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

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This article argues that courts should not adopt a rule of strict shareholder choice that requires managers to obtain shareholder consent for any defensive action taken after a hostile bid has been made because strict shareholder choice both over-regulates post-bid defenses and encourages substitution into alternative defenses that may be more costly for shareholders. Strict shareholder choice over-regulates post-bid defenses because even ostensibly non-coercive bids can threaten a target's value unless managers can respond quickly. For example, a hostile bid can threaten the target's value by undermining its ability to enter into long-run implicit contracts whose value could be undermined by a change of control. Often only managers are able to act quickly enough to respond to such a threat. Strict shareholder choice also can harm target shareholders by inducing managers to substitute into unregulated alternative defenses that are more costly for the firm than regulated defenses. The problem of defense substitution is enhanced if courts attempt to reduce the cost of over-regulating post-bid defenses by amending strict shareholder choice to grant managers authority to adopt some post-bid defenses because post-bid defenses are particularly attractive substitute defenses for managers.

These problems are well-illustrated by the Oracle-PeopleSoft contest. Oracle's bid threatened PeopleSoft's value by undermining its ability to enter into long-run relational contracts with new customers who were worried that Oracle would breach PeopleSoft's long-run implicit contracts with them. PeopleSoft's managers were able to preserve PeopleSoft's value by quickly and unilaterally adopting a Customer Assurance Program (CAP) designed to ensure that Oracle honored PeopleSoft's implicit

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commitments. PeopleSoft could not have preserved its value as effectively had its managers been unable to commit to the CAP until they got shareholder approval. Analysis of the PeopleSoft contest also illustrates managers' ability to engage in defense substitution when unable to rely on traditional defenses and the problems courts would have in attempting to prevent this substitution. Under strict shareholder choice, managers seeking entrenchment could adopt CAPs pre-bid; under modified shareholder choice they could adopt them post-bid. Either is potentially costly for shareholders if used primarily as a defense. Courts cannot feasibly differentiate legitimate from illegitimate uses of such defenses, as the controversy over PeopleSoft's own CAPs demonstrates.

Corporate scholars generally agree that managers cannot be given unfettered authority to employ takeover defenses, even though they are better informed than are shareholders, because managers often do not use their superior information for shareholders' benefit once a hostile bid has been announced.1 Takeovers often presage termination of current management. Faced with the threat of being fired should a hostile bid succeed, managers have a strong incentive to intervene to resist a hostile acquisition, even if the deal would benefit the target's shareholders. Indeed, the desire to survive is so fundamental to human nature, that it would be unusual if managers did not protect themselves from such a fundamental threat to their livelihood. Managers also may use their authority over acquisitions to extract substantial private benefits from the bidder, at shareholders' expense. 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 over takeover defenses?2 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 shareholders can best be protected by a rule of "strict shareholder

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 appears 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 . . . ").

2. This article addresses the merits of proposals for strict shareholder choice that would preclude the use of all pure defenses (and potentially many embedded defenses). It does not address the question of whether courts should adopt more modest shareholder choice proposals that grant managers some degree of unilateral authority over pure defenses.
choice" that requires managers to obtain shareholder approval 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.4

Strict shareholder choice is not the answer to the problem of managerial entrenchment for many firms, however. Targets may be worse off under strict shareholder choice than under a more moderate takeover defense rule (combined with alternative mechanisms for regulating management) for two reasons. First, targets can benefit from granting managers unilateral authority to adopt defenses. Managerial authority to adopt post-bid defenses can benefit targets because target managers are not the only people who threaten the welfare of target shareholders during a contest for control. Acquirers also can threaten the target. For example, a hostile bid can undermine a target whose value depends on its ability to enter into long-run implicit contracts with third parties in the shadow of the bid. Third parties may be reluctant to enter into such contracts in reliance on the reputation of the target alone when the target is subject to a change of control. The best way to preserve the value of the target may be to incorporate change of control provisions in its third party contracts in order to assuage customers' concerns. Yet these

3. Throughout this article, strict shareholder choice is defined as a rule that precludes managers from adopting any measure post-bid that could deter a hostile bid, unless they obtain shareholder approval. It also requires managers to obtain shareholder approval to retain any pure defenses adopted pre-bid once a hostile bid has materialized. A "pure defense" is a defense whose only purpose and effect is to give the board authority to reject a hostile bid. A poison pill is a classic example of a pure defense. An "embedded defense" is a measure that could deter a hostile bidder but also could serve legitimate business purposes. A post-bid acquisition of another firm (such as the Time/Warner deal) is an example of a post-bid embedded defense. See generally Jennifer Arlen & Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 U. Pa. L. Rev. 577 (2003).

measures also impose costs on potential acquirers. In such circumstances, a target could be hurt by a strict shareholder choice rule that subjects all such post-bid measures to a shareholder vote requirement because this would preclude the target from acting quickly to preserve its value.

In addition, strict shareholder choice can harm targets by encouraging managers to switch from defenses regulated by the rule into defenses that are not regulated. These defenses often are more costly to the target than are the defenses regulated by strict shareholder choice.\(^5\) Strict shareholder choice regulates both measures whose only purpose is to deter a hostile acquisition (“pure defenses”) and post-bid measures that potentially deter acquisitions but also may serve a legitimate business purpose (“post-bid embedded defenses”). Yet strict shareholder choice does not aggressively regulate pre-bid actions adopted for an ostensibly legitimate business purpose, even if they also impose costs on a change of control (hereinafter, “pre-bid embedded defenses”).\(^6\) The combination of strict regulation of pure defenses and weak regulation of pre-bid embedded defenses provides an incentive for managers to substitute out of regulated pure defenses and into unregulated embedded defenses. Substitute embedded defenses are more costly for shareholders than are pure defenses because pure defenses only deter hostile deals whereas substitute embedded defenses often deter friendly and hostile deals alike (or otherwise negatively affect firm value).\(^7\)

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5. Arlen and Talley, supra note 3 (identifying the problem of defense substitution). This article extends that analysis to explore the implications of defense substitution for efforts to regulate post-bid embedded defenses.

6. A change of control provision in the target’s third-party contracts that grants these third parties a financial reward in the event of a change of control (hostile or friendly) is a classic example of an embedded defense. Targets have many legitimate reasons to adopt such measures but they also can deter a change of control. As courts cannot easily distinguish the legitimate use of such measures from a purely entrenchment motivated use, managers seeking entrenchment can achieve this goal by adopting pre-bid embedded defenses that other firms adopt for legitimate reasons. See id. (analyzing the problem of defense substitution under strict shareholder choice).

