

ISSN 1045-6333

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

REGULATING POST-BID EMBEDDED
DEFENSES: LESSONS FROM ORACLE
VERSUS PEOPLESOFT

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Discussion Paper No. 561

10/2006

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Cambridge, MA 02138

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This paper is also a discussion paper of the
John M. Olin Center's Program on Corporate Governance

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

Jennifer Arlen*

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 even ostensibly non-coercive bids can threaten the target's value unless managers have the ability to take quick unilateral action. A hostile bid is particularly likely to threaten the target's value when it undermines the target's ability to enter into value-enhancing long-run implicit contracts with third parties in the shadow of the bid. This threat is well-illustrated by the Oracle-PeopleSoft contest in which Oracle's bid threatened PeopleSoft's ability to enter into long-run relational contracts with new customers who were worried that Oracle would breach PeopleSoft's implicit contract regarding the quality of long-run product support and customer service. PeopleSoft's managers were able to assuage customers, and enhance firm value, by adopting a Customer Assurance Program (CAP) designed to deter Oracle from reducing future quality. PeopleSoft would have been hurt by a shareholder vote requirement because PeopleSoft's shareholders could not have adopted the CAP sufficiently quickly to preserve the firm.

Shareholder choice proponents cannot remedy the over-regulation problem by amending strict shareholder choice to grant managers authority to adopt some post-bid defenses because enlarging the zone of defenses that strict shareholder choice weakly regulates would increase managers' ability to substitute into these weakly regulated defenses that may be more costly for the firm than are traditional takeover defenses.

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

Jennifer Arlen

Most corporate scholars agree that managers should not enjoy unfettered authority to employ takeover defenses, even though they are better informed than shareholders, because managers cannot be relied on to use their superior information for shareholders' benefit once a hostile bid has been made.¹ Managers may use their authority contrary to shareholders' interests because takeovers often presage termination of current management. 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. 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. 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?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 choice”³ that

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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.

³ Throughout this article, strict shareholder choice is defined for simplicity 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. In fact, even under strict shareholder choice managers may be able to cannot adopt post-bid defenses that are unregulated by the rule. Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 UNIV. PENN. L. REV. 577 (2003). This article abstracts away from that concern. It assumes that strict shareholder choice can achieve its goal of regulating all pure defenses and all *post-bid* embedded defenses. 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.

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.⁴ This argument appears to be gaining ground with institutional investors, who are offering a growing number of shareholder proposals aimed at curbing managers' authority over acquisitions.

But strict 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. A hostile bid is particularly likely to threaten the target's value when it undermines the target's ability to enter into value-enhancing long-run implicit contracts with third parties. In these situations, target managers may be the only people able to protect the target because only they can act quickly enough to protect the firm. The best action for target managers, however, may be to structure post-bid contracts in ways that place burdens on the acquirer. A rule, such as strict shareholder choice, that would preclude all such unilateral contracts could hurt shareholders of some targets by preventing managers from taking unilateral actions that enhance the value of the target.

Moreover, the challenge that legitimate post-bid embedded defenses poses for strict shareholder choice cannot be eliminated by modifying the rule to grant managers unilateral authority to adopt those post-bid embedded defenses that protect the target from the bidder, while retaining the prohibition on managers adopting other embedded defenses post-bid or retaining unilateral authority over any "pure defenses"⁵ (defenses whose only purpose and effective is to deter a hostile bid). Indeed, this "modified strict shareholder choice"⁶ rule could be more costly for

An important feature of strict shareholder choice is that it does not preclude managers from adopting any and all *pre-bid* embedded defenses. Managers retain authority to adopt such measures. See *id.*, at 599 (discussing the scope of strict shareholder choice).

⁴ 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).

⁵ See *supra* note [3] (defining "pure defenses").

