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BARGAINING IN THE SHADOW OF PEOPLESOFT'S (DEFECTIVE) POISON PILL

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Bargaining in the Shadow of PeopleSoft's (Defective) Poison Pill

Guhan Subramanian*

Abstract

This Commentary is part of a dealmaking symposium on the Oracle-PeopleSoft contest from 2003-2004. The facts of the case are described in Millstone & Subramanian (2005). This Commentary examines Oracle's alternatives and PeopleSoft's potential responses in the fall of 2004. I demonstrate that certain defects in the design of PeopleSoft's poison pill made a deliberate pill trigger a plausible course of action for Oracle at this critical juncture. This radical maneuver becomes even more attractive because Oracle had made the negotiated acquisition route extremely expensive for itself by revealing that it had \$26 per share in its pocket nine months earlier. Even if Oracle had not actually triggered PeopleSoft's poison pill, threatening this maneuver would have given Oracle bargaining power that it could have used to pay a lower price in its negotiated acquisition. The Commentary closes with implications of this analysis for practitioners, boards of directors, and the Delaware courts.

Keywords: hostile takeover, Oracle, PeopleSoft, poison pill

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* Joseph Flom Professor of Law & Business, Harvard Law School; H. Douglas Weaver Visiting Professor of Business Law, Harvard Business School. I thank Jennifer Arlen, Skip Battle, Bill Bratton, Bill Carney, Richard Hall, Hon. Jack Jacobs, Eric Robinson, Hon. Leo Strine, and seminar participants at Georgetown Law School and Harvard Law School for helpful comments on prior drafts. It should be noted that I served as an expert witness for Oracle in the California and Delaware state court actions. Some of the data provided in this Commentary are drawn from my reports in those matters. My involvement was prompted, at least in part, by a then-recently published Article that provided a theoretical model of the negotiation process in takeover bids. See Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 Yale L. J. 621 (2003). This Commentary provides a special application of that general model.

Bargaining in the Shadow of PeopleSoft's (Defective) Poison Pill

Guhan Subramanian

Introduction

Just as the leveraged buyout of RJR Nabisco was the touchstone M&A deal of the 1980s and QVC's effort to break up Paramount-Viacom was the dealmaking event of the 1990s, so too might commentators look back on Oracle's hostile takeover bid for PeopleSoft in 2003-2004 as the most notable M&A deal of its decade. The fight took eighteen months from announcement to resolution, putting it second only to U.S. Surgical's bid for Circon as the longest-running hostile takeover bid in the modern era of takeovers.¹ The parties' maneuvers during this time tested the boundaries of U.S. antitrust law, Delaware corporate law, and California competition law. And not to be overlooked, the personalities on all sides were formidable and often entertaining. Larry Ellison, David Duffield, and Craig Conway could certainly rival Ross Johnson, Henry Kravis, and Sumner Redstone for wit, style, and force of personality.

This Commentary examines the negotiation dynamic between Oracle and PeopleSoft in October 2004, just after the Justice Department had announced that it would not appeal the U.S. District Court's antitrust ruling. I explore the possibility of a deliberate pill trigger, and implications for Oracle's bargaining strategy. While a deliberate pill trigger is a radical maneuver, never before attempted in our twenty year history with pills, particular features of PeopleSoft's pill and the situation overall made a deliberate pill trigger more plausible. First, by giving itself a "last look" at redeeming the pill (rather than irrevocably committing to dilution) PeopleSoft made it very unlikely that the pill's dilutive effect would have actually played out against Oracle. Second, by revealing that it had \$26 per share "in its pocket," Oracle made the negotiated acquisition route extremely expensive for itself in the fall of 2004.

Putting these two factors together, the familiar negotiation prescription of "looking forward and reasoning back" suggests that deliberately triggering PeopleSoft's pill would have allowed Oracle to acquire PeopleSoft for approximately \$3.75 less per share than it actually did, or \$1.4 billion in lower total cost. I acknowledge that this is a strong claim, based on several educated guesses about the unknown and unknowable, so I close this Commentary with what I believe to be a more cautious conclusion. By raising the possibility of a deliberate pill trigger, which to my knowledge no one on Oracle's side did, Oracle would have changed PeopleSoft's perception of its no-deal alternative, in a way that would have provided Oracle greater bargaining power at the table. In the end, the deal would still have ended with a negotiated acquisition, but Oracle's purchase price would have come in considerably lower than the \$26.50 per share that it actually paid.

Part I of this Commentary lays the groundwork with a detailed examination of the mechanics of PeopleSoft's poison pill. Part II applies this analysis to Oracle's decision in October 2004,

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¹ See LUCIAN ARYE BEBCHUK, JOHN C. COATES IV & GUHAN SUBRAMANIAN, HOSTILE BIDS DATABASE, 1996-2005 (examining all hostile takeover bids between 1995 and 2005). For a detailed description of the Circon contest, see HALL, ROSE & SUBRAMANIAN, CIRCON (A), Harv. Bus. Sch. Case Study No. 9-801-403 (2001).

just after the Justice Department had announced it would not appeal the U.S. District Court's antitrust ruling. Part III provides lessons for boards of directors, practitioners, and judges.

I. PeopleSoft's Poison Pill

A. Baseline mechanics

PeopleSoft installed a “dead hand” poison pill with a ten-year duration in February 1995. When the Delaware Supreme Court invalidated dead hand provisions in 1998,² PeopleSoft stripped out the dead-hand feature of its pill, leaving behind a “plain vanilla” poison pill that would have expired in February 2005. It is widely believed that a poison pill, even a plain vanilla pill, is a “show-stopper” against a hostile bidder because it severely dilutes an acquirer's stake if triggered. The bidder's only way to acquire the target is through a proxy contest.

While this general understanding is common knowledge, many businesspeople, including directors of U.S. public companies, do not understand how the pill achieves this effect.³ At the highest level, the pill provides rights for all other target shareholders to acquire shares of the target at a severely discounted price in the event that an acquirer buys more than a specified percentage of the target's stock. In the case of PeopleSoft's pill, if Oracle crossed the 20% trigger threshold (a so-called “Trigger Event” in pill-speak), all other PeopleSoft shareholders would have had the right to buy \$380 worth of PeopleSoft stock (valued at the average trading price for the thirty trading days prior to the Trigger Event) by paying \$190 cash to PeopleSoft, for each share of PeopleSoft previously held (a “Pill Exercise”).

It is well-known in corporate law that a poison pill has never been deliberately triggered so as to unleash its full dilutive impact on the bidder.⁴ For this reason an actual Trigger Event would be uncharted territory. But consider hypothetically how a deliberate pill trigger would have played out in the Oracle-PeopleSoft context. PeopleSoft's average price for the 30 trading days prior to October 1, 2004 was \$18.54. Normally the process of buying sufficient shares to trigger a pill would push the trading price up further, but in this case the share price already reflected the fact that PeopleSoft was in play. Therefore we can assume, as a rough approximation, that

² *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

³ As just one illustration of this point, when I teach the mechanics of the poison pill in a bi-annual Harvard Business School executive education program for corporate directors, many in the room – including directors of companies that have poison pills – are surprised and even shocked that the mechanics of the poison pill are legal under U.S. corporate law. Misperceptions of the pill persist, in part, through the impenetrable nature of the pill documents themselves. See William J. Carney & Leonard Silverstein, *The Illusory Protections of the Poison Pill*, 79 NOTRE DAME L. REV. 211 (2003) (“[F]ew documents are as impenetrable as a rights plan, with its elaborate definitions (often buried within the text) and its antidilution and antidestruction provisions, much less its extraneous matter, such as rights to purchase preferred stock that will never be exercised.”).

⁴ The closest anyone has come to a deliberate triggering of a poison pill was Sir James Goldsmith's successful bid for Crown Zellerbach in 1985. Goldsmith crossed the twenty percent threshold that caused the rights to be distributed to Crown shareholders, but he avoided the negative dilutive effects of the pill by withdrawing his tender offer, acquiring majority control through open market purchases, and maintaining ownership below the 100% threshold that would have made the rights exercisable. The parties eventually reached a negotiated settlement that gave Goldsmith control of the company. See Mike Tharp, *Goldsmith Wins Fight for Crown Zellerbach Corp.*, WALL ST. J. (July 26, 1985) at A3. There have been inadvertent pill triggers over the years. See, e.g., *Emeritus Corp. v. ARV Assisted Living, Inc.*, No. 793420 (Cal. 1999) (hostile bidder found to have inadvertently triggered target's pill in successful takeover bid).

Oracle could have acquired its 20% stake in PeopleSoft (=73.0 million shares) at \$18.54 per share, or \$1.35 billion total.