7. See id. 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’ use of debt covenants with “hostile-bid” change of control puts to deter hostile bids 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’ issuance of
Defense substitution is important both in and of itself and because it limits courts' ability to address the post-bid defense over-regulation problem by modifying the rule to allow managers to adopt those post-bid embedded defenses designed to protect the target from the bidder. This "modified strict shareholder choice" rule could be more costly for shareholders than its stricter cousin because it expands the zone of weakly regulated embedded defenses beyond pre-bid embedded defenses to include certain post-bid embedded defenses. This expansion increases the feasibility and attractiveness of defense substitution because post-bid embedded defenses impose lower costs on managers than do pre-bid embedded defenses. Pre-bid embedded defenses (such as blanket penalty change of control provisions) often deter friendly and hostile deals alike. This harms managers to the extent that managers expect to gain substantial private benefits from friendly deals. By contrast, post-bid embedded defenses allow managers to wait to adopt a defense until a hostile bid materializes, thereby leaving friendly deals unencumbered. 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 former enables them to act post-bid, when they can target only hostile bids. Shareholders may be hurt by these substitute defenses because they both deter hostile bids and reduce the benefit to shareholders of any hostile bids that do succeed notwithstanding the defense.

The contest between Oracle and PeopleSoft aptly illustrates the problems that post-bid embedded defenses pose for both strict shareholder choice and modified strict shareholder choice. The Oracle-PeopleSoft contest demonstrates the direct cost of strict shareholder choice because PeopleSoft's shareholders would have obtained a preferred stock to people friendly to managers' interests as a defense against hostile bids.

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8. "Modified strict shareholder choice" is the same as strict shareholder choice except that it allows boards to adopt post-bid embedded defenses when a hostile bid directly threatens the value of the target, for example by undermining the target's ability to enter into implicit contracts in the shadow of the bid. It would not permit other embedded defenses, such as those justified by managers' concern that shareholders cannot assess the long-run value of various options. Thus, modified strict shareholder choice would preclude managers from adopting any measure post-bid that could deter a hostile bid without shareholder approval -- except this small class of embedded defenses. It also requires managers to obtain shareholder approval to retain any pure defenses adopted pre-bid once a hostile bid has materialized. See also supra note 3 (defining strict shareholder choice and pure and embedded defenses).

9. 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.
lower premium had a court precluded PeopleSoft’s managers from acting quickly and unilaterally to defend PeopleSoft from Oracle’s bid. Oracle’s bid threatened to reduce PeopleSoft’s value — and thereby weaken its bargaining position — because PeopleSoft’s value depended on its ability to enter into long-run, high value, customer contracts whose value depended on customers’ faith that PeopleSoft would honor its implicit commitments to provide future product upgrades and high quality customer support. Customers were reluctant to contract with PeopleSoft in the shadow of Oracle’s bid because they were concerned that Oracle would not honor PeopleSoft’s implicit commitments if it purchased the firm. To preserve its value in the face of this threat, PeopleSoft needed a way to commit to its implicit contracts now that the threatened change of control made customers unwilling to rely on PeopleSoft’s own reputation. PeopleSoft provided this commitment by adopting a “Customer Assurance Program” (CAP) that offered customers a large financial payment should Oracle purchase PeopleSoft and thereafter decrease the quality of future product support and customer service during a specified time after the customer contract date. This CAP achieved PeopleSoft’s goal by providing a financial incentive for Oracle to honor PeopleSoft’s implicit contracts. As a result of the CAP, PeopleSoft had a successful quarter. PeopleSoft’s managers thereafter induced Oracle to increase its bid by more than 60 percent.

Strict shareholder choice would have harmed PeopleSoft because the firm could not have protected itself from the threat posed by Oracle had its managers been unable to unilaterally adopt this post-bid measure. PeopleSoft would have been harmed by the shareholder vote requirement imposed by strict shareholder choice because PeopleSoft needed to act quickly in order to guarantee strong quarterly earnings during the contest for control. PeopleSoft’s managers could not have responded quickly enough to prevent a significant loss of revenues had they been required to wait to adopt a CAP until the firm was able to go through the lengthy and expensive process required to obtain shareholder approval. Moreover, strict shareholder choice would have made it impracticable for the firm to modify the CAP program as new circumstances arose. Thus, application of strict shareholder choice to PeopleSoft’s managers would have harmed PeopleSoft’s shareholders more than they likely were.

10. See infra Section II.A for a more precise description of the CAPs.
11. Cf. Bebchuk, Board Veto, supra note 4 (arguing that managers should submit post-bid actions, such as mergers with White Knights, to shareholder vote).
Regulating Post-Bid Embedded Defenses

harmed by any actions managers took in an effort to save their jobs.12 The PeopleSoft case thus reveals the danger of applying strict shareholder choice to firms whose value depends on an ability to credibly commit to implicit long-run contracts with third parties.13

The Oracle-PeopleSoft contest also provides evidence that managers precluded from adopting pure defenses can and will employ substitute embedded defenses that courts cannot effectively regulate. PeopleSoft’s CAP is a potential substitute embedded defense. Yet courts cannot confidently regulate such measures because firms often have legitimate need for such change of control provisions, as the Oracle-PeopleSoft contest demonstrates. Indeed, the heated debate over whether PeopleSoft’s CAPs were legitimate measures or invalid defenses reveals how difficult it is to distinguish legitimate embedded defenses from illegitimate ones, even when the measure is adopted post-bid. This uncertainty sets the stage for managers of other firms to adopt a similar measure for less legitimate reasons. Defense substitution would be a particularly large concern under modified strict shareholder choice14 because managers often prefer post-bid embedded defenses to pre-bid embedded defenses because the former can be targeted at hostile deals.

Indeed, the problem of defense substitution may be evident in the PeopleSoft case itself. Although PeopleSoft’s managers adopted

12. This conclusion is not inconsistent with the discussion of the PeopleSoft case in Arlen & Talley, supra note 3, at 622-23. Arlen & Talley examined whether regulation of pure defenses and post-bid embedded defenses would be likely to induce managers to substitute into unregulable defenses, focusing on whether such defenses exist and managers’ incentives to adopt them. Arlen & Talley discussed PeopleSoft to show both that embedded defenses exist and that managers may substitute into them if unable to use pure defenses. We also observed that, even under strict shareholder choice, a similar provision adopted pre-bid would likely get business judgment protection (if applicable to any change of control).

We observed that under strict shareholder choice, PeopleSoft’s CAP would likely be subject to court challenge because it was adopted post-bid. We did not address the question presented here, however: whether it would be optimal for a court to invalidate those versions of PeopleSoft’s CAPs that were predicated on a change of ownership of the firm.

13. Courts cannot remedy the over-regulation problem by subjecting such measures to non-deferential court review that permits courts to validate legitimate post-bid measures because targets cannot get the full benefit of these measures if third parties fear that a court will err and improperly invalidate the measure under non-deferential court review. 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. See infra note 67. Moreover, this modified shareholder choice rule enhances the defense substitution problem, as discussed below.