⁶ "Modified strict shareholder choice" is the same as strict shareholder choice except that it allows boards to adopt post-bid embedded defenses that 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

shareholders than strict shareholder choice rule. All strict shareholder choice rules regulate the pure defenses that managers prefer but leave a zone of defenses unregulated (or weakly regulated). In particular, strict shareholder choice does not strictly regulate measures that many firms adopt pre-bid, ostensibly for legitimate business reasons that nevertheless impose costs on (or reduce the probability of) a change of control (hereinafter, embedded defenses).⁷ The combination of strict regulation of pure defenses and weak regulation of pre-bid embedded defenses is potentially costly for target shareholders because it creates an incentive for managers who are seeking entrenchment to substitute out of pure defenses (which affect only hostile deals) and into unregulated embedded defenses, which can be costly for shareholders because they deter friendly and hostile deals alike (or otherwise negatively affect firm value).⁸ In turn, modified strict shareholder choice is even 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 of 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 which harms managers to the extent that managers expect to gain substantial private benefits from friendly deals. Post-bid embedded defenses, by contrast, allow managers to leave friendly deals unencumbered by allowing them to adopt a defense if, but only if, a hostile bid materializes.⁹ 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 hostile bids. Shareholders may be hurt by these substitute defenses because they both deter hostile bids and reduce the

once a hostile bid has materialized. See also supra note [3] (defining strict shareholder choice and pure and embedded defenses).

⁷ 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 classic examples 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 an purely entrenchment motivated use, managers seeking entrenchment can achieve this goal by adopting pre-bid embedded defenses that other firms adopt for legitimate reasons. Arlen & Talley, supra note [] (analyzing the problem of defense substitution under strict shareholder choice).

⁸ Arlen & Talley, supra note []. 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 preferred stock to people friendly to managers' interests as a defense against hostile bids).

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.

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 proposals. The Oracle-PeopleSoft contest demonstrates the direct cost of strict shareholder choice because PeopleSoft's shareholders would not have been able to reap the gains they eventually obtained from the deal under a rule that precluded PeopleSoft's managers from acting quickly and unilaterally to defend PeopleSoft from the negative effects of 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, implicit contracts with customers, whose value depended on customers' faith that PeopleSoft would honor its commitment to provide high quality long-term product support in the form of product up-grades and customer service. Customers were reluctant to contract with PeopleSoft in the shadow of Oracle's bid because they were concerned that Oracle would not honor the terms of PeopleSoft's long-term implicit contracts with them. To preserve its value in the face of this threat, PeopleSoft needed a way to commit to its implicit contracts, once 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 decreased the quality of future product support and customer service during a specified time after the customer contract date.¹⁰ 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%.

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 a post-bid defense. PeopleSoft needed its managers to act quickly in order to guarantee strong quarterly earnings during the contest for control. Managers could not have responded quickly enough to prevent substantial harm to itself 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 a vote on the CAP.¹¹ 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 were harmed by any ill-advised actions managers took in an effort to save their jobs.¹² The PeopleSoft case thus

¹⁰ For a more precise description of the CAPs see *infra* Section II.A.

¹¹ Compare with *Bebchuk, Board Veto*, *supra* note 4 (arguing that managers should submit post-bid actions, such as mergers with White Knights, to shareholder vote).

¹² This conclusion is not inconsistent with the discussion of the PeopleSoft case in *Arlen & Talley*, *supra* note [], 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. The article focused on whether such defenses exist and managers' incentives to adopt them.

reveals the danger of applying strict shareholder choice to any firm whose value depends on its ability to credibly commit to implicit long-run contracts with third parties (such as customers or suppliers).¹³ Adoption of a strict shareholder choice rule would be detrimental for these firms.