The pill is triggered. If PeopleSoft does nothing (more on this below), the rights become exercisable after ten days, and all shareholders other than Oracle can pay \$190 cash to PeopleSoft and receive PeopleSoft shares worth \$380. If all eligible PeopleSoft shareholders exercised these rights, and using October 1, 2004 as the pill trigger date, PeopleSoft shareholders would have paid \$55.5 billion in cash and received back 6.0 billion new PeopleSoft shares.

The issuance of 6.0 billion new PeopleSoft shares would dilute Oracle's previous 20% stake down to 1.1%. The value of Oracle's stake would drop from \$1.35 billion to \$715 million, or a \$638 million loss for Oracle. All other PeopleSoft shareholders would share pro rata in the \$638 million, assuming that they exercised their deep-in-the-money options. Exhibit 1 provides more detail on these calculations.

Exhibit 1: Triggering the PSFT pill

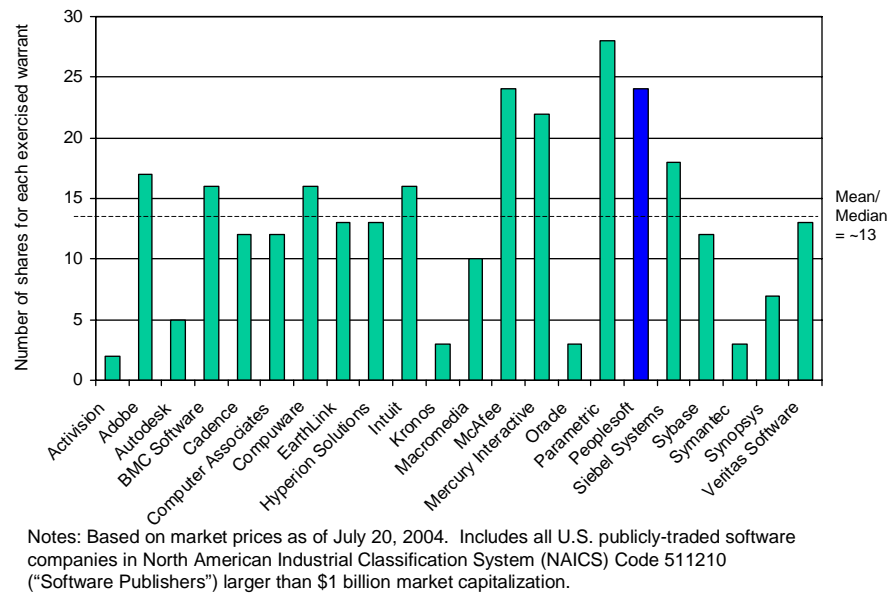
Inputs: 364.9 million shares outstanding; 20% pill trigger threshold; 50% dilution factor; \$190 pill exercise price.

Analysis:

- 1. Oracle buys 20% stake** (=73.0 million shares) for \$1.35 billion ($\18.54×73.0 million shares)
- 2. Pill is triggered:** PeopleSoft issues 5,983 million new shares ($=\$190 \times 2 / \$18.54 \times 80\% \times 364.9$ million) in exchange for \$55.5 billion cash ($=80\% \times 364.9 \times \190 exercise price)
- 3. Oracle's 20% stake is diluted to 1.1%** ($= 73.0 / (364.9 + 5,983)$)
- 4. Value per fully diluted share = \$9.80** ($\1.35 billion $\times 5 + \$55.5$ billion) / (364.9 + 5,983)
- 5. Oracle's 73.0 million shares are worth \$715.4 million** (representing a loss of \$638 million compared to \$1.35 billion purchase price)

To put this dilutive impact in context, I have collected data on the poison pills installed at all U.S. publicly-traded software companies with market capitalization of at least \$1 billion. Exhibit 2 provides the number of common shares that would have been issued to the target's shareholders for each common share outstanding, in the event of a pill trigger.

Exhibit 2: Pill Potency Comparison



Using market prices as of July 2004, Exhibit 2 shows that the average poison pill in this sample provided approximately thirteen shares of the target for each share previously owned. Exhibit 2 also shows that PeopleSoft's pill provided twenty-four shares for each share previously owned, *nearly double* the average among comparable companies.

Interestingly, this severe potency was not intended. When PeopleSoft installed its pill in February 1995, its share price was \$33-\$34 per share, which would have meant approximately eleven shares for each share previously owned. But when PeopleSoft's share price declined to \$15-\$18 per share over the next eight years without any corresponding adjustment in the pill exercise price, PeopleSoft's pill became more potent than originally intended.

This potency would have had unintended consequences for PeopleSoft. If all eligible shareholders exercised their rights to buy additional PeopleSoft shares, PeopleSoft would issue 6.0 billion new shares with a market value of \$9.80 per share, or a total market value of \$58.8 billion. A \$58.8 billion equity issue would be the largest of all time. According to the Securities Industry Association (SIA), the *total* global common stock issuance in 2004 was \$170 billion. The largest single equity issues in 2004 were Enel Spa (\$9.5 billion), France Telecom (\$6.2 billion), and Royal Bank of Scotland (\$4.8 billion).⁵ Due to PeopleSoft's size and the potency of its pill, it is no understatement to say that triggering its pill would put severe strain on global capital markets.

It would also throw PeopleSoft's balance sheet into disarray, *quadrupling* the asset side of PeopleSoft's balance sheet, with a corresponding increase in shareholder's equity. This cash would impose an insurmountable drag for years to come on PeopleSoft's return on assets, return on equity, and virtually all other accounting measures. This analysis demonstrates that

⁵ I thank Professor Carliss Baldwin for this data.

straightforward pill exercise would not just hurt Oracle; it would cause problems for PeopleSoft as well.

B. Pill variations

Fortunately for PeopleSoft, poison pills are constructed to be extremely malleable instruments. During the ten day period between a Trigger Event and Pill Exercise, the PeopleSoft board could not redeem (eliminate) the pill, but it could amend the pill in any way it liked.⁶ In the countdown to Pill Exercise, PeopleSoft's board would presumably receive guidance from its advisors that the "do nothing" strategy could yield an equity infusion that would be unprecedented in the history of the capital markets. The natural question, then, would be how to avoid such an outcome.

One possibility would be to reduce the exercise price for the rights, or equivalently, include some fraction of the cash from exercise in the value delivered back to shareholders. For example, a \$2 (net) exercise price would mean a far more digestible \$582 million cash infusion arising from pill exercise. If PeopleSoft maintained the 50% dilution factor (meaning \$4 of PeopleSoft stock, to continue the illustration) a lower exercise price would monotonically (though not linearly) reduce the dilution that Oracle suffered. For example, a \$2 exercise price and a 50% dilution factor would mean a \$100 million loss to Oracle from triggering PeopleSoft's pill.

If instead PeopleSoft increased the dilution factor so as to leave the \$190 difference unchanged, Oracle would suffer greater dilution than previously provided in the pill. For example, a \$2 exercise price and \$192 value delivered would cause a \$1.19 billion loss to Oracle – nearly twice the loss calculated in Exhibit 1.⁷ This "juicing up" of PeopleSoft's pill would raise serious concerns under general equitable principles in Delaware corporate law.⁸ Over the past two decades the Delaware courts have steered a middle ground on pills, validating "plain vanilla" pills but invalidating "high octane" pills such as dead-hand and slow-hand pills.⁹ Allowing a target board to juice up its pill after a bid has been launched would open the door to limitless pill potency, which would seem to run afoul of the middle-ground course that Delaware has navigated in its pill jurisprudence. Put more simply, how can a defense be "proportional" to anything if it can be legally juiced up to achieve limitless dilution? It would seem, then, that in treading the line between maximizing economic potency on the one hand and minimizing legal risk on the other, PeopleSoft would be stuck with its \$190 exercise price and 50% dilution factor.

There is still a way for the PeopleSoft board to avoid a \$56 billion cash infusion. Section 24 of the PeopleSoft Rights Agreement (the "exchange feature"), common in many pills today, permits the PeopleSoft board to choose a simplified, cashless exercise of one PeopleSoft share per Right. According to one senior M&A practitioner who has examined PeopleSoft's pill in detail in conjunction with this Commentary, the Oracle-PeopleSoft case "would be a perfect case

⁶ See PeopleSoft Rights Agreement § 22 ("Prior to the occurrence of a Distribution Date [i.e., ten days after a Trigger Event], the Company may supplement or amend this Agreement in any respect.").

⁷ Section 11(a)(iii) of the PeopleSoft Rights Agreement specifies that the \$190 difference should be preserved in any amendment to the pill, but of course this Section too could be amended.

⁸ See, e.g., *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437, 439 (Del. 1971) (noting that "inequitable action does not become permissible simply because it is legally possible").