14. See supra note 8 (defining modified strict shareholder choice).
the CAP for legitimate reasons, their subsequent decision to adopt new CAPs with greater penalties may have been partly motivated by their desire to use the CAPs as substitute defenses because PeopleSoft's managers did not have access to effective pure defenses.\textsuperscript{15} They would not have distorted the CAPs in this way had they been able to use lower cost pure defenses. Strict shareholder choice could be expected to encourage other managers with legitimate reasons for using embedded defenses to distort them to enhance their defensive effect. Moreover, future managers will likely find ways to "improve on" PeopleSoft's CAP to enhance its ability to deter a hostile bid.\textsuperscript{16}

Accordingly, the present analysis suggests that strict shareholder choice is not the answer to the fear that managers will use takeover defenses to entrench themselves at shareholders' expense. While managerial agency costs are substantial, firms cannot remain unprotected because bidders also can be a threat. Given this, strict shareholder choice may harm shareholders by precluding managers from acting quickly and unilaterally to defend the target from the consequences of the hostile bid. It also can harm shareholders by encouraging costly defense substitution. Moreover, courts could not reduce these costs by modifying the rule to permit certain post-bid defenses. This would reduce the problem of over-regulation but would increase the problem of costly defense substitution by making available additional, lower cost, substitute defenses.

These twin costs of over-regulation of post-bid embedded defenses and enhancement of defense substitution suggest that courts and institutional shareholders should carefully consider alternatives to strict shareholder choice that have the potential to deter managers from using their authority to entrench themselves without either discouraging the legitimate use of defenses or encouraging defense substitution. Other potential mechanisms include structuring executive compensation and altering board structure to reduce officers' desire

\textsuperscript{15} 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 concerning takeover defenses. PeopleSoft did not have an effective classified board. It also did not have an effective poison pill. Guhan Subramanian, Bargaining in the Shadow of PeopleSoft's (Defective) Poison Pill, 12 HARV. NEGOT. L. REV. 41 (2007) (explaining that PeopleSoft had adopted an inadequate poison pill prior to Oracle's bid).

\textsuperscript{16} 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 either deter deals or channel some of the benefits of an acquisition to third parties, especially if misused by managers intent on entrenchment.
and ability to entrench themselves while retaining their ability to defend the firm using the lowest cost mechanism available to achieve the desired goal. Reform should await full analysis of the relative costs and benefits of strict shareholder choice and these alternatives for achieving similar ends.

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 and inducing defense substitution. The modified version would harm targets by increasing the defense substitution problem. Section II uses the Oracle versus PeopleSoft contest to demonstrate both the existence of value-enhancing post-bid 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 embedded defenses exist that courts either cannot or should not regulate. Embedded defenses present 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 value-enhancing post-bid embedded defenses that shareholders cannot adopt themselves with sufficient speed. The other is a problem of under-regulation: shareholder choice could harm firms by inducing managers to substitute out of relatively low cost pure defenses and into embedded defenses that are more costly for the firm. The risk of defense substitution increases if courts attempt to correct the over-regulation problem by modifying shareholder choice to allow managers to adopt apparently legitimate post-bid embedded defenses because this makes defense substitution easier and thus more likely.

A. The Case for Absolute Shareholder Authority over Tender Offers

A central premise of corporate law is that managers of publicly held firms should enjoy unfettered authority to make business decisions on behalf of their firms in the ordinary course of business. Shareholders benefit from granting managers this authority because it ensures that business decisions are made by experts, free from interference by shareholders who are less informed about the firm.
Delegating authority to management also avoids the inevitable delay associated with shareholder voting. Shareholders thus benefit when they delegate authority to experts who can make business decisions expeditiously, notwithstanding the fact that managers' preferences are not perfectly aligned with those of shareholders.17

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.18 Managerial authority to adopt takeover defenses can harm shareholders because tender offers often presage managers' termination. Faced with a threat to their welfare, managers are likely to attempt to either fend off the bid or transform it into a friendly deal that grants them large private benefits, even when doing so harms shareholders. Managers have many tools at their disposal to enable them to block a hostile bid and can implement such measures without first seeking shareholder approval. Shareholders currently 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 block a deal includes not only pure defenses (whose only purpose is to deter a bid) but also embedded defenses

17. E.g., Bebchuk, Board Veto, supra note 4, at 995-96. Indeed, the central premise of Delaware General Corporation Law § 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). Consistent with this, the Business Judgment Rule reduces shareholders' ability to interfere with a management decision after-the-fact by precluding suits that are based only on the claim that a given business decision harmed the firm. It is assumed that shareholders are better off attempting to regulate agency costs in ordinary business transactions through indirect means, such as incentive contracts, voting and the market for corporate control.

18. The strongest arguments against board authority to adopt takeover defenses can be found in a series of articles by Bebchuk. See supra note 4. Another, more moderate, proposal to cabin managers' authority to adopt takeover defenses is presented in Black & Kraakman, supra note 4.
Proponents of managerial choice argue that managers should retain authority to manage the firm in the wake of a hostile bid. This includes the authority to adopt post-bid embedded measures arguably intended to serve legitimate business purposes, 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. Beyond this, proponents of managerial choice argue that managers should have authority to employ pure defenses whenever managers believe in good faith that doing so enhances firm value. Proponents of strict shareholder choice argue that managers should not be granted post-bid authority over any defenses – not even post-bid embedded defenses – because the cost of managerial authority exceeds the benefit once a hostile bid is announced. A hostile bid increases the cost of managerial authority because managers cannot be expected to act primarily in the shareholders’ best interests when faced with a hostile bid that is likely to result in their termination should it succeed. Managers 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 harms shareholders.

In addition, a hostile bid reduces the benefit of delegated management because shareholders can effectively decide the fate of the firm.

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19. Arlen & Talley, supra note 3 (defining the terms pure and embedded defenses).
20. 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 Constitution: Antitakeover Charter Provisions as Precommitment, 152 U. PA. L. REV. 473, 484-88 (2003) (boards are better able to implement a selling strategy than are shareholders) and 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).
21. Strict shareholder choice nevertheless leaves managers free to adopt many pre-bid embedded defenses. See supra note 3 (defining strict shareholder choice); Arlen & Talley, supra note 3.
22. For a discussion of how shareholders may be able to use contractual mechanisms, such as options, to mute agency costs associated with managers’ desire for entrenchment 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
firm in the shadow of a hostile bid. Shareholder authority is more effective post-bid than in the ordinary course of business because the bid both provides shareholders with an incentive to become informed and lowers cost to them of doing so. A tender offer is a rare event in the life of a firm that has 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. In addition, shareholders' information costs are lower post-bid because takeover contests are actively covered by analysts and the media. Finally, the delay associated with shareholder voting is less costly in this situation because many takeover contests entail considerable delay and generally require a shareholder vote if successful in any event. Thus, little is lost by also requiring a shareholder vote on whether to maintain a takeover defense, it is argued.

Faith in shareholders’ ability to manage firms post-bid has prompted a number of leading scholars to call on courts to place greater limits on managers' ability to adopt or maintain anti-takeover defenses post-bid. The strongest of these shareholder choice proposals would 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. Under this rule, 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. This prohibition would include post-bid embedded defenses arguably adopted for legitimate business purposes. For example, managers seeking to pursue a friendly acquisition of one firm instead of a hostile deal with another would be required to obtain shareholder approval.

(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).

23. E.g., Bebchuk, Board Veto, supra note 4, at 991-94, 1003; Gilson, supra note 4, at 845-48 (managers should not be able to block hostile offers). See Black & Kraakman, supra note 4, at 524-25 (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).