The Oracle-PeopleSoft contest provides evidence to support the claim that courts cannot remedy the over-regulation problem associated with strict shareholder choice by adopting a rule of modified strict shareholder choice instead. As previously explained, modified strict shareholder choice that combines strict regulation of pure defenses with weak regulation of post-bid embedded defenses justified by a need to preserve the target share price from a threat posed by the bidder¹⁴ would encourage costly defense substitution by expanding the scope of available substitute embedded defenses to include post-bid embedded defenses. This risk of defense substitution is evident in the PeopleSoft case. PeopleSoft's arguably legitimate use of its CAP opens the door for other managers to adopt a similar measure for less legitimate reasons, should they be precluded from using pure defenses by a rule of modified strict shareholder choice. Moreover, future managers will likely find ways to "improve on" PeopleSoft's CAP to enhance its ability to deter a hostile bid.¹⁵ In addition, modified strict shareholder choice is likely to encourage managers with legitimate reasons for using post-bid embedded defenses to alter them to enhance their defensive effect. Indeed, we may see such strategic enhancement in the evolution of the CAP that PeopleSoft employed. While PeopleSoft's initial CAP appears to have been primarily motivated by a desire to protect its customer relationships, PeopleSoft's decision to strengthen its CAP may have been motivated by its managers' desire to defend themselves against Oracle.¹⁶

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, however, a similar provision adopted pre-bid would likely get business judgment protection (if applicable to any change of control).

Given our focus on the scope of defense substitution under strict shareholder choice, we suggested that *if* courts were to adhere to strict shareholder choice, then PeopleSoft's CAP would likely be subject to court challenge because it was adopted post-bid. (We also observed that one version of the CAP that imposed a penalty on the firm in the event of any and all change in the control of the board that is unconsented to by the board -- as distinct from changes in the ownership of the firm -- also would appear to be regulable). We did not address the question presented here, however: whether it would be optimal for a court to invalidate a post-bid defense such as PeopleSoft's CAP (focusing on those CAPs that are predicated on a change of ownership of the firm).

¹³ Courts remedy this problem by subjecting such measures to non-deferential court review -- while agreeing to accept legitimate ones -- because third parties offered such measures for legitimate reasons will not give the target the full benefit of the guarantee these measures provide if they 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 [63].

¹⁴ See *supra* note [6] (defining modified strict shareholder choice).

¹⁵ 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.

¹⁶ 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. See John Coates, *Blame*

Accordingly, 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, managers are not the only threat that target shareholders face. Sometimes the bidder is the 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. 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.¹⁷ This analysis suggests that there may 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.¹⁸ Those concerned with managerial entrenchment may fare better by looking at other ways to constrain managerial agency costs.

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.

the Experts: PeopleSoft as a Case Study in Professional Service Market Failure, [] HARV. NEG. L. REV. [] (2006).

¹⁷ Unregulable defenses may be more costly because they deter friendly and hostile deals alike. When they do not deter the deal, they can harm target shareholders by channeling some of the benefits of the deal to third parties.

¹⁸ 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 strict shareholder choice.

A. THE CASE FOR ABSOLUTE SHAREHOLDER AUTHORITY OVER TENDER OFFERS

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.¹⁹

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.²⁰ 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

¹⁹ E.g., Bebchuk, *Board Veto*, supra note 4, 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). Consistent with this, the Business Judgment Rule reduces shareholders' ability to interfere with a management decision after-the-fact by precluding suits that 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.

²⁰ 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 4. Another, more moderate, proposal to cabin managers' authority to adopt takeover defenses is presented in Black & Kraakman, supra note 4.

deter a bid) but also measures that both serve legitimate business purposes and potentially deter bids (hereinafter “embedded defenses”).²¹ 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.²²

Proponents of strict shareholder choice argue that managers should not be granted authority to adopt any defenses – not even post-bid 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.²³ 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.²⁴

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

²¹ Arlen & Talley, supra note [] (defining the terms pure and embedded defenses).

²² 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).