⁹ See *Quickturn Design Systems, Inc., v. Shapiro*, 721 A. 2d 1281 (Del. 1998) (invalidating slow-hand pill); *Carmody v. Toll Brothers*, 723 A.2d 1180 (Del. Ch. 1998) (invalidating dead hand pill).

for a board to exercise the exchange feature.”¹⁰ Under this feature, all other PeopleSoft shareholders would surrender their rights in exchange for 291.9 million new PeopleSoft common shares. Oracle’s 20% stake would be diluted down to 11.1% (compared to 1.1% in Exhibit 1) and Oracle would suffer an economic loss of \$598 million (compared to \$638 million in Exhibit 1). Exhibit 3 provides the details of these calculations.

Exhibit 3: Utilizing the exchange provision

Inputs: 364.9 million shares outstanding; 20% pill trigger threshold; exchange ratio of one new common share for each right not held by acquirer.

Analysis:

1. **Oracle buys 20% stake** (=73.0 million shares) for \$1.35 billion (\$18.54 x 73.0 million shares)
2. **Exchange provision is triggered:** PeopleSoft issues 291.9 million new shares (=364.9 * 80%).
3. **Oracle’s 20% stake is diluted to 11.1%** (= 73.0 / (364.9 + 291.9))
4. **Value per fully diluted share = \$10.30** (\$18.54 x 364.9 million shares) / (364.9 + 291.9)
5. **Oracle’s 73.0 million shares are worth \$751.9 million** (representing a loss of \$598 million compared to \$1.35 billion purchase price)

For the remainder of this Commentary I assume that PeopleSoft would have used the default provisions examined in Exhibit 1, which would have resulted in the maximum dilution of \$638 million, though Exhibit 3 demonstrates that the dilution is almost the same if the PeopleSoft board utilized the exchange option instead. On points where the default pill and the exchange provision would yield different outcomes, I explore both possibilities. Before pushing forward in this analysis, however, I consider one other critical feature of PeopleSoft’s poison pill.

C. The defect in PeopleSoft’s pill

As noted above, PeopleSoft’s pill provides a ten-day window between Pill Trigger and Pill Exercise. During this ten-day window, the pill is not redeemable, but it can be amended in any way by the PeopleSoft board. Not all pills are designed this way: according to TrueCourse, Inc., the most comprehensive database for examining the features of U.S. poison pills, half of all pills provide a ten-day window like PeopleSoft’s pill, while the other half distribute the rights and permit exercise immediately after a Trigger Event.

While this difference in pill design has not received attention from pill commentators, it has important implications for the negotiation dynamics that the pill creates. On one hand, the ten-

¹⁰ See Memo from Senior M&A Practitioner (July 22, 2006). The practitioner continues: “Compared to your Exhibit 1, the utilization of the exchange provision is a clean, simple, and effective solution that avoids the substantial complications and uncertainties from shareholders having to invest \$55 billion to exercise the rights.”

day window allows the board to cure any defects in the pill that would thwart exercise – for example, further fractionalization of the preferred shares in order to permit the intended dilution against the bidder.¹¹ On the other hand, the ten-day window allows the board to amend the pill so as to make exercise no longer economically attractive – for example, simply changing the dilution factor from 50% to 0%. In effect, the ten-day window means that *PeopleSoft*, not Oracle, chooses whether the dilutive effect of the pill is actually realized.

In negotiation analytic terms, the pill does not effectively commit to financial Armageddon in the event that Oracle buys more than 20% of *PeopleSoft*. By giving *PeopleSoft* a “last look” to avoid disaster, the pill in fact weakens *PeopleSoft*’s bargaining hand.¹² Analogies to nuclear weapons are obvious here: whoever has the last chance to pull back is likely to take it due to the severity of the instrument, which in turn gives bargaining power to the party that can irrevocably commit. By giving itself a last look, *PeopleSoft* made it less likely that Oracle would have suffered the dilutive effect of the pill.

To see why, consider the coalitional dynamics during the ten-day window. Oracle, clearly, would like the *PeopleSoft* board to eliminate the pill through its amendment power. Less obviously, *PeopleSoft* shareholders would likely have the *same* interest as Oracle. The reason is that exercise is not as much of an economic windfall as the deep-in-the-money options would suggest, particularly if (as seems certainly to be the case) it reduces the likelihood of an acquisition. Assuming the straightforward pill exercise described in Exhibit 1, a *PeopleSoft* shareholder would pay \$190 for each share owned and receive back 20.5 shares ($=\$190 * 2 / 18.54$), worth \$200.86 ($20.5 * \$9.80$) after all the dust had settled. The return on this investment would be 5.7% ($\$200.86 / \190.00). This return must then be discounted by the possibility that pill exercise will make Oracle go away, thereby eliminating the possibility of a 40% return (\$21.00 offer on the table / \sim \$15.00 pre-offer trading price). In effect *PeopleSoft* shareholders would balance a 40% return today (if the pill were redeemed) against a 5.7% return today and some reduced probability of a 40% return later. If a Pill Exercise decreases the likelihood of a takeover by 14% ($=5.7\% / 40\%$), Pill Exercise becomes economically unattractive for *PeopleSoft* shareholders taken as a whole. And once time value of money is introduced, the break-even probability becomes even lower.

The exchange provision provides slightly better economics for *PeopleSoft* shareholders: one share worth \$18.54 becomes two shares worth \$20.60 (from Exhibit 3), or a 11.1% return. Not bad, until one again considers the increased likelihood of no-deal and the potential 19% drop in *PeopleSoft*’s share price to pre-deal levels. Or worse: if *PeopleSoft* did not have critical scale to remain competitive in the long-term enterprise application software marketplace, as many

¹¹ In fact, *PeopleSoft*’s pill would need such an amendment in order to be fully-functioning. The *PeopleSoft* pill required 6.0 billion common share equivalents to permit full exercise. *See supra* Exhibit 1. *PeopleSoft*’s charter, as amended in June 1998, authorized 702.0 million shares of common stock and 2.0 million shares of Preferred Stock. *See* Amendment filed Nov. 17, 1999. By October 2004, *PeopleSoft* had 364.9 million common shares outstanding. “Series A” Preferred Shares were also authorized, but a mandated 1,000-to-1 conversion ratio in the *PeopleSoft* charter made these shares unhelpful in the event of a Pill Exercise. Therefore, *PeopleSoft* would have had to create a new Series of Preferred Shares in order to permit full exercise. *See also* E-mail from Senior Advisor to Oracle A (“[The *PeopleSoft* pill] was not the subject of extensive study, but it was noted that like many pills PSFT did not have enough stock authorized to permit full exercise of the rights. . . . As to the use of the fractionalized preferred shares, this did not appear likely because of the mandated ratio of consideration between preferred and common shares.”) (Jan. 4, 2006).

¹² *See generally* THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* (1960).

observers believed, the no-deal alternative could have been free-fall in the PeopleSoft stock price. Empirical evidence shows that target shareholders receive lower long-run returns, on average, relative to the bidder's offer when the target successfully resists the bid.¹³ PeopleSoft would seem to be particularly vulnerable to this phenomenon given its strategic position in 2003-04.

The only clear-cut win for PeopleSoft shareholders was a sale to Oracle. Any maneuver that would put that outcome in jeopardy would be economically unattractive, unless it provided immediate returns on the order of 30-40%. Pill Exercise would have delivered short-run returns on the order of 5-11% to PeopleSoft shareholders – not enough to give up the clear-cut win.

The result of this analysis is an unusual coalition between the Oracle board and PeopleSoft shareholders during the ten-day window before Pill Exercise. Oracle could have cemented this coalition with a conditional offer that provided an equivalent return during the countdown to pill exercise, e.g., "\$2.00 more per share if the PeopleSoft board redeems the pill." In the case study, PeopleSoft director Skip Battle describes the negotiating tactics of the arbitrageurs holding PeopleSoft shares: "We met with three groups of arbs one morning, eight at a shot for an hour from 7:00 to 8:00 to 9:00. That's like being raw meat in a lion's den. Those guys are intemperate and pretty obnoxious."¹⁴ With the time-bomb ticking toward Pill Exercise, it would seem that PeopleSoft shareholders would put even more pressure on its board to redeem the pill and accept an (ideally, increased) offer from Oracle.

The final piece in the coalitional analysis is PeopleSoft's board. Here there is a natural split in interests between David Duffield, the sole inside directors after Craig Conway was fired, and the outside directors, led by Skip Battle. Duffield clearly had no interest in selling, at virtually any price – for him the idea of imposing \$600+ million damage on Oracle would be extremely appealing. The other directors would likely feel differently. The idea of stewarding a company through the only deliberate pill trigger in corporate law history would no doubt be terrifying for outside directors who stood very little to gain and everything to lose from further resistance. The prospect of blowing through D&O coverage and facing personal out-of-pocket exposure would no doubt loom large in their minds. These directors would have a very strong incentive to effectively redeem the pill during the ten-day window, particularly if Oracle could make it easy for them to do so through a modest conditional bump in the offer price.