24. Successful tender offers are often followed by a merger which requires a vote of the shareholders of the target. In addition, some acquirers need shareholder approval of an acquisition.

25. For a defense of this position see Bebchuk, Board Veto, supra note 4.
approval before completing the friendly deal if it would deter the hostile one. 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 adopting shareholder choice would be small, it is claimed.

Yet the cost of strict shareholder choice is not as low as proponents claim. Indeed, for some firms the costs are likely to be substantial. Strict shareholder choice could harm shareholders in two ways. First, it could harm them by precluding managers from adopting value-enhancing post-bid embedded defenses needed to preserve the target when a hostile bid threatens its value. Second, it could harm them by encouraging managers to adopt substitute embedded defenses that would be costly for the firm. This latter cost is enhanced if courts respond to the first problem by modifying strict shareholder choice to permit managers to adopt some post-bid embedded defenses. Post-bid embedded defenses are particularly attractive substitute defenses because managers can target them at hostile deals, while remaining free to pursue friendly ones.

B. Over-Regulation of Value-Enhancing Post-Bid Embedded Defenses

Leading shareholder choice proponents assume that shareholders gain little from delegated management once a bid is announced because, in that situation, shareholders can and will obtain the information they need to make decisions on behalf of the firm. Accordingly, they claim that shareholders have little 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

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26. 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. See Bebchuk, Board Veto, supra note 4. But see Kahan & Rock, supra note 20 (arguing that managerial choice may enhance returns to shareholders by enabling managers to precommit to a value-enhancing selling strategy).

27. In addition, strict shareholder choice could increase the cost to some shareholders of managers' quest for entrenchment by inducing managers to substitute into pre-bid embedded defenses that remain unregulated (or weakly regulated) even under strict shareholder choice. This article does not discuss this problem. It is analyzed in detail in Arlen & Talley, supra note 3.

28. Bebchuk, Board Veto, supra note 4, at 1003. See Black & Kraakman, supra note 4, 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
would prefer, to shareholders for a vote.\textsuperscript{29} Yet, even when shareholders and managers are equally informed, shareholders may benefit from granting managers authority to adopt tender offer defenses. Managers may be able to defend the firm more effectively than shareholders because they can act much more quickly than can shareholders and at considerably lower cost.

Shareholders need managers to be able to act quickly because managers are not the only ones who threaten the welfare of target shareholders. Bidders also can threaten their welfare.\textsuperscript{30} Moreover, not all threats take the form of openly coercive bids that can be regulated by courts. A non-coercive hostile bid can threaten the target if it undermines the targets' ability to operate effectively during the takeover contest. This is particularly likely to happen if the target's value depends on its on-going ability to enter into implicit contracts with third parties, such as customers or suppliers.

A target's ability to enter into implicit contracts generally depends on its ability to use its reputation to bond its promise to adhere to non-contractible future commitments. A target's ability to enter into such contracts can be adversely affected by a hostile bid if the bidder has more to gain, and less to lose, than the target if it fails to honor the target's implicit deal should it gain control. In this situation, customers may be reluctant to enter into relational contracts during the takeover contest for fear that the bidder will not honor the implicit deal. To prevent this loss of revenue, the target's managers need to act quickly and effectively to preserve the value of the firm, unfettered by a requirement that they obtain shareholder approval.\textsuperscript{31}

\textsuperscript{29} See Bebchuk, \textit{Board Veto}, supra note 4.

\textsuperscript{30} This Article focuses on one advantage to shareholders of managerial authority. For a discussion of another benefit see Kahan & Rock, supra note 20 (boards are better able to implement a selling strategy than are shareholders).

\textsuperscript{31} Professors Andrei Shleifer and Lawrence Summers identified the threat that acquirers will breach a target's implicit contracts as a reason why hostile acquisitions may occur that do not enhance social welfare. Andrei Shleifer & Lawrence H. Summers, \textit{Breach of Trust in Hostile Takeovers}, in \textit{Corporate Takeovers: Causes and Consequences} 33 (Alan J. Auerbach ed., 1988). This Article shows that the potential anticipated breach by the acquirer of implicit contracts can also threaten the value of the target once a bid is announced when the target's value depends on its ability to enter into such contracts in the shadow of the bid.

In a recent paper, Professors Cremers, Nair and Peyer provide empirical evidence for the proposition that weak shareholder rights over takeovers may enhance firm
Managers and boards cannot act quickly if they are required to obtain shareholder approval.\textsuperscript{32} State and federal laws governing shareholder voting by publicly held firms require that firms subject their proposed proxy solicitations to regulatory oversight and also mandate a minimum delay period to allow notice of the meeting to reach shareholders. The benefits of granting managers authority to adopt post-bid defenses is likely to be even higher when the target is presented with a dynamic contest which requires the target to adjust its responses on a moment to moment basis to new actions by a bidder. The cost of requiring a shareholder vote is enormous if the firm needs to hold multiple meetings to obtain approval for each additional measure necessitated by a new action 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's management.\textsuperscript{33}

Managerial authority to respond unilaterally to a bid that threatens the target can benefit shareholders both ex post and ex ante. Shareholders may benefit ex ante if acquirers' knowledge that managers can defend the firm deters acquirers from structuring bids to threaten the target's value. Shareholders may benefit ex post if managers succeed in preserving the value of the target in the face of a hostile bid because this increases the expected value to target shareholders of either selling the firm or pursuing any long-run strategy that managers may prefer.

C. The Problem of Defense Substitution

Strict shareholder choice also can harm shareholders by encouraging managers to switch from pure defenses, which impose little direct cost on the firm, to embedded defenses that are not regulated by

\textsuperscript{32} Officers can act to deter a bid immediately because they do not need a formal meeting. The scope of their authority to act is narrower than that of the board, however. The board must wait to hold a meeting, but can do so quickly. They are not subject to long or expensive notice requirements. Moreover, if necessary, the board can meet by conference call.

\textsuperscript{33} Shareholders would not be able to obtain the full benefit of post-bid embedded defenses if courts decided to review the validity of these defenses post-bid, without enormous deference to managers. Contracting parties will not be willing to pay for the quality guaranteed by these contractual provisions if courts are likely to invalidate any such provisions that impede a hostile acquisition.
the shareholder choice rule and are more costly for the firm. Defense substitution is a cost of shareholder choice, in and of itself. It also reduces courts' leeway to employ a modified strict shareholder choice rule that grants managers' authority to adopt certain post-bid embedded defenses in order to address the concern that strict shareholder choice over-regulates post-bid embedded defenses. Modified strict shareholder choice may be more costly for shareholders, in the aggregate, than would strict shareholder choice because it would encourage even more defense substitution.

Defense Substitution

Any strict shareholder choice rule that precludes managers from retaining authority over pure defenses can harm shareholders by inducing managers to substitute into alternative measures outside the reach of the rule. Defense substitution is an unavoidable cost of strict shareholder choice because, even under the strongest shareholder choice regime, managers still retain authority to adopt pre-bid embedded defenses. Courts cannot regulate these effectively without interfering in the everyday management of publicly held firms.