²³ 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 []

²⁴ 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 (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).

target's managers prefer.²⁵ Moreover, because many takeover contests entail considerable delay – and likely require a shareholder vote if successful²⁶ – 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.²⁷ 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.²⁸

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 could harm shareholders by precluding managers from adopting value-enhancing post-bid embedded defenses needed to preserve the target when a hostile bid threatens its value.²⁹ Moreover, within the confines of strict shareholder choice, courts cannot effectively eliminate this problem by granting managers' authority to adopt certain post-bid embedded defenses as this would increase the likelihood that shareholder choice leads to costly defense substitution.

²⁵ 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 (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).

²⁶ 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.

²⁷ For a defense of this position see Bebchuk, Board Veto, supra note 4.

²⁸ 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, Board Veto, supra note 4. But see Kahan & Rock, supra note 24 (arguing that managerial choice may enhance returns to shareholders by enabling managers to precommit to a value-enhancing selling strategy).

²⁹ 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 [].

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 decisions on behalf of the firm.³⁰ 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.³¹ Yet, even when shareholders and managers are equally informed, shareholders may benefit from granting managers authority to adopt tender offer defenses. 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.³² 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. 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 a promise whose terms are noncontractable. A target's ability to enter into such contracts often can be adversely affected by a change of control because the bidder may not have the same reputational incentive to adhere to the terms of the target's deal. When the bid threatens the value of the target, the target's managers must be able to act quickly and effectively to preserve the value of the target, unfettered by a requirement that they obtain shareholder approval.³³

³⁰ 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 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).

³¹ See Bebchuk, Board Veto, supra note 4.

³² This article focuses on one advantage to shareholders of managerial authority. For a discussion of another benefit see Kahan & Rock, supra note 24

³³ 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, *Breach of Trust in Hostile Takeovers*, in ALAN J. AUERBACH, ED. CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (1988). This article shows that the potential anticipated breach by the acquirer of implicit contracts also can threaten the value of the target once a bid is announced to the extent that the target's value depends on its ability to enter into such contracts in the shadow of the bid.

A shareholder vote requirement can harm shareholders because the targets' value is likely to depend on managers' ability to act quickly. Managers and boards can do so if there is no shareholder vote requirement.³⁴ They cannot act quickly if no action is valid absent shareholder approval because obtaining shareholder approval is a time-consuming process. State law 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 vote to reach shareholders. The benefits of granting managers authority to adopt post-bid defenses 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. The cost of requiring a shareholder vote is enormous if the firm needs to hold multiple meetings to obtain approval for additional 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.³⁵

Shareholders can benefit both ex post and ex ante from a rule that grants managers discretion to employ post-bid embedded defenses aimed at preserving firm value during a bid. Shareholders may benefit ex ante if acquirers' knowledge that managers have authority to 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, as this can be expected to increase the expected value to target shareholders of either selling the firm or pursuing any long-run strategy that managers may prefer.

This suggests that courts should not adopt a uniform rule of strict shareholder choice for all firms. 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; they also should scrutinize closely the potential advantages of using other mechanisms to address the agency cost problem, such as private contractual arrangements.³⁶

In a recent paper, Professors Cremers, Nair and Peyers provide empirical evidence for the proposition that weak shareholder rights over takeovers may enhance firm value when customers care about the survival of the firm and firms operate in competitive markets. See K.J. Cremers, Vinay B. Nair, Urs Peyers, *Weak Shareholder Rights: A Product Market Rationale* (April, 2006) (available on SSRN).

³⁴ 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.

³⁵ Shareholders would not be able to obtain this protected 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.

³⁶ See Kahan & Rock, *supra* note 24, at 896-97 (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).