In more theoretical terms, Oracle, as the much larger player, should take a risk-neutral approach toward the takeover contest, while the PeopleSoft directors should be risk averse, with very little to gain and everything to lose through a deliberate pill trigger. In any game of chicken, it is not difficult to predict what will happen if the risk neutral player can give the risk averse player the last clear chance at pulling away from the brink. The defect in PeopleSoft's pill permits Oracle to do precisely this.

Interestingly, this defect was easily avoidable. Compare PeopleSoft's unrestricted amendment provision ("Prior to the occurrence of a Distribution Date [i.e., ten days after a

¹³ See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 STAN. L. REV. 887 (2002); Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Commentators*, 55 STAN. L. REV. 885 (2002).

¹⁴ Millstone & Subramanian at 21.

Trigger Event], the Company may supplement or amend this Agreement in any respect.”) with the standard amendment provision supplied by Wachtell, Lipton, Rosen & Katz, the inventors of the poison pill:

The Company may from time to time supplement or amend this Agreement without the approval of any holders of Rights Certificates in order to cure any ambiguity, to correct or supplement any provision contained herein which may be defective or inconsistent with any other prior provisions herein, or to make any other provisions with respect to the Rights which the Company may deem necessary or desirable. . . ; *provided however*, that from and after such time as any Person becomes an Acquiring Person, this Agreement shall not be amended in any manner that would adversely affect the interests of the holders of Rights.¹⁵

The Wachtell pill cuts off the ability to redeem through amendment after a Trigger Event, because such an amendment would almost certainly be construed to “adversely affect the interests” of target shareholders. This design commits irrevocably to dilution in the event of a Trigger Event, thus deterring Trigger Events *ex ante*.

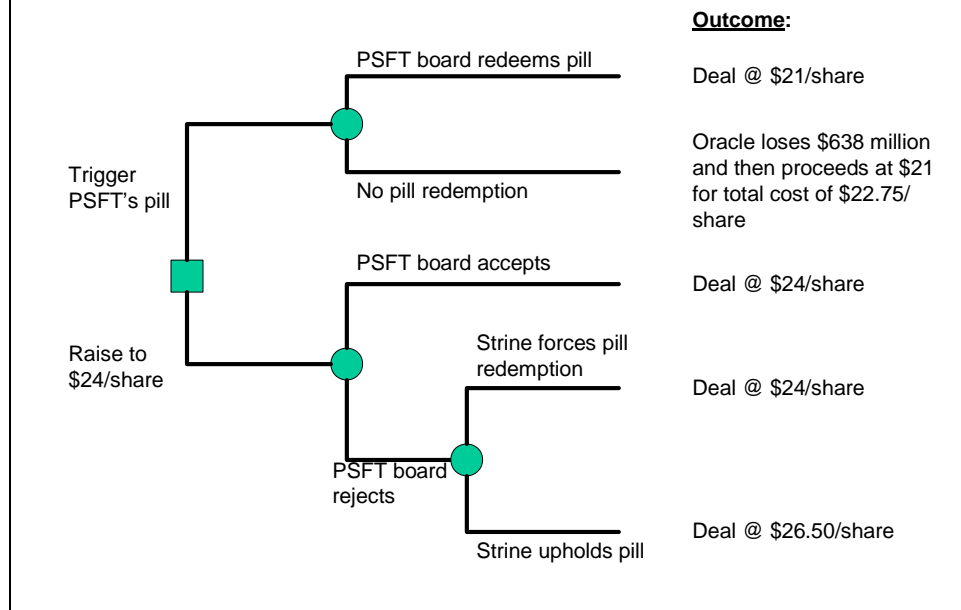
To summarize: the PeopleSoft pill was defective because it gave the PeopleSoft board a “last look” as to whether the pill would actually be triggered. By not irrevocably committing to Pill Exercise, the PeopleSoft board left itself open to a ten-day negotiation over whether the dilutive effect would actually be realized. In that negotiation, Oracle, PeopleSoft’s shareholders, and PeopleSoft’s outside directors would all favor pill redemption. In the worst case, the pill would not be redeemed, and Oracle would suffer a \$600-\$640 million loss. In the best (and in my view more likely) case, PeopleSoft would redeem its pill during the ten-day window and Oracle would proceed with its acquisition at \$21-\$23 per share.

II. Oracle’s Decision in October 2004

Return to October 1, 2004. The Department of Justice had just announced that it would not appeal the U.S. District Court’s antitrust ruling. The offer on the table was \$21 per share cash, where it had stood since May. Oracle’s next move was to press forward with its litigation challenging the validity of PeopleSoft’s poison pill under Delaware corporate law. But the previous Part suggests an alternative move, one that to my knowledge Oracle and its advisors did not seriously contemplate: triggering PeopleSoft’s poison pill. Rigorously thinking through a deliberate pill trigger would have led to insights for the bargaining table. Exhibit 3 provides the decision tree that Oracle faced.

¹⁵ EOG Resources, Inc. Rights Agreement § 27 (pill installed by Wachtell, Lipton in February 2000) (emphasis added).

Exhibit 4: Oracle's decision in Fall 2004



A. The unimaginable: a deliberate pill trigger

The top half of the tree is the one developed in the previous Part. If Oracle triggered PeopleSoft's pill, PeopleSoft would then have ten business days to determine whether to redeem its pill. If the board redeemed the pill (following the top branch in Exhibit 4), it seems very likely that a majority of PeopleSoft shareholders would have tendered at \$21.00. Oracle's market research indicated that the clearing price for a majority of the PeopleSoft shares was \$19.50.¹⁶ Moreover, without the benefit of a bargaining agent (i.e., the board) that a pill provides, there is a slight "pressure to tender" problem induced by the fact that shareholders who tender into the front-end tender offer will receive their cash sooner than those who tender into the back-end freeze-out.¹⁷ Even a few months difference could be meaningful for the arbitrageurs who held a large fraction of the PeopleSoft shares by this time.¹⁸ Therefore it seems highly likely that Oracle would win at \$21.00 per share if it triggered the pill and the PeopleSoft board chose to redeem its pill.

Following the bottom fork of the same chance node for Oracle (decision node for PeopleSoft), the board could opt to do nothing, and in ten business days the pill rights would become exercisable. If all rights were then exercised, Oracle would suffer a one-time loss of \$600-\$638 million, depending on whether the PeopleSoft board utilized the exchange provision.

¹⁶ See Millstone & Subramanian at 9 ("We spoke to the holders of a majority of the shares and \$19.50 was above where every one of them indicated they would sell their shares to us. In fact many were saying 'Give us \$18.00 and it's over.' At \$19.50 we were comfortably above the clearing price.").

¹⁷ See Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 983-85 (2002).

¹⁸ See David Millstone, *Between Wilmington and Washington: Lessons from Oracle-PeopleSoft* (this issue).

On one hand, this is a lot of money. On the other hand, \$638 million amounts to \$1.75 per PeopleSoft share, or \$0.12 per Oracle share.¹⁹ During the course of the Oracle-PeopleSoft contest, the Oracle share price moved more than \$0.12 on 28% of trading days. Exposure to a \$638 million loss, then, would not seem unreasonable; nor would it have any significant impact on Oracle's share price.

An important question is whether PeopleSoft might put in a new poison pill at this point. Because a first pill has never been deliberately triggered, no board has ever been faced with a decision to put in a second pill, and no court has ruled on the legality of such a maneuver. But putting aside the legal risk that a second pill would pose under a *Unocal/Unitrin* analysis,²⁰ there is an economic obstacle to a second pill. A detailed examination of pill mechanics makes clear that the damage imposed on the balance sheet by subsequent pills is multiplicative, not additive. The equity issue mandated by a second PeopleSoft pill would clearly be larger than the entire equity issued in the public marketplace for its year – clearly well beyond what the capital markets could bear, and therefore beyond what PeopleSoft's board could credibly threaten. In addition, triggering a second pill would force PeopleSoft to delist for failure to meet the NASDAQ minimum bid price requirements, unless PeopleSoft (quickly) executed a reverse stock split to get its share price above \$1.00.²¹ For these reasons, a second pill seems unlikely in general and particularly unlikely in the PeopleSoft case. After “swallowing” the first pill, Oracle would then proceed with its tender offer and back-end freeze-out at a pill-adjusted \$21.00 per share, for a total cost of \$22.75 per share.

Another important question at this juncture is whether other bidders might appear after Oracle had suffered the dilution of swallowing PeopleSoft's pill.²² There are two conditions that must be satisfied in order for this to be a concern. First, other bidders must view PeopleSoft's pill as an impediment – if instead other bidders were only interested in a friendly acquisition, then the elimination of the pill does not change their assessment of the target. Here, only IBM and SAP had expressed any meaningful interest in PeopleSoft, and public speculation about both of these bidders focused only on their “white knight” appearance, that is, as a friendly bidder. For IBM and SAP, then, the fact that Oracle swallowed PeopleSoft's pill would not make it any easier for them to acquire PeopleSoft. To the contrary, an acquisition after Oracle's pill trigger would actually be more difficult due to the new “bulk” on PeopleSoft's balance sheet, unless PeopleSoft executed its share repurchase or cash dividend as described above.