For example, strict shareholder choice would not preclude managers from incorporating into pre-bid contracts a provision that protects third parties from the consequences of a change of control by granting them a financial payoff in the event that a change of control occurs. Penalty change of control provisions are difficult for courts to regulate reliably because many are used to enhance firm value by assuaging legitimate concerns of third parties. Any effort to expand shareholder choice to eliminate the use of such provisions could harm those firms which benefit from their use.

The existence of such unregulated provisions presents a challenge for strict shareholder choice because managers governed by strict shareholder choice could simply incorporate penalty change of control provisions into their third-party contracts in order to ward off hostile deals. This defense substitution would be costly for shareholders because many embedded defenses impose greater costs on the

34. See Arlen & Talley, supra note 3.
35. Id.
36. They also would retain the authority to adopt some post-bid embedded defenses. Id. at 605-28 (discussing available embedded defenses in more detail).
37. See id. at 628-32 (discussing circumstances under which managers may respond to a strong shareholder choice regime by adopting embedded measures that deter friendly and hostile deals alike).
firm than do pure defenses. Although pure defenses deter hostile bids, they do not otherwise reduce firm value and do not deter friendly deals.\textsuperscript{39} By contrast, most embedded defenses harm the firm whether or not a hostile bid emerges. For example, under strict shareholder choice, managers employing a pre-bid penalty change of control provision as a substitute defense would need to draft it broadly to apply to both friendly and hostile deals, as provisions targeted at hostile deals would be treated as invalid pure defenses. This broad provision would harm shareholders by reducing the likelihood of, and gains to shareholders of, the friendly deals that are the leading form of corporate combination and from which shareholders currently derive considerable benefit.\textsuperscript{40} Accordingly, any strict shareholder choice rule could harm shareholders by inducing managers to employ substitute embedded defenses that are more costly for shareholders than are pure defenses.\textsuperscript{41}


\textsuperscript{40} Strict shareholder choice would regulate all pure defenses, including all pre-bid defenses targeted only at hostile acquisitions. Consequently, under strict shareholder choice, managers seeking to employ substitute defenses that appear to serve legitimate (non-entrenchment) goals would have to employ pre-bid embedded defenses that apply to both friendly and hostile deals, as these are the defenses most likely to mimic legitimate measures.

\textsuperscript{41} 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, \textit{supra} note 3.
Implications for the Regulation of Post-Bid Embedded Defenses

Defense substitution is not only a concern in and of itself, it also reduces courts’ latitude to reduce the harshest consequences of strict shareholder choice by modifying the rule to allow managers to adopt some post-bid embedded defenses when necessary to preserve the target. The expected cost of defense substitution often is greater under a modified strict shareholder choice rule than under strict shareholder choice.

Courts cannot reliably distinguish managers’ legitimate from illegitimate post-bid embedded defenses. Thus, any effort to give managers authority to adopt value-enhancing post-bid embedded defenses also would enable other managers to adopt post-bid embedded defenses purely to deter a hostile bid. Accordingly, modified strict shareholder choice would exacerbate the cost of defense substitution because it would give managers an incentive to use substitute defenses and expand the zone of unregulated defenses to include post-bid embedded defenses.42

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. Post-bid defenses allow managers to deter hostile deals without burdening the friendly ones that grant them substantial private benefits.43 By contrast, pre-bid embedded defenses usually must burden hostile and friendly deals alike.44 Post-bid embedded defenses nevertheless can be more costly for shareholders than pure defenses because managers

42. See supra note 40.

43. The cost to managers of employing blanket pre-bid defenses may be less than it might seem should courts adopt strict shareholder choice. Strict shareholder choice reduces the cost to managers of deterring friendly deals by reducing the expected private benefits that managers can expect to reap from those deals. Managers expect to gain less from friendly deals under strict shareholder choice than under managerial choice because friendly bidders pursuing a target governed by strict shareholder choice need to court shareholders, not managers. Acquirers thus will be reluctant to offer managers large private benefits because this reduces the amount they can offer shareholders, who determine the outcome. Thus, strict shareholder choice drastically reduces the main factor deterring managers from using “blanket” embedded defenses that deter friendly and hostile deals alike. See Arlen & Talley, supra note 3.

Nevertheless, managers are still likely to prefer post-bid embedded defenses to pre-bid embedded defenses that deter friendly deals, so long as managers still can reap some private benefits even under strict shareholder choice. This is likely to the extent that acquirers need the existing managers to remain with the firm until the transaction is complete. In this case, the threat of defense substitution is heightened when managers can use substitute post-bid embedded defenses which often are less costly for them than are pre-bid embedded defenses.

44. See supra note 40.
cannot redeem them, the way they can redeem the poison pill, should they decide to pursue the deal. As a result, relative to pure defenses, post-bid embedded defenses may reduce the likelihood that the target's managers will be able to eventually negotiate a friendly deal; they also may lower the value to target shareholders of any deal that does occur.

Modified shareholder choice, thus, is not necessarily the lower cost rule. It would benefit those firms that need managerial access to post-bid defenses, but only at the expense of those firms that would be hurt by managers' greater ability and willingness to employ costly substitute defenses to entrench themselves.

D. **Summary**

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 more limited court oversight. This is especially likely to the extent that shareholders can use alternative mechanisms to mute agency costs.

Shareholders could be worse off if courts adopt a rule of strict shareholder choice because certain firms benefit when their managers can respond post-bid to a hostile raider. Strict shareholder choice also encourages managers to adopt costly substitute embedded defenses. Substitute defenses may reduce firm value more than pure defenses. Thus, managers' embrace of substitute embedded defenses could harm targets. The problem of defense substitution could be enhanced if courts attempted to remedy the over-regulation problem by modifying strict shareholder choice 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. Firms could be hurt because modified shareholder choice improves managers' ability to employ substitute embedded defenses because post-bid embedded defenses are less costly for them than are pre-bid embedded defenses.

This suggests that courts should not adopt a uniform rule of strict shareholder choice because firms differ in their vulnerability both to a hostile bid and to costly defense substitution. It also suggests that institutional shareholders should not rush to embrace strict shareholder choice to govern all firms, but instead should consider the costs and benefits of the rule as applied to a particular firm. In particular, they should scrutinize closely the potential advantages of using other mechanisms to address the problem of managerial entrenchment, including governance and incentive arrangements that
reduce managers' ability, and incentives, to entrench themselves in the face of a hostile bid.\textsuperscript{45}

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.\textsuperscript{46} It also depends on the availability of alternative substitute defenses. 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 illustrates the potential for strict shareholder choice to over-regulate post-bid defenses.

This section then shows that PeopleSoft's legitimate need for post-bid embedded defense opens the door for managers of other firms to employ such measures defensively, should they be forced to substitute out of pure defenses. Managers could employ such measures pre-bid. Under modified strict shareholder choice they also would likely employ them post-bid. Courts could not easily distinguish the legitimate from the illegitimate use of these measures. Indeed, the Oracle-PeopleSoft contest itself may provide evidence of defense substitution in the form of the defensive enhancement of an otherwise legitimate measure in response to ineffective pure defenses.