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 retaining authority over pure defenses can harm shareholders by inducing managers to substitute into alternative measures outside the reach of the rule.³⁷ Defense substitution is an unavoidable risk of strict shareholder choice because even the strictest rule suggested does not regulate all potential takeover defenses. Even under the strongest shareholder choice regime, managers retain authority adopt pre-bid embedded defenses. For example, the strict shareholder choice rule currently does not preclude managers from adopting change of control provisions during the ordinary course of business that require a large payment to a third party in the event of any change of control, whether friendly or hostile because so many firms need these provisions for legitimate business reasons.³⁸ Yet the existence of such unregulated provisions presents a challenge for strict shareholder choice because managers governed by such a rule can be expected to substitute into pre-bid embedded defenses that mimic measures used for legitimate reasons.³⁹

³⁷ Arlen & Talley, *supra* note [].

³⁸ One available embedded defense is a change of control provision 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. Penalty change of control provisions are difficult for courts to regulate reliably because many 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 benefit from their ability to use such measures to assuage legitimate concerns of third parties. Arlen & Talley, *supra* note [].

The existence of such measures presents a challenge for strict shareholder choice, however, because managers governed by strict shareholder choice could incorporate penalty change of control provisions into their third-party contracts in order 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 [], 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).

³⁹ See Arlen & Talley, *supra* note [], at 605-628 (discussing available embedded defenses in more detail). But see Guhan Subramanian, *The Emerging Problem of Embedded Defenses: Lessons from Air*

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

Defense substitution can be costly for shareholders because many pre-bid embedded defenses 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.⁴⁰ 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.⁴¹ Accordingly, any strict shareholder choice rule could harm shareholders by inducing managers to employ substitute embedded defenses that are more costly for shareholders.⁴²

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

Line Pilots Assn. v. UAL Corp., 120 HARV. L. REV. (forthcoming 2007) (arguing that courts can, and should, regulate post-bid embedded defenses).

⁴⁰ 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).

⁴¹ Strict shareholder choice would regulate all pure defenses, and thus 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.

⁴² 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 [].

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.⁴³

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 benefits.⁴⁴ 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.⁴⁵

Defense substitution may harm shareholders because post-bid embedded defenses may be less costly from shareholders than pure defenses, especially when managers' compensation agreements provide them with significant incentives 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 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.

⁴³ Managers who adopt pre-bid embedded defenses generally burden hostile and friendly deals alike because both strict shareholder choice and modified strict shareholder choice regulate any pre-bid measure targeted only at a hostile bid (to the extent that it appears to be a pure defense).

⁴⁴ 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 to deterring friendly deals by reducing the expected private benefits 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 are the people 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 [].

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, as these are less costly for them.

⁴⁵ See *supra* note [38].

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 court oversight. 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. Courts cannot 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 pre-bid embedded defenses. These defenses often are more costly for the firm than are pure defenses, however. Thus, managers' embrace of post-bid embedded defenses would harm many firms.

The analysis above suggests that there does not exist a uniform shareholder choice rule that is optimal for all firms because firms differ in their vulnerability to both a hostile bid and to costly defense substitution. This suggests that the best solution to the takeover defense problem may lie reforms that facilitate optimal contracting between shareholders and managers over the scope of takeover defenses to govern individual firms.⁴⁶

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.⁴⁷ 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 retain the restrictions on pure defenses while granting managers freedom to adopt certain post-bid embedded defenses could enhance the cost of strict shareholder choice for some firms, by substantially enhance the likelihood that managers of other firms would use them purely for entrenchment purposes. The Oracle-PeopleSoft contest also provides evidence for the potential for defense substitution.

⁴⁶ Regulators thus should focus on impediments to effective shareholder voting and the related problem of ensuring that votes are linked to beneficial interest in the firm.

⁴⁷ 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 [] (discussing the problem of substitute pre-bid embedded 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 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.⁴⁸ 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.⁴⁹ 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.⁵⁰

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. 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 implicit understanding that PeopleSoft would undertake those updates and revisions that were needed. Without it, PeopleSoft's product was much less valuable to them.⁵¹

⁴⁸ Lynn Paine, Guhan Subramanian, and David Millstone, *Oracle vs. PeopleSoft (A)*, Harvard Business School Case Study N9-306-058 (October 31, 2005).