The second condition is that the third-party hostile bidder must believe that it can pay more for PeopleSoft than Oracle could pay. Once Oracle triggered the pill, the dilution cost would be sunk and Oracle would rationally bid up to its full willingness-to-pay. In a perhaps unintentional move, Oracle had signaled a very high willingness-to-pay with its \$26.00 per share offer in February 2004. It seems unlikely that IBM or SAP would believe that it was a higher-value bidder in October of that year, when a deliberate pill trigger became a possibility.

¹⁹ While this loss may seem surprisingly small for casual observers of the pill, other work confirms that, as a general matter, the actual loss from pill exercise is smaller than what the conventional wisdom would suggest. See Carney & Silverstein, *supra* note 3.

²⁰ See *id.* at 212-219 for such an analysis.

²¹ See NASDAQ minimum bid price requirements (minimum \$1.00 bid price for ten consecutive days).

²² I thank Professor Jennifer Arlen for this point.

In summary, while the prospect of a third-party hostile bidder free riding off a deliberate pill trigger might be a concern in some situations, it does not seem that it would have been a concern in the Oracle-PeopleSoft case.

Returning to the decision tree presented in Exhibit 4, the expected value of the top branch is a weighted average of \$21.00 per share (pill redeemed) and \$22.75 per share (pill not redeemed). For the reasons described in the previous Part, it is unlikely that the PeopleSoft board would not redeem the pill. It would seem, then, that the expected value of the top branch of the decision tree is closer to \$21.00 than to \$22.75, though, as will be seen from the analysis of the other branch of the tree, the final conclusion that emerges does not depend on where in this range the expected value might fall.

A deliberate pill trigger would have an important intangible benefit as well. It is well-understood that acquirers develop reputations in the M&A marketplace,²³ and Oracle would have been especially cognizant of the reputational effects of its moves because it had announced that PeopleSoft would be the first, and most important, of several acquisitions in the enterprise software marketplace.²⁴ Indeed, in the months following the PeopleSoft acquisition Oracle acquired Retek and Siebel Systems, as well as no fewer than twenty smaller players.²⁵ One drawback of making a hostile bid is that future acquirers would be less willing to discuss friendly acquisitions, or at least would require a long-term standstill before sitting down to negotiate with Oracle.²⁶ While there is no public record on this point, Oracle presumably was advised to this effect by its bankers and lawyers before initiating its hostile bid against PeopleSoft in June 2003.

The decision to nevertheless go forward demonstrates Oracle's willingness to play hardball. Future targets would be more likely to pay attention to friendly overtures after Oracle had demonstrated its willingness to use the "club" of a hostile takeover bid. Of course, strong takeover defenses would mitigate this fear. But a deliberate pill trigger would demonstrate Oracle's seriousness. Future targets, with or without strong takeover defenses, would come to the table more quickly when Oracle called, and might be likely to agree to less attractive terms than they would against other, less determined, acquirers. A deliberate pill trigger, then, would have certain reputational benefits that Oracle could use in future acquisitions. These benefits are particularly important in view of Oracle's stated strategy of being "the consolidator and not the consolidated."²⁷

B. The influence of DGCL § 203 and the "flip-over" feature in PeopleSoft's pill

Before leaving the top branch of the Exhibit 4 decision tree, it is important to consider two technical points, Section 203 of the Delaware corporate code and the "flip-over" feature in PeopleSoft's poison pill, as well as the connection between these two provisions. DGCL § 203 prohibited any "business combination" between Oracle and PeopleSoft for three years after Oracle passed 15%, unless (a) the takeover is approved by PeopleSoft's board before Oracle

²³ See, e.g., John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory & Evidence*, 53 STAN. L. REV. 307, 360-362 (2000) (describing reputational effects of taking a lockup in a competitive bidding situation).

²⁴ See Millstone & Subramanian.

²⁵ See Andrew Lavalley, *Oracle's Earnings Lead Nasdaq Higher*, Wall St. J. (Sept. 20, 2006).

²⁶ See Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L. J. 621, 652-53 (2003).

²⁷ See Millstone & Subramanian.

crosses 15%;²⁸ (b) Oracle moved from below 15% to above 85% in a single tender offer, excluding inside directors' shares;²⁹ or (c) Oracle got board approval and 2/3 approval from the minority who remained after the takeover.³⁰ In most hostile takeover contests the poison pill "dominates" DGCL § 203 so as to make the Delaware provision irrelevant.³¹ In Oracle-PeopleSoft, however, because the Section 203 threshold was lower than the pill trigger threshold (15% versus 20%) Section 203 would have become an important factor to consider.

If Oracle went down the route of a deliberate pill trigger, the simplest way around Section 203 would have been to simply wait the three years specified in the statute before executing the back-end minority freeze-out. For Oracle, the cost of keeping a minority float in PeopleSoft would have been the cost of public filings and the inability to fully integrate PeopleSoft's operations into Oracle. The cost of public filings is trivial at the corporate scale of either Oracle or PeopleSoft. While it is impossible to estimate the second cost (non-integration) with any certainty, it is interesting to note that Oracle had already announced its intention to maintain PeopleSoft products for far longer than three years, suggesting that Oracle's promises of customer support may have required even more than what Section 203 required. In fact, in a curious twist (one wholly unintended by the Delaware legislature when it passed Section 203 in 1987), a legal obligation to retain PeopleSoft as a separate corporate entity for three years might have actually bolstered Oracle's product support assurances with PeopleSoft's customers. That is, business constraints imposed by Oracle on itself may have made the legal constraints imposed by Section 203 less costly than they otherwise might have been.

There is a further benefit to DGCL § 203, related to the "flip-over" feature in PeopleSoft's poison pill. The flip-over feature allows right holders who do not exercise their "flip-in" rights to buy shares of *Oracle* after the freeze-out merger at the same 50% discount. Prior academic commentators claim that bidders are indifferent between flip-in exercise and flip-over exercise, because target shareholders have a fixed profit regardless of which mechanism is used (e.g., in PeopleSoft's case, \$190).³² However, in reality bidders vastly prefer flip-in exercise because of the difference in where this fixed profit comes from: with flip-in, the profit comes, in part, from other target shareholders; with flip-over the profit comes solely from the bidder. Therefore it becomes important to determine whether PeopleSoft shareholders would decide to flip-in or flip-over in the event of a pill exercise.

There are two reasons why target shareholders are very likely to flip-in rather than flip-over in the event of a pill exercise. The first is simple time value of money. Unlike traditional options, where the strike price is specified, here the spread is fixed (at \$190) so time value of money dictates earlier (flip-in) rather than later (flip-over) exercise.³³ DGCL § 203 then bolsters this point: by subjecting itself to a three-year delay under Section 203, Oracle virtually guarantees that target shareholders will want to exercise their flip-in rights rather than waiting for flip-over, which will only occur three years later.

²⁸ DGCL § 203(a)(1). This is the provision that, in the end, the parties used to avoid the effect of DGCL § 203.

²⁹ DGCL § 203(a)(2).

³⁰ DGCL § 203(a)(3).

³¹ See John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 321 (2000).

³² See Carney & Silverstein, *supra* note 3, at 197.

³³ See Carney & Silverstein, *supra* note 3, at 191.

The second reason why target shareholders will flip-in rather than flip-over is the legal risk inherent in flip-over provisions. According to former Delaware Chancellor Bill Allen and Professor Reinier Kraakman:

How can the target's board create a right that requires a third party to sell its stock at half price to the target's shareholders? Well, we are not certain that it can be done, since the question of whether a *triggering* shareholder must respect an obligation created by a flip-over plan has yet to be litigated. The reason these plans are *supposed* to work, however, is that they purport to compel the target's board to put terms in any merger agreement (or asset sale agreement, etc.) with the acquirer that will force the acquirer to recognize flip-over rights.³⁴

Although *Moran v. Household International* validated a flip-over provision installed on a "clear day," other commentators have similarly questioned the legal validity of flip-over rights as exercised.³⁵ Regardless of how a Delaware court might come out on this issue, even the possibility of invalidation would send PeopleSoft shareholders rushing to flip-in rather than flip-over.

In short, then, the combination of time value of money, restrictions imposed by DGCL § 203, and legal risk surrounding flip-over would combine to make it highly likely that shareholders would flip-in rather than flip-over in the event of a pill exercise. This technical aside reinforces the conclusion from the previous Part that Oracle would lose no more than \$600-\$625 million from deliberately triggering PeopleSoft's pill.