A. The Oracle-PeopleSoft Contest

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

\textsuperscript{45} See Kahan & Rock, supra note 22, at 896-97 (arguing that shareholders can employ adaptive mechanisms, such as executive compensation, to mute the agency costs associated with shareholder choice).

\textsuperscript{46} This claim only depends in part on the existence of unregulable post-bid embedded defenses. Defense substitution is a problem even if courts regulate all post-bid defenses, because strict shareholder choice will induce managers to substitute into pre-bid embedded defenses. See Arlen & Talley, supra note 3 (discussing the problem of substitute pre-bid embedded defenses).
Regulating Post-Bid Embedded Defenses

unattractive and 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.\(^4^7\) Moreover, Oracle's initial bid was, by all accounts, very low. Oracle's initial bid of $16 was barely above the then-current market price for PeopleSoft; it also was below the 30-day average trading price.\(^4^8\) Oracle's decision 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 pending deal with J.D. Edwards.\(^4^9\)

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 on PeopleSoft's commitment to support it. 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. It is too difficult to contract over all the circumstances where an update might be needed. It also is difficult to specify adequate customer support in future years. As a result, producers and customers in this market rely on long-run relational contracts that are supported by the producers' reputation for quality. PeopleSoft had a strong reputation for good customer service and, in fact, derived substantial revenues from the fees its customers


\(^4^8\) Id. at 4. See also David Millstone & Guhan Subramanian, *Oracle v. PeopleSoft: A Case Study*, 12 HARV. NEGOT. L. REV. 1, 7 (2007).

\(^4^9\) 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 hurt the J.D. Edwards shareholders and potentially end the deal. Cf. Millstone & Subramanian, *supra* note 48, at 7 (noting that a large PeopleSoft investor stated that Oracle's announcement of its bid made Oracle sound like they had a "Machiavelian strategy" to destroy a competitor).
paid for both customer support and the right to receive periodic updates. Customers depended on the implicit understanding that PeopleSoft would undertake those updates and revisions that were needed. Without this understanding, PeopleSoft's product was much less valuable.\textsuperscript{50}

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 by making 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's products.\textsuperscript{51} This statement left customers uncertain about whether Oracle would invest in updating and supporting PeopleSoft's products. Customers' concerns were heightened by statements of some Oracle employees that Oracle's software, and not PeopleSoft's software, would be the surviving platform if Oracle acquired PeopleSoft.\textsuperscript{52} In addition, some analysts

\textsuperscript{50} Millstone & Subramanian, supra note 48, at 6. Customers relied on PeopleSoft to live up to the implicit terms of the long-run agreement. PeopleSoft's product, enterprise applications software, is extremely expensive. The product alone costs many customers hundreds of thousands; for some it costs over a million, dollars. Moreover, 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. 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 at 1043, Oracle v. PeopleSoft, No. 20377 (Del. Ch. October 7, 2004). Indeed, PeopleSoft derived substantial revenues from the fees its customers paid for both customer support and for the right to receive periodic updates. These update and future services contracts were necessarily incomplete in that they did not specify precisely PeopleSoft's obligation 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.


\textsuperscript{52} 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. Order Denying Oracle's Motion for Summary Adjudication on PeopleSoft's Claim for Intentional Interference with Prospective Economic Advantage,
reported that Oracle would not support the PeopleSoft platform following the acquisition.\textsuperscript{53} 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 from Oracle.

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, the bid 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 financial strength 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), designed to attract new customers by reassuring them that they would get the full value of PeopleSoft's product. The initial CAP promised customers a refund worth two times the value of the contract in the event of certain adverse events following an acquisition of PeopleSoft. Subsequent CAPs enhanced the refund to up to five times the licensing fee and first year's maintenance fee.\textsuperscript{54} The potential liability on these contracts – if every customer exercised its right to be paid on them – eventually reached over $2 billion.\textsuperscript{55}

\footnotesize
PeopleSoft v. Oracle, No. RG03101434, 2004 WL 3266120 (December 16, 2004). By contrast, Oracle claims it was not going to immediately kill PeopleSoft. Nevertheless, it did state that Oracle was not going to actively market PeopleSoft's product. This statement raised reasonable concerns about how much Oracle would invest in updating and supporting PeopleSoft's platform.

53. Post-Trial Brief of Plaintiff Concerning the Customer Assurance Program at 6 & n.5-6, Oracle Corp. v. PeopleSoft, Inc. (Civil Action No. 20377 NC) (Public Revised Version).

54. 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, \textit{PeopleSoft Guarantees May Be Costly}, ZD\textit{Net} News, Jul. 3, 2003, http://news.zdnet.com/2100-3513_22-1023255.html?tag-nl. Over time, the terms of the CAP evolved. Eventually, the CAP 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 by an acquisition within a two or four year period, respectively. The final version was triggered only by an acquisition by Oracle. Millstone & Subramanian, \textit{supra} note 48, at 16.

55. Paine, Subramanian & Millstone, \textit{supra} note 47, at 23.
The CAPs had their desired effect. PeopleSoft had a very strong second quarter of 2003 — exceeding industry estimates. 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 CAPs are the type of post-bid embedded defense that would be precluded by a rule of strict shareholder choice. The CAPs were 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. PeopleSoft’s shareholders benefited from the CAPs, which enabled PeopleSoft to both retain its value and force Oracle to raise its bid substantially. PeopleSoft’s shareholders could not have obtained these benefits under a rule that required a shareholder vote to validate the CAPs because PeopleSoft needed the protection of the CAPs long before shareholder approval could have been obtained.

PeopleSoft needed the CAPs because Oracle’s bid threatened PeopleSoft’s ability to use its reputation to guarantee its implicit promise to provide high quality future service. This reputational commitment was essential to its ability to enter into contracts for future services that were not precisely specified. Oracle’s statement that it was not going to “actively market” PeopleSoft’s products signaled that Oracle did not plan to invest long-term in these products. As owner of PeopleSoft, Oracle would have less incentive to maintain

57. 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 the process PeopleSoft used to adopt the CAPs.
58. 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 the firm of the resulting decrease in revenues from future customers exceeds the benefit it could obtain from cutting quality on services provided to existing customers.
PeopleSoft's reputation for quality because it could channel some of PeopleSoft's former customers to its own products.\footnote{Managers of a firm that has received a hostile bid have many legitimate reasons to maximize the value of the firm by continuing to contract with customers, suppliers and financers. Shareholders are served when managers strive to maximize firm value whether or not shareholders want the firm sold. Shareholders seeking to sell the firm 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 from the acquirer. Managers also must continue to maximize firm value in case the hostile bid does 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' need to preserve firm value may be particularly great when faced with a bid from a rival firm that appears to be bidding simply to hurt the target.}