⁴⁹ *Id.* at 4. David Millstone & Guhan Subramanian, *Oracle v. PeopleSoft: A Case Study*, HARV. NEG. L.J. [p. 5 in draft] (2006)

⁵⁰ 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 49, 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).

⁵¹ Millstone & Subramanian, *supra* note 49, at [5]. Customers depended heavily on the 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

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.⁵² 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.⁵³ Some analysts reported that Oracle would not support the PeopleSoft platform following the acquisition.⁵⁴ 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.

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

thousands, and some 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, 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.

⁵² 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).

⁵³ 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 Oracle was not going to actively market PeopleSoft's product, which raised reasonable concerns about how much Oracle would invest in updating and supporting PeopleSoft's platform.

⁵⁴ 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.

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.⁵⁵ The potential liability on these contracts – if every customer exercised its right to be paid on them – eventually reached over \$2 billion.⁵⁶

The CAPs had their desired effect. PeopleSoft had a very strong second quarter of 2003 – exceeding industry estimates.⁵⁷ 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.⁵⁸ 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.

Oracle's bid threatened PeopleSoft's ability to use its reputation to guarantee its promise to provide good quality future service, thereby enabling it to enter into

⁵⁵ 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 49, at [12].

⁵⁶ Paine, Subramanian & Millstone, *supra* note 48, at 23.

⁵⁷ Oracle Corporation v. PeopleSoft, Inc., Defense Post-Trial Brief, at 14.

⁵⁸ 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.

contracts for future services that were not precisely specified.⁵⁹ 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 faced less incentive to maintain PeopleSoft's reputation for quality if it could channel customers to its own products.⁶⁰

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 way to do this was 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 provided Oracle that incentive by adopting a CAP that required Oracle to pay a large penalty if Oracle 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.⁶¹ The CAP, thus, operated as 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-

⁵⁹ Reputation can be a commitment mechanism when the benefit 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.

⁶⁰ 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 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 by a bid from a rival firm which appears to be bidding simply to hurt the target.

⁶¹ 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 Jennifer Arlen & W. Bentley MacLeod, *Malpractice Liability for Physicians and Managed Care Organizations*, 78 New York University Law Reviews 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 customary care of the industry. As a result, PeopleSoft faced significant contracting problems in drafting the terms governing when its CAPs were triggered. 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.

standing commitments, and not just to compensate customers for future losses. PeopleSoft's customers needed near certainty that they could safely purchase from 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.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.

PeopleSoft's CAP also is superior to the alternatives Oracle preferred, such as offering customers source code escrows. These mechanisms would not have enabled PeopleSoft to compete effectively with its rivals since they do not provide customers with a guarantee that PeopleSoft will 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 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 it could have obtained from PeopleSoft.

Nor can PeopleSoft's 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.⁶³ 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 CAPs.⁶⁴ Accordingly, there is nothing untoward about PeopleSoft's decision not to adopt a CAP until faced with Oracle's bid and general acquisition strategy.⁶⁵

⁶² 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).

⁶³ Indeed, software providers and customers rely on long-run relational contracting in the first place when it is hard to define, *ex ante*, the software suppliers' obligation to support and upgrade its product. See *supra* note [52].

⁶⁴ Nor should PeopleSoft have simply adopted a CAP 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

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,⁶⁶ but shareholder voting cannot be used effectively to regulate business transactions whose value is reduced (or eliminated) by delay.⁶⁷ 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.⁶⁸ 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 renegeing 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.⁶⁹ Given

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. Coates, *supra* note [9]; 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).

⁶⁶ Bebchuk, Board Veto, *supra* note 4. 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 that allowing managers to adopt post-bid defenses if they obtain a shareholder approval after the measure is adopted. A target cannot obtain the full benefit of a measure design 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.

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 through 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 24 (discussing how shareholders can use compensation arrangements to affect boards' incentives to sell).