C. A comparison to the road taken: pushing the litigation and a negotiated deal

I now return to the decision tree presented in Exhibit 4. PeopleSoft had formally rejected \$21 per share. The next move was an increase to \$24 per share, which Oracle announced on November 1st, 2004. Then there is a chance node: would PeopleSoft's board of directors accept the revised offer? In answering this question one fact looms large: the PeopleSoft directors would have exposed themselves to enormous personal liability by accepting a \$24 offer. The reason is that \$26 had been put on the table and rejected in February 2004. By accepting \$24 in November, just nine months later, the PeopleSoft board would lose face in view of its previous statement that \$26 was inadequate.

More importantly, accepting \$24 would have inevitably triggered litigation claiming breach of fiduciary duty that caused injury to the PeopleSoft shareholders. Damages would have been painfully easy to quantify: \$2 per share across 364.9 million shares, or \$730 million in total.

³⁴ WILLIAM T. ALLEN & REINIER KRAAKMAN, *CASES AND COMMENTARIES ON THE LAW OF BUSINESS ORGANIZATION* 507 (2003) (emphasis in original). *See also A Household Name*, 6 M&A JOURNAL 10 at 18, 20 (2006) ("Looking back on the Household fight, [Delaware Vice Chancellor Steve] Lamb was still wondering how it could be that the directors of one company can be allowed [to] send their own shareholders to plunder the stock of another company at a discounted price that they unilaterally determine in advance. He rolled his eyes and smiled: 'I just don't know.'").

³⁵ *See, e.g., Julian Velasco, The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 410 (2002) (questioning analogy between flip-over provisions and "anti-destruction" provisions in preferred stock); Peter V. Letsou, *Are Dead Hand (and No Hand) Poison Pills Really Dead?*, 68 U. CIN. L. REV. 1101, 1124 (2000) (noting tension between flip-over provisions and emphasis on redeemability in Delaware Supreme Court's *Quickturn* decision).

PeopleSoft had waived director liability for monetary damages under Section 102(b)(7) of the Delaware corporate code,³⁶ but this exculpatory provision only permits waiver of liability for breaches of the duty of care. Here, there is a strong duty of loyalty claim (namely, board entrenchment) to which a 102(b)(7) waiver would not apply.

The extent of D&O coverage for the PeopleSoft directors is not a matter of public record. However, the sheer magnitude of the claim makes it unlikely that D&O coverage would have completely protected the PeopleSoft directors from liability. In a mock oral argument held at Harvard Law School in October 2005, well after the case had been settled, Michael Carroll, chief litigator for Oracle, noted that the “PeopleSoft board must be deeply worried” about the possibility of personal liability for the \$730 million. In the real situation, when the PeopleSoft board rejected \$26, a senior lawyer on Oracle’s side told me only half-jokingly that “either the PeopleSoft board loves litigation or they have unbelievably large D&O coverage.”

This analysis suggests that \$24 was a number that the PeopleSoft board could not possibly accept. Sure enough, they didn’t, and the analysis on the bottom half of the decision tree then proceeds to Vice Chancellor Strine’s courtroom. If V.C. Strine forced PeopleSoft’s board to redeem its pill, Oracle would be able to proceed at \$24 per share, which as noted earlier was well above the market-clearing price. If V.C. Strine upheld the pill, then Oracle would have to go above \$26 in order to extinguish the potential claim against the PeopleSoft board and make it feasible for them to accept. Here, the probabilities were notoriously difficult to predict. Assume, as a best case from Oracle’s perspective, that Oracle had a 70% chance of prevailing in Delaware Chancery Court, as some advisors to outside parties to the deal estimated.³⁷ Paring back the bottom half of the tree and eliminating the branch in which PeopleSoft accepted \$24 (based on the agency analysis above) provides a \$24.75 expected cost to get the deal done.

Beyond the per share expected cost, the bottom half of the decision tree also creates costs due to delay. In the best-case scenario, Oracle would have had to wait until Vice Chancellor Strine issued his ruling in January 2005 before being able to proceed. And if V.C. Strine ruled in favor of PeopleSoft on the pill question, Oracle would have to wait until PeopleSoft’s annual meeting in May 2005. Beyond the usual time value of money, delay in this deal meant the continued accrual of the Customer Assurance Program (CAP). By October 2004, the two-to-five times multiples provided by CAP Versions 5 and 6 was accruing a potential liability at the ferocious rate of approximately \$150 million per month.³⁸ A simplistic view is that the CAP would be costless to Oracle as long as Oracle did what it said it was going to do in terms of supporting the PeopleSoft products. More sophisticated commentators understood that the CAP would provide PeopleSoft customers with a club that they could use to extract concessions from Oracle in negotiations over what constituted adequate product support.³⁹ The cost of delay, then, was much larger in this deal than the usual time value of money.

³⁶ See PEOPLESOFT CHARTER ARTICLE XIII.

³⁷ See Millstone & Subramanian.

³⁸ See *id.*

³⁹ See, e.g., Millstone & Subramanian at 13 (citing testimony from Larry Ellison in the Delaware trial: “The biggest concern I have right now is something I learned very recently, which is the ambiguity in some of the [CAP] contracts. The trouble is we live in a litigious world. And some customers might decide to take advantage of the insurance, just see what happens in court – or, at the very least, use that as a negotiating technique against us. . . . Someone will say, ‘All right, I have this offer of five times my money back, but why don’t you just cut my

D. Implications for Oracle's negotiation strategy

To summarize the analysis thus far, the top half of the Exhibit 3 decision tree has an expected cost of somewhere between \$21.00 and \$22.75 per share, depending on the probability that PeopleSoft would cave after Oracle crossed the pill trigger threshold. This analysis does not include the intangible costs due to DGCL Section 203 and the intangible reputational benefits from a deliberate pill trigger. The bottom half of the decision tree, the route actually taken, has an expected cost of \$24.75 in October 2004, putting aside the additional costs of delay, and an actual cost of \$26.50 per share when the dust finally settled in December. When viewed from Oracle's perspective in October 2004, we see then that crossing the 20% threshold actually had at least a \$2.00 per share lower expected value than the route taken. Of course, with the benefit of hindsight, crossing the 20% threshold seems even more attractive than this: as a worst case, paying an extra \$1.75 per share by triggering the pill and suffering the full dilution would still have been less costly than the extra \$5.50 per share that Oracle eventually paid to acquire PeopleSoft. The size of the deal makes these differences non-trivial. From an *ex ante* perspective, the \$2.00 per share difference in expected values amounts to \$730 million in total. From an *ex post* perspective, the \$3.75 per share difference between the expected cost of triggering the pill and the actual \$26.50 deal price amounts to \$1.4 billion that Oracle would have saved.

Of course, risk and uncertainty may have played a role here in Oracle's decision to not trigger the pill. The lower branch of the decision tree in Exhibit 3 is well-understood and well-tested. The downside risk is smaller because there is no immediate, potentially uncompensated, \$638 million outlay. But notice that it would not take an actual pill trigger in order to achieve the benefits described in this Part. By thinking through the unthinkable – what *actually* would have happened by deliberately triggering PeopleSoft's pill – Oracle would have gained considerable bargaining power.

In the actual negotiation, PeopleSoft believed that it had an impenetrable defense in the form of the poison pill, at least until Vice Chancellor Strine ruled on the pill or the annual meeting arrived in May 2005, whichever came first. In the actual end-game, several insiders to the deal indicated to me that PeopleSoft finally came to the table because of the real likelihood that V.C. Strine was going to force the PeopleSoft board to redeem its pill. By introducing, perhaps through a back-channel, even the *possibility* of a deliberate pill trigger, Oracle would likely have brought PeopleSoft to the bargaining table sooner, and might have permitted a deal at a lower price. Imagine, for example, the likely impact on PeopleSoft's perceived bargaining position if Oracle leaked a banker presentation that included some version of Exhibit 4 of this Commentary. Or simpler, a press release announcing that Oracle was "considering all possible methods for acquiring PeopleSoft, including a deliberate triggering of PeopleSoft's pill." The last clause would have sent PeopleSoft's board scrambling to re-assess its policy of not talking to Oracle.