Unable to rely fully on its reputation to guarantee its future performance, PeopleSoft needed a substitute mechanism to enable it to credibly commit to its long-run commitment to quality. One effective alternative mechanism was to adopt a provision that provided Oracle with a financial incentive to honor PeopleSoft's commitments even if it did not plan to invest in PeopleSoft's products in the future. PeopleSoft provided Oracle this incentive by adopting CAPs that required Oracle to pay a large penalty if it acquired PeopleSoft and reduced the quality of product support or customer service. This penalty reassured customers that Oracle would invest in their contracts, even if it did not invest in the long-run welfare of PeopleSoft.\footnote{The problem of how to credibly commit to provide high quality service when quality is determined post-contract and is non-contractible arises in other areas, such as medical malpractice. Sanctions often are used to address this problem. The central problem that arises is how to establish a clear standard for determining when a sanction should be imposed when quality is non-contractible. In some areas, such as medical malpractice, this problem can be addressed by establishing a common duty to apply "customary quality care," as determined by the courts. While this solution is not perfect, it provides an external standard for determining when the sanction applies. See generally Jennifer Arlen & W. Bentley MacLeod, Malpractice Liability for Physicians and Managed Care Organizations, 78 N.Y.U. L. Rev. 1929 (2003). PeopleSoft could not resort to a clear external standard to govern when the sanction applies because it was attempting to commit to providing its historical level of care and not the customary care of the industry. This level of care was not easy to define in a contract. As a result, PeopleSoft had to draft vague terms governing what diminution in the quality of service offered by Oracle would trigger the CAPs.}

The CAPs thus operated as an effective substitute for PeopleSoft's lost ability to contract based on its reputation.

The magnitude of the penalty PeopleSoft imposed 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 PeopleSoft. Purchasing managers who elected to buy from PeopleSoft in the shadow of the risk posed by Oracle's bid faced termination should Oracle purchase PeopleSoft and renge on PeopleSoft's implicit long-run commitments.\(^6\)

In addition, PeopleSoft's CAPs were superior to the alternatives Oracle preferred, such as offering customers source code escrows.\(^6\)\(^2\) These mechanisms would not have enabled PeopleSoft to compete effectively with its rivals since they would not have provided customers with a guarantee that PeopleSoft would provide high quality long-term. Source code escrows only mitigate the cost to customers 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 with a customer so that it could do upgrades itself, because many customers are unable to use this code effectively to provide the same quality upgrades and support that they could have obtained from PeopleSoft.

Nor can PeopleSoft's CAPs be presumed to be invalid simply because PeopleSoft did not adopt a CAP until after Oracle made its bid. Prior to Oracle's hostile bid, PeopleSoft had no need for a CAP because it had a strong reputation for quality. Thus, before the hostile bid, PeopleSoft could only hurt itself by adopting a CAP. The CAPs required PeopleSoft to define the trigger terms for the penalty; this entailed contracting over quality terms that were, in fact, non-contractible.\(^6\)\(^3\) As long as PeopleSoft was able to rely on its reputation to provide its customers with the assurances they wanted, PeopleSoft was better off relying on long-run relational contracts instead of

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61. 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 CAPs would deter Oracle from reducing quality).

62. It might appear that PeopleSoft could have achieved this goal by employing alternatives such as discounts and rebates that did not affect the bidder. Yet a CAP is superior to these alternatives. These alternatives would have forced PeopleSoft to bear the cost of the market uncertainty itself, in the form of lower prices to customers. This would not have achieved managers' legitimate goal of ensuring that the firm's second quarter revenues did not suffer as a result of Oracle's bids.

63. Indeed, software providers and customers rely on long-run relational contracting when it is hard to define, ex ante, the software suppliers' obligation to support and upgrade their products. See supra note 50.
Regulating Post-Bid Embedded Defenses

Accordingly, there is nothing untoward about PeopleSoft’s decision not to adopt a CAP until faced with Oracle’s bid and general acquisition strategy.

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 shareholders of certain firms. Strict shareholder choice can harm target firms even when shareholders are well informed because managers may need 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. But shareholder voting cannot be used effectively to regulate business transactions whose value is reduced (or eliminated) by delay. Strict shareholder choice, therefore, creates an inevitable risk of excessive regulation of value-enhancing post-bid defenses.

Shareholders are particularly likely to benefit from managerial authority over tender offer defenses when the target firm is vulnerable to uncertainty over its 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

64. Nor should PeopleSoft have simply adopted a CAP pre-bid to govern in the event of any change of control by any bidder. PeopleSoft apparently was under no pressure from customers for protection from an unspecified bidder, and PeopleSoft’s managers would have legitimately wanted to avoid adopting a broad CAP as this would burden potential friendly deals. PeopleSoft thus properly did not adopt a CAP until its customers’ response to Oracle’s bid created pressure for it to do so.

65. Moreover, even if it would have been optimal for PeopleSoft to use a CAP pre-bid, PeopleSoft’s failure to do so cannot be taken as evidence that their post-bid use of the CAP was illegitimate. The argument that PeopleSoft’s failure to adopt the CAP pre-bid bears on the legitimacy of their actions post-bid assumes that PeopleSoft’s approach to defenses pre-bid was optimal. Yet PeopleSoft did not have many pre-bid defenses that arguably would have been sensible for managers to adopt. It appears that PeopleSoft did not receive the best legal advice, pre-bid, on how to plan for the possibility of a hostile bid. See Subramanian, supra note 15.

66. For a critique of justifications for managerial choice based on their superior ability to maximize long-term firm value, see Bebchuk, Board Veto, supra note 4. See also Black & Kraakman, supra note 4.

67. Courts cannot solve the delay problem by adopting a rule allowing managers to adopt post-bid defenses if they obtain shareholder approval after the measure is adopted. A target cannot obtain the full benefit of a measure designed to protect third parties if third parties cannot rely on the measure until its validity is determined by a shareholder vote, many weeks hence. A shareholder vote requirement thus would preclude firms from obtaining the full benefit of such measures.
firm was acquired by a bidder who did not intend to invest in its long-run reputation. When third parties value the contract less if the raider succeeds, the target's value may be undermined if it cannot adopt provisions designed to induce the bidder to abide by the target's relational contracts with third parties. In such circumstances, managers may need unilateral authority to adopt such measures post-bid, whether or not the target wants to remain independent. Firm value could be reduced by a rule that invalidates all post-bid defenses not approved by a time-consuming shareholder vote.

D. The Problem of Defense Substitution

An analysis of the PeopleSoft-Oracle contest also highlights the concern that strict shareholder choice will induce some managers to adopt substitute defenses that may be more costly for shareholders. Strict shareholder choice cannot regulate all defenses. Managers precluded from using traditional pure defenses will seek refuge in whatever unregulated defenses are available to them. CAPs, and similar change of control provisions, are one such set of possible substitute defenses. CAPs are attractive substitute defenses because courts cannot fully regulate them. Firms have legitimate, value-enhancing, reasons for adopting them. Moreover, courts cannot easily distinguish between a firm that legitimately needs to use a CAP and a firm that does not. Indeed, the fierce debate over the legitimacy of PeopleSoft's CAPs illustrates how difficult it is to determine whether a CAP is a legitimate business measure or an invalid defense, even when adopted post-bid. This uncertainty creates an opening for defense substitution. As a result, strict shareholder choice can be expected to induce managers to include more CAPs (and similar measures) in pre-bid contracts, even when

68. 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 on the identity of the other party.