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 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 retaining the prohibition on managerial control over pure defenses while permitting managers to adopt post-bid defenses designed to preserve the value of the firm. Indeed, this more permissive form of strict shareholder choice may be worse than the stricter 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, encourages managers to adopt costly substitute post-bid embedded defenses. Defense substitution can take the form of managers who have a legitimate need for embedded defenses strategically altering these defenses to implement a larger, more costly, measure than is justified as a substitute for their low-cost pure defenses they prefer. Defense substitution also can take the form of managers employing embedded defenses when they have a colorable claim to facing a legitimate threat, even though they have no real need for them.

PeopleSoft's approach to its own CAPs may provide an example of the first form of defense substitution. PeopleSoft had a legitimate need to adopt a CAP to defend itself against Oracle.⁷⁰ Nevertheless, a question remains whether the evolution of PeopleSoft's CAP over time was driven by legitimate business concerns or entrenchment concerns. 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.⁷¹ It is possible that this expansion was in response to customer demand for a large CAP. Yet also is likely that PeopleSoft's managers expanded the magnitude and temporal scope of the CAP in order to deter Oracle. In pushing the CAP above the level needed to attract customers, PeopleSoft's managers risked reducing the value to shareholders of any eventual friendly deal between the two firms.

⁷⁰ For a discussion of why PeopleSoft was inadequately protected by the standard pure defenses employed by most firms, see Coates, *supra* note 65; see also Subramanian, *supra* note 65 (discussing deficiencies in PeopleSoft's poison pill).

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. See Paine, Subramanian, Millstone, *Oracle vs. PeopleSoft (A)*, *supra* note 48, at 23.

In addition, the apparently legitimate justifications for PeopleSoft's CAP opens the door other managers to employ post-bid change of control provisions primarily to entrench themselves. 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, today's lawyers will be able to enhance the deterrent potential residing in otherwise apparently legitimate post-bid 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 in particular industries will still enjoy considerable leeway to employ such measures defensively. These defenses could harm shareholders if they either deter a hostile bid altogether or reduce the target's ability to extract substantial gains from a friendly deal.⁷²

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.⁷³

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.⁷⁴ To the extent that

⁷² The fact that PeopleSoft's CAP did not prevent Oracle from buying PeopleSoft does not imply that managers of other firms could not use the insights from PeopleSoft to design CAP programs 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 40, at [17]. This change the relative benefit to PeopleSoft of combining with PeopleSoft, as opposed to remaining independent.

⁷³ 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).

⁷⁴ *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 even value-enhancing post-bid embedded defenses. 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 may benefit when target managers retain unilateral authority to adopt some post-bid defense when hostile bids threaten the target's value. As the Oracle-PeopleSoft contest illustrates, a bid may threaten the value of a target when it undermines the target's ability to contract with third parties because the latter cannot rely on the target's commitment to any implicit terms in the contracts. Managers often are the only ones capable of acting quickly enough to adopt value-enhancing defenses designed to preserve the target's value. The need for and 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 the joint strict regulation of pure defenses and weak regulation of post-bid embedded defenses provides both motive and opportunity for managers to substitute into costly embedded defenses. Defense substitution would hurt shareholders to the extent that post-bid embedded defenses are more costly for shareholders than are pure defenses. 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.⁷⁵ Given this, it may be that shareholders

⁷⁵ 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 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 possibility that, in a world of unregulable (and noncontractable) defenses, some degree of legal uncertainty may be a welfare enhancing response to the problems

are best served when courts place relatively loose constraints on managers seeking to deter a bid,⁷⁶ 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 that affect contracting between managers and shareholders, such as rules governing voting and disclosure of various internal corporate contracts.

presented by regulating activities whose purpose and effect are difficult to discern. See Arlen & Talley, *supra* note [], at 657.

⁷⁶ 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 the problem of 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. Elimination of pure defenses is what leads managers to substitute into more costly embedded defenses.