entirety, suggest that the multiplier be increased by three, and order that the annual meeting of PeopleSoft be moved to December of 2005. ... All of that, ... [is a] way of saying that I think that savvy people [can find a way to justify retreating from your prior positions and finding a deal] that delivers real value for the PeopleSoft stockholders and deal certainty for Oracle. Right?

Lynn Paine, Guhan Subramanian, and David Millstone, Oracle vs. PeopleSoft (B), Harvard Business School Case Study N9-306-059 (October 31, 2005).

⁶⁶ *Id.* at 657. For a discussion of other benefits Delaware may obtain from vague laws see Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

greater certainty is needed, it is likely better achieved by legal reforms that enable shareholders and managers to address the issue of takeover defenses by contract.

CONCLUSION

Courts cannot adopt a rule of strict shareholder choice without harming shareholders of many firms. The strictest version would harm targets by precluding managers from adopting value-enhancing post-bid embedded defenses that only they can adopt effectively. The modified version of strict shareholder choice would harm targets by inducing managers to make excessive use of post-bid embedded defenses to the detriment of shareholders.

Shareholders benefit when target managers retain some unilateral authority to adopt defense because targets sometimes need to adopt defense in order to preserve their value from the threat posed by a hostile bidder. Moreover, managers often are the only ones capable of acting quickly enough to adopt these value-enhancing defenses. Managers also are better able to adjust their response as circumstances change. This need for value-enhancing defenses is well-illustrated by the Oracle-PeopleSoft contest. PeopleSoft needed to act swiftly to respond to the threat that Oracle's bid posed to its customer base. Only PeopleSoft's managers were capable of responding quickly enough to protect PeopleSoft's shareholders. Accordingly, shareholders may benefit from granting managers unilateral authority to defend the target from a threat posed by a hostile bid, even when they are sufficiently informed to determine what the optimal response should be. The existence of these value-enhancing post-bid defenses thus undermines the case for strict shareholder choice.

The challenge presented by value-enhancing post-bid defenses cannot be avoided by modifying the rule to grant managers limited discretion to adopt some post-bid embedded defenses. Modified strict shareholder choice would likely be even more costly for shareholders than strict shareholder choice because its strict regulation of pure defenses and weak regulation of post-bid embedded defenses would induce managers to substitute out of the former and into the latter. Defense substitution would hurt shareholders to the extent that post-bid embedded defenses are more costly for shareholders. Many post-bid embedded defenses are costly because, once adopted, they impose costs on any change of control. Managers cannot waive these costs should they eventually negotiate a friendly deal. Accordingly, post-bid embedded defenses reduce the probability that a friendly deal will emerge from the contest, and also lower the value to target shareholders of any deal that does occur.

Proper attention to the challenge presented by post-bid value-enhancing defenses suggests there does not exist a uniform shareholder choice rule that is optimal for all firms, since the benefits of managerial authority and the costs of defense substitution vary from firm to firm.⁶⁷ Given this, it may be that shareholders

⁶⁷ Shareholders also may benefit from a non-uniform rule in another way. Analysis of the dynamic contest between Oracle and PeopleSoft presents the possibility that one of Delaware's strengths may lie in the judiciary's refusal to adopt clear bright line rules governing takeover defenses and the concomitant uncertainty over the zone of regulation about which some have complained. The trial transcripts of the litigation in Delaware suggest that Judge Leo Strine was cognizant of both

are best served when courts place relatively loose constraints on managers,⁶⁸ while leaving it to shareholders to place more binding constraints in those circumstances where they are justified. This suggests that the solution to the problem of takeover defenses may lie in altering the rules governing contracting between managers and shareholders to facilitate optimal contracting over shareholder choice.

PeopleSoft's need to defend itself and of the problem of defense substitution. His strong statements to both sides about his ability to decide this case either way, and his admonitions to them to consider the consequences, appear to be a strategic use of legal uncertainty to constrain both target managers and bidders alike. This raises the intriguing possibility that, in a world of unregulable (and noncontractable) defenses, some degree of legal uncertainty may, in fact, be a welfare enhancing response to the problems presented by regulating activities whose purpose and effect are difficult to discern. See Arlen & Talley, *supra* note 3, at 657. For a discussion of other benefits Delaware may obtain from vague laws see Kamar, *supra* note 66.

⁶⁸ While the present analysis concludes that a uniform rule of strict shareholder choice is not optimal, this does not imply that courts should embrace absolute managerial choice. There are defenses that are so pernicious that they should be regulated, notwithstanding any concern about defense substitution. The central point of this analysis is that courts must be wary of extending aggressive oversight of particularly damaging defenses to all defenses. In particular, courts must be wary of strictly regulating all pure defenses, as the elimination of pure defenses is what leads managers to substitute into more costly embedded defenses.