69. 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 by the grant of substantial options that do not vest for many years under normal circumstances, but which vest immediately upon a change of control. See Kahan & Rock, supra note 22 (discussing how shareholders can use compensation arrangements to affect boards' incentives to sell).

70. The post-bid substitute defense adopted by PeopleSoft is not the only post-bid embedded defense that would survive the adoption of modified strict shareholder choice. For a discussion of other post-bid embedded defenses, see Arlen and Talley, supra note 3.
they do not need to do so for business reasons. Modified strict shareholder choice is likely to induce greater use of CAPs and other change of control provisions because these defenses are less costly when adopted post-bid.

In addition to increasing the use of CAPs, strict shareholder choice is also likely to alter the structure of those CAPs (and other change of control provisions) that are employed for legitimate business purposes. Under strict shareholder choice, managers who normally would have used such provisions can be expected to alter their structure to enhance their defense effect. Indeed, the PeopleSoft case may provide evidence of such a distortion. While PeopleSoft legitimately needed to adopt a CAP to defend itself against Oracle, questions remain about why it increased the cost of its CAPs over time. Was this decision driven solely by legitimate business concerns or also by entrenchment concerns?

The first CAP—adopted by managers directly in response to customers' concerns—was relatively modest. The penalty was not enormous and the CAP only lasted for a limited period of time. As the contest for control progressed, however, PeopleSoft expanded the CAPs. It enhanced the penalty to up to five times the purchase price. It also expanded the temporal scope of the CAPs so that the penalty could be triggered if Oracle cut support anytime within four years of the contract.\textsuperscript{71} This expansion of the CAPs may have been legitimate since PeopleSoft needed a large penalty to induce Oracle to honor PeopleSoft's contracts. Nevertheless, PeopleSoft also may have expanded the CAPs beyond the minimum amount needed to attract customers solely to deter Oracle.\textsuperscript{72} Any strategic enhancement of the defensive power of the CAPs risked reducing the value to shareholders of any eventual friendly deal between the two firms.\textsuperscript{73} Yet because the CAPs both served a legitimate purpose and involved third

\textsuperscript{71} 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 was set to reach as high as five times the original purchase price in the event that the CAP was triggered. \textit{See} Paine, Subramanian & Millstone, \textit{supra} note 47, at 23.

\textsuperscript{72} PeopleSoft's managers relied on the CAPs for a defense because they did not have access to effective pure defenses, as a result of poor planning.

\textsuperscript{73} The conclusion that the CAPs may have been bigger than necessary to attract customers does not imply that the court should have invalidated them. It is far from clear that they were bigger, given that PeopleSoft needed a big penalty to deter Oracle from reneging on its implicit customer contracts. Moreover, even if the CAPs were
parties, the court could not invalidate or alter them without trammeling on both managers' authority to protect the target and third parties' legitimate reliance interests. Thus, this evolution of the CAPs illustrates both difficulties courts face in regulating post-bid embedded defenses and the potential for strategic defense substitution that arises if these defenses are weakly regulated when pure defenses are unavailable.\textsuperscript{74}

Finally, strict shareholder choice would induce future managers to employ CAPs that are more effective at deterring raiders than the CAPs PeopleSoft adopted. Just as lawyers in the 1980s were able to seize on the deterrent potential in Unocal's selective share redemption and transform it into the poison pill, today's lawyers would be able to enhance the deterrent potential residing in CAPs, and other otherwise apparently legitimate change of control provisions, if adequately motivated to do so by the adoption of strict shareholder choice. While the courts probably can identify and properly invalidate particularly outrageous change of control provisions, well-counseled targets would still enjoy considerable leeway to employ such measures defensively. Substitution into these defenses could harm shareholders by either deterring deals altogether or reducing target shareholders' ability to extract substantial gains from a friendly deal.\textsuperscript{75}

**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 even value-enhancing post-bid embedded defenses. It also creates an incentive for managers to engage in costly defense substitution to the detriment of bigger than ideal, the total benefits of the CAPs – in terms of attracting customers – likely exceeded the entrenchment costs. And courts must tread carefully before invalidating or rewriting provisions that third parties have relied on.

\textsuperscript{74} For a discussion of why PeopleSoft was inadequately protected by the standard pure defenses employed by most firms see Subramanian, supra note 15 (discussing deficiencies in PeopleSoft's poison pill).

\textsuperscript{75} The fact that PeopleSoft's CAPs did not prevent Oracle from buying PeopleSoft does not imply that managers of other firms cannot design CAPs that would deter the hostile bidder, to the detriment of their shareholders. PeopleSoft's CAP could be improved upon by future lawyers. Moreover, future managers might be more motivated than PeopleSoft was, in the end, to stay independent. PeopleSoft's desire to resist Oracle fell after PeopleSoft's board terminated PeopleSoft's CEO for reasons unrelated to the CAP. Millstone & Subramanian, supra note 48, at 24. This changed the relative benefit to PeopleSoft of combining with Oracle, as opposed to remaining independent.
Regulating Post-Bid Embedded Defenses

the target's shareholders. The modified version of strict shareholder choice would reduce the costs associated with over-regulating post-bid defenses, but it would increase the problem of defense substitution by permitting managers to use post-bid embedded defenses as substitutes for pure defenses.

The Oracle-PeopleSoft contest illustrates the concern that strict shareholder choice would over-regulate post-bid defenses. In that contest, Oracle's bid threatened the value of PeopleSoft by undermining its ability to contract with third parties, in particular customers. Customers could not rely on PeopleSoft's implicit commitment to provide high quality service in the future because there were reasons to believe that Oracle would not honor that commitment. To preserve its ability to continue to contract with customers in the shadow of Oracle's bid, PeopleSoft needed to be able to provide its customers' guarantees. And it needed to provide them quickly. Only PeopleSoft's managers could adopt defenses quickly enough to preserve the firm's value. The need for, and existence of, these value-enhancing post-bid defenses in this case shows the potential for strict shareholder choice to over-regulate post-bid embedded defenses, to the detriment of some firms.

Strict shareholder choice also can harm firms by encouraging managers to substitute into embedded defenses that may be more costly for the firm. The risk of defense substitution is likely to be especially high if courts respond to the over-regulation problem by modifying strict shareholder choice to grant managers limited discretion to adopt some post-bid embedded defenses. Post-bid defenses are particularly attractive substitute defenses because they can be targeted at unwanted hostile bids. Strict shareholder choice also may distort the structure of otherwise legitimate contracts. Such a distortion may be evidence in the evolution of PeopleSoft's CAPs.

Attention to the challenge presented by post-bid embedded defenses suggests that the fact that managers are likely to try to protect their jobs in the face of a hostile bid does not imply that courts can best serve shareholders by removing from managers all authority to adopt pure and post-bid defenses. While courts can safely regulate particularly pernicious defenses, they cannot regulate all defenses without harming shareholders by either over-regulating legitimate actions or inducing defense substitution. This suggests that, before embracing shareholder choice, courts, regulators, and institutional shareholders should fully explore alternative mechanisms for controlling managers' proclivity for entrenchment.