Once face-to-face, Oracle's message to PeopleSoft could have gone something like this: "We are prepared to deliver more value to your shareholders than our current offer of \$21 per share. We can do this by triggering your pill, which would deliver \$1.75 per share to your shareholders,

maintenance fees in half instead and forget the whole thing.' And we end up having to do that with hundreds and hundreds of customers, which will be very expensive."). See generally Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L. J. 950 (1979) (demonstrating how the "shadow of the law" provides endowments that influence outcomes).

but this would force you into a very difficult position. We can also do this through delivering more – say \$2.00 per share more – in a negotiated deal. You choose.” In negotiation terms, altering PeopleSoft’s perception of its own no-deal alternative might have allowed a cheaper deal for Oracle in the end.⁴⁰

Larry Ellison’s reputation would have facilitated this negotiation strategy. To see why, consider this account by H.R. Haldeman, chief-of-staff to President Richard Nixon:

We were walking along a foggy beach after a long day of speechwriting. He said, “I call it the Madman Theory, Bob. I want the North Vietnamese to believe I’ve reached the point where I might do anything to stop the war. We’ll just slip the word to them that, ‘for God’s sake, you know Nixon is obsessed about Communism. We can’t restrain him when he’s angry – and he has his hand on the nuclear button.’”⁴¹

As the case study makes clear, Ellison’s reputation was detrimental to several aspects of Oracle’s hostile bid – most importantly, it fueled the initial perception that Oracle was “not serious” and only wanted to disrupt PeopleSoft’s operations. But here, Ellison’s reputation for taking on large risks in his personal life (racing yachts, flying fighter planes) would have lent credibility to his willingness to engage in the high-risk negotiation strategy developed here. In fact, Ellison could probably threaten more credibly than any other public-company CEO today to “press the button” and deliberately trigger a pill.

I therefore close my analysis of the Oracle-PeopleSoft case study with a more modest claim than where I began. The analysis presented in this commentary suggests that Oracle could have paid approximately \$730 million (*ex ante*) to \$1.4 billion (*ex post*) less for PeopleSoft by deliberately triggering PeopleSoft’s poison pill. However, I readily admit that this analysis is based on educated guesses about moves and counter-moves in the uncharted territory of a deliberate pill trigger. Even if Oracle did not have the appetite for taking on such risk, it could have used this analysis to demonstrate to PeopleSoft the apparent viability and feasibility of a deliberate pill trigger. That is, by raising the possibility of a deliberate pill trigger, which to my knowledge no one on the Oracle side did,⁴² Oracle would have changed PeopleSoft’s perception of its no-deal alternative, in a way that would have provided Oracle greater leverage at the bargaining table. In the end, the deal would still have ended with a negotiated acquisition, but

⁴⁰ A natural question arises from this analysis. If PeopleSoft’s board could not accept less than \$26.00 per share because of inevitable shareholder litigation from doing so, then how might they be prompted into accepting less than \$26.00 through a threatened pill trigger? The explanation is that an actual pill trigger would also lead to inevitable litigation against the PeopleSoft board. If the board redeemed its pill during the ten-day window after pill trigger and the \$21.00 per share offer were successful, plaintiffs would allege breach of fiduciary duty for the \$5 difference. If instead the PeopleSoft board did not redeem the pill, plaintiffs would claim breach of fiduciary duty in allowing the dilutive effect to play out, and/or breach of fiduciary duty for implementing a defective pill. Regardless of how things actually played out, it is clear that an actual pill trigger would put the PeopleSoft board in a very difficult position. As soon as that possibility was put on the table, it seems likely that the board’s sole effort would be to close as much of the gap to \$26 as possible, in order to maximize shareholder value and minimize their litigation exposure.

⁴¹ Quoted in JOHN C. MOWEN, JUDGMENT CALLS: HIGH-STAKES DECISIONS IN A RISKY WORLD at 221-222 (1993).

⁴² See, e.g., E-mail from Senior Advisor to Oracle A (“The answer is that this [a deliberate pill trigger] was not considered. My sense is that the economic effect would have been prohibitive unless you assume that the pill-triggering purchase was of a very high percentage of the stock and associated rights. . . . But I confess that I did not run the numbers to confirm this.”). (Jan. 5, 2006)

Oracle's purchase price would have come in considerably lower than the \$26.50 per share that it actually paid.

III. Implications

A. For boards of directors

The Oracle-PeopleSoft case study has two implications for boards of directors. The first is that takeover defense should be a board-level issue, not a legal issue to be left to outside or inside counsel. When pills were first introduced in the mid-1980s, boards would meet for four or five hours to understand the mechanics of the pill, and how the dilutive effect would play out if triggered.⁴³ Today, pill adoption is mechanical, often after perfunctory review and discussion by the board.⁴⁴ The result is that boards have only the vaguest sense of how pills actually work, and often believe (incorrectly) that the pill directly prohibits the acquisition of a stake above the pill trigger threshold.⁴⁵

Analogies to other technologies are clear: for example, drivers in the 1920s understood well how their automobile worked, while today most drivers would be hard-pressed to identify where a carburetor is located, much less what it does. The pill, like the automobile, has become a “black box” for its customers. But the Oracle-PeopleSoft case makes clear that a poorly designed pill can cause headaches or even disasters down the road for a board of directors. In installing a pill, a board should require its outside counsel to walk through its mechanics, perhaps using a chart like the one provided here in Exhibit 1.

A second implication for boards is that takeover defenses generally, and especially defenses that are pegged to stock prices such as poison pills, require regular board-level check-ups. It is my sense that boards today only re-examine defenses when they are up for renewal – in the case of poison pills, every ten years. The example of Oracle-PeopleSoft indicates that this is not often enough. An annual check-up, for example, would allow a board to re-assess the mechanics of its pill in view of the current state of its balance sheet and stock price.

Beyond the practical benefits of an annual pill check-up, there is a doctrinal benefit as well. In the 1980s and early 1990s, practitioners urged boards to install pills on a “clear day,” because the legal ability to put in a pill after a bid was launched was not known. By the mid-1990s, the ability to put in a so-called “morning after” pill was well-settled, and target boards regularly did so.⁴⁶ As a result practitioners generally shifted their guidance to recommend waiting until a bid was launched before putting in a pill.⁴⁷ While it is certainly correct that putting in a plain vanilla poison pill after a bid is launched is tactically unremarkable and legally safe, “juicing up”

⁴³ See, e.g., *Moran v. Household International*.

⁴⁴ See, e.g., HALL, ROSE & SUBRAMANIAN, *supra* note 1.

⁴⁵ See *supra* note 3.

⁴⁶ See, e.g., HALL, ROSE & SUBRAMANIAN, *supra* note 1.

⁴⁷ See Subramanian, *supra* note 26, at 639 (quoting interview with eminent corporate lawyer and investment banker Robert Kindler: “I have always counseled – as a lawyer and as a banker – companies that don’t have poison pills, that they should not put them in, because if you put a poison pill in all you’re doing is attracting attention to yourself. I don’t think it’s a prudent thing to put a pill in place if you don’t have one, because you can always put one in in a half an hour.”).

a pill after a bid has been launched is on much shakier ground.⁴⁸ In the particular case of Oracle-PeopleSoft, the *Economist* noted: “Mr. Strine may yearn to scrap PeopleSoft’s poison pill and send a clear message that American boards cannot just say no.”⁴⁹ Fiddling with a pill after a deliberate pill trigger might give a judge like Vice Chancellor Strine the excuse needed to force a pill redemption. Conversely, an annual pill check-up would minimize the likelihood of providing such an excuse.

B. For practitioners

One obvious implication for practitioners is to beware mistakes. Mistakes happen regularly even at the highest levels of corporate practice,⁵⁰ and perhaps are inevitable to some degree, but pill design is a high-stakes issue that is error-prone due to the complex nature of the pill documents themselves.⁵¹ It would therefore seem appropriate for M&A practitioners to invest partner-level resources in installing poison pills, rather than viewing pill installation as “boilerplate” to be delegated to associates. A partner, more so than an associate, would be more likely to understand the connection between the redemption provision and the amendment provision in PeopleSoft’s pill, and the negotiation consequences thereof.⁵²

Or perhaps not. The law firm that installed PeopleSoft’s amended and restated poison pill in 1998 was Wilson, Sonsini, Goodrich & Rosati. Wilson Sonsini is well-known for its deep expertise in taking companies public, and may very well be the best firm to advise a company at the IPO stage, but it has been singled out in academic commentary for its inexperience with takeover defenses.⁵³ In the mid-1990s, not all law firms had deep expertise with designing poison pills, and PeopleSoft’s pill may have been one manifestation of this point.

In a corporate law blog posting reacting to this Commentary, Robert Schwartz writes:

I once used a set of documents prepared by Skadden Arps as a poison pill. Some time later, I discovered a minor but not immaterial glitch . . . There were what must have been a couple of dropped lines in a paragraph. In order to fix it, we had to put a charter amendment on the agenda at an annual meeting (the client was an Ohio corp; a Delaware [corporation] would not have had to have done that). I later found out that the same glitch popped up in a lot of pills Skadden

⁴⁸ See ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSES (6th ed. 2000 & Supp. 2002) at §7.11[B][d] (“Directors’ pre-planned defensive actions, such as the adoption of a shareholder rights plan, are accorded a stronger presumption of validity than defensive tactics adopted as a reaction to a particular change-in-control threat. Thus, the courts are more likely to substantively scrutinize an action which constitutes a specific response to a particular takeover proposal.”).

⁴⁹ *Face Value: The Case of the Poison Pill*, THE ECONOMIST (Dec. 11, 2004).

⁵⁰ See HALL, ROSE & SUBRAMANIAN, *supra* note 1 (pill resolution not filed by Circon board); John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1368-69 (2001) (finding inconsistencies between charter and bylaws at IPO companies); Computer Associates (mistake in stock option agreement); John C. Coates IV, *Blame the Experts: PeopleSoft as a Case Study in Professional Service Market Failure* (this issue).

⁵¹ See *supra* note 3.

⁵² See Senior M&A Partner E-mail (dated July 24, 2006) (“I would view the broader amendment language in the PeopleSoft pill as a defect (since it is inconsistent with the redemption provision) that weakens the pill.”).

⁵³ See Coates, *supra* note 50.

had done. This was before Edgar, but the lesson is clear, you must read and think through everything.⁵⁴

But the implications for dealmaking practitioners go beyond simple prescriptions of avoiding mistakes and understanding limits on areas of expertise. In an advanced negotiation class that I teach at Harvard Law School, Steve Munger, Chairman of the Global Mergers & Acquisitions Group at Morgan Stanley, spoke of the “fog of war” that can cloud negotiators’ ability to make decisions in the heat of the battle.⁵⁵ Dealmakers can oftentimes “walk themselves off a cliff” by thinking through only the next step to be taken. Munger stated that a central role for M&A advisors is to “take things up one level” – thinking three or four days ahead, rather than just thirty minutes ahead, in difficult deal-making situations. This lesson is readily generalizable: a rigorous thinking-through of just the first few moves and counter-moves can yield insights for the bargaining table that go well beyond what the typical dealmaker, in the heat of the battle, is able to contemplate.

In the particular case of Oracle-PeopleSoft, when the DOJ announced that it would not appeal the District Court’s antitrust ruling, the next obvious step was to push forward with the Delaware litigation challenging the validity of PeopleSoft’s pill and the CAP. The analysis presented in this Commentary suggests that taking a step back and thinking through what *really* would have happened with a deliberate pill trigger would have suggested a somewhat different strategy. The powerful negotiation prescription of “looking forward and reasoning back” would likely have yielded insights for the bargaining table that would have allowed Oracle to pay a lower price in the end.

In a recent interview with the *New York Times*, famed M&A dealmaker Bruce Wasserstein was portrayed as a master on taking things “up one level:”

If Mr. Wasserstein is good at anything, it is thinking, overthinking, doubting his own thinking and thinking some more. . . . While he may be a card-carrying master of the universe, he is more brainy wonk than banker jock. . . . “You can’t just assume things are the way they are and that they have to be the way they are,” he said about his obsession with questioning everything.⁵⁶

Of course, to my knowledge, even Bruce Wasserstein has not contemplated a deliberate pill trigger. As a reader of an early draft of this Commentary put it to me: “Can you get malpractice insurance that covers the exposure if you make the gamble to encourage your client to run the pill and fail?” Admittedly, the analysis put forward here has the benefit of nothing at risk and 20-20 hindsight, as is common from the academic perch. To put the point more strongly, as someone involved in the Oracle-PeopleSoft matter in October 2004, I did not raise the possibility of a deliberate pill trigger, nor is it likely that I would have done so had it occurred to me at the time.

Nevertheless, it is important to highlight that the argument put forward in this Commentary is only one of probabilities. Increasing the likelihood of a deliberate pill trigger from 0% to, say,

⁵⁴ Posting by Robert Schwartz, available at http://www.theconglomerate.org/2006/05/copyright_and_d.html (May 5, 2006).

⁵⁵ Guest lecture by Steve Munger in *Advanced Negotiation: Deal Design & Implementation* (April 7th, 2006).

⁵⁶ Andrew Ross Sorkin, *He Likes Challenges. But Time Warner?*, NEW YORK TIMES (Jan. 15, 2006).

5% would have changed PeopleSoft's perception of its no-deal alternative. Practitioners at the highest levels are able to cut through the "fog of war" to think creatively, cast a wide net, and "question everything" before choosing a particular course of action. This Commentary suggests that doing so in October 2004 would have yielded important benefits for Oracle at the bargaining table.

C. For judges

One of the most important debates in corporate law over the past two decades has been the validity of the poison pill. In the 1980s the debate focused on whether the pill should be valid at all, while in the 1990s and today the debate has shifted to focus on the particular circumstances under which a target board should be required to redeem its poison pill. It was thought that the Oracle-PeopleSoft contest would provide the first judicial guidance on this question in fifteen years. The fact that there was a reasonable chance of a forced pill redemption suggests that the question of whether, and under what circumstances, a poison pill should be redeemed is very much in play. Put differently, claims that the "Just Say No" defense is "alive and well" are overstated.

Despite the volumes that have been written on the question of forced pill redemptions, commentators to date have not differentiated among pills with different mechanics and mathematics, beyond the broad classes of "plain vanilla," "dead hand" and "no hand" poison pills. The analysis presented in this Commentary suggests that differentiation among pills is warranted even within the class of "plain vanilla" pills where most of the attention focuses today. Specifically, in addition to the other well-known factors that have been endorsed by the Delaware courts, judges should pay attention to the magnitude of the dilution imposed by the target's pill in determining whether the continued use of the pill is "preclusive or coercive"⁵⁷ and, if not, "reasonable in relation to the threat posed."⁵⁸ Several factors might be considered in this analysis: the overall loss to the bidder from triggering the pill (i.e., the calculation presented in Exhibits 1 and 3); the per share loss, either from the target's or bidder's perspective; and/or the number of shares issued by a pill trigger, either as an absolute matter or relative to comparable companies (i.e., the calculation presented in Exhibit 2).

In many ways this approach would represent a return to the very earliest days of the pill. In the seminal case *Moran v. Household International*, lawyers from Wachtell, Lipton, Rosen & Katz (the firm that invented the poison pill) argued before the court that the pill merely gave target boards more bargaining power against an acquirer. The Delaware Chancery Court endorsed this reasoning in upholding the pill, framing the question as a balance between "the unrestricted right of shareholders to participate in nonmanagement sanctioned offers" and "the right of a Board of Directors to increase its bargaining powers."⁵⁹ It follows from this analysis that the magnitude of the pill dilution (i.e., the degree of enhancement to the board's bargaining powers) must be a critical factor in determining whether the balance has been maintained.

In the Oracle-PeopleSoft case, the specific factors noted above would cut in somewhat different directions. On one hand, the overall loss to the bidder is large (\$638 million) and the

⁵⁷ See Unitrin.

⁵⁸ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁵⁹ 490 A.2d 1059, 1074 (Del. Ch.), aff'd, 500 A.2d 1346 (Del. 1985).

number of shares issued per exercisable right (~ 24) is nearly double the average among comparable companies. On the other hand, the per share loss seems relatively small, when considered from PeopleSoft's perspective (\$1.75 per share) or especially from Oracle's perspective (\$0.12 per share). Regardless of the outcome on these competing factors, the endorsement of this general approach by the Delaware courts would provide incentives for practitioners to put in less potent pills. As a policy matter, this approach would provide a return to the original purpose of providing enhanced – but not unfettered – bargaining power for target boards against a hostile bidder. This more nuanced analysis of pills would in my view be an improvement over the binary nature of the debate to date on the validity of poison pills under Delaware corporate law.

Conclusion

In all of the complexity of the Oracle-PeopleSoft deal, it is important not to lose sight of certain basic facts. PeopleSoft's pre-deal trading price was approximately \$15.00. The clearing price for a majority of the PeopleSoft shares, by most estimates, was somewhere between \$19.00 and \$21.00. Yet Oracle paid \$26.50 per share.

One possible explanation for this wide gap is that Oracle was playing a larger game, involving control over the future of the enterprise application software industry, and it simply did not care what price it paid. This seems possible, but even Larry Ellison should prefer to acquire PeopleSoft for \$5.50 per share less, or \$2.0 billion less in aggregate. As one observer to the deal put it: "If the U.S. successfully invaded Luxembourg but suffered 50,000 casualties in doing so, we would not call it a victory for the U.S."

The better explanation, then, is that PeopleSoft's board played a weak hand well, and Oracle, while victorious, made several negotiation errors. One error was starting at \$16.00 per share, which became "Exhibit A" in the public relations campaign that Oracle was not serious. Another error was offering \$26.00 per share while the PeopleSoft-initiated DOJ investigation was underway, and PeopleSoft could not accept. These errors are well-known among M&A practitioners. This Commentary identifies a third, more subtle, error of not "looking forward and reasoning back" to understand what really would have happened through a deliberate pill trigger. This alternative may have been the best route forward at the critical juncture in October 2004. Even if it were not, a rigorous contemplation of this alternative would have given Oracle insights that it could have used to its advantage in its final negotiated acquisition of PeopleSoft. This analysis, all of which admittedly conducted only with the benefit of hindsight, provides lessons for M&A practitioners, boards, and the Delaware courts.