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THE EMERGING PROBLEM OF EMBEDDED DEFENSES:  
LESSONS FROM AIR LINE PILOTS ASS'N,  
INTERNATIONAL V. UAL CORP.

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How should courts regulate contract terms with nonshareholder constituencies that have an antitakeover effect? On one hand, contracts formed in the ordinary course of business would seem to be at the very core of operational decisionmaking, over which courts have traditionally exercised deferential business judgment review. On the other hand, contracts can have antitakeover effects, and takeover defenses have long been subject to heightened “intermediate” scrutiny under Delaware corporate law due to the “omnipresent specter” that boards may be acting to entrench themselves.<sup>1</sup> Despite the seemingly fundamental nature of the question, it has, to my knowledge, been addressed only once in U.S. corporate law. The case was *Air Line Pilots Ass’n, International v. UAL Corp.*,<sup>2</sup> which involved the short-lived business strategy of UAL, the parent of United Airlines, in the mid-1980s. Fortunately, the judge was Richard Posner, writing for a Seventh Circuit panel. Judge Posner affirmed a district court ruling that certain contractual provisions in a United Airlines collective bargaining agreement with its machinists’ union violated Delaware corporate law. In doing so, Judge Posner suggested an approach toward “embedded defenses”<sup>3</sup> that was not Delaware corporate law at the time but has increasingly become Delaware law over the past fifteen years. Like many great judges, Judge Posner was ahead of his time. This Commentary proposes a general approach toward embedded defenses that draws heavily from Judge Posner’s approach in *UAL*. Such an approach will be important as boards increasingly engage in “defense substitution” away from the most important takeover defense of the past twenty years, the poison pill.

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<sup>1</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

<sup>2</sup> 897 F.2d 1394 (7th Cir. 1990).

<sup>3</sup> This term was coined in Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 582 (2003).

## I. SUMMARY OF THE CASE

In the mid-1980s, UAL bought Hertz, a leading car rental company, and Hilton International, a leading hotel chain, as part of an effort to become a full-service travel company.<sup>4</sup> The strategy proved less than successful: by January 1987, UAL's stock price was down fifteen percent from its 1986 peak,<sup>5</sup> and employee morale had deteriorated.<sup>6</sup> That April, the United pilots' union proposed a \$4.5-billion highly leveraged employee buyout of the airline.<sup>7</sup> The pilots' plan envisioned the sale of the hotel and car rental businesses and would have given employees ownership of the airline in proportion to the wage and benefit concessions made by each employee group.<sup>8</sup>

UAL's board unanimously rejected the proposal, concluding that its integrated travel services strategy was superior to the pilots' restructuring plan.<sup>9</sup> The board was able to block the pilots' offer through a dead-hand poison pill, which it had adopted in December 1986.<sup>10</sup> The International Association of Machinists (IAM), which represented approximately one-third of UAL's employees, also opposed the pilots' proposal because IAM preferred the integrated strategy and believed that the pilots' proposal would cause significant job losses in IAM's ranks.<sup>11</sup>

Immediately after the pilots — in IAM's words — “dropped their atomic warhead,” IAM broke off the negotiations that were underway with UAL for a new collective bargaining agreement.<sup>12</sup> UAL and IAM eventually resumed talks and announced a new collective bargaining agreement that included several “protective covenants” designed to respond to the still-pending pilots' offer.<sup>13</sup> Section B(1)(b) of the agreement provided that, in the event of any change in control, IAM could file a notice under section 6 of the Railway Labor Act<sup>14</sup> that would allow the union to strike even though IAM had previously given up that right.<sup>15</sup> Section C allocated any UAL employee stock plan to each la-

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<sup>4</sup> From April 1987 to May 1988, UAL changed its name to Allegis Corp., reflecting its new strategy. For clarity of exposition, I refer to the parent company as UAL throughout.

<sup>5</sup> Data were obtained from the Center for Research in Security Prices, Wharton Research Data Services, <http://wrds.wharton.upenn.edu>.

<sup>6</sup> *Air Line Pilots Ass'n, Int'l v. UAL Corp.*, 699 F. Supp. 1309, 1313–14 (N.D. Ill. 1988).

<sup>7</sup> *Id.* at 1314.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 1315.

<sup>10</sup> *Id.* at 1314.

<sup>11</sup> *Id.* at 1315–16.

<sup>12</sup> *Id.* at 1316 (quoting the record) (internal quotation marks omitted).

<sup>13</sup> *Id.* at 1324.

<sup>14</sup> 45 U.S.C. § 156 (2000).

<sup>15</sup> *See UAL*, 699 F. Supp. at 1326.

bor group by reference to “market” wages,<sup>16</sup> in contrast to the pilots’ proposal, which would have allocated employee participation in proportion to the magnitude of concessions from current wages. Because IAM believed that the pilots were overpaid and the machinists were underpaid relative to the rest of the airline industry, IAM wanted a market wages test for allocating employee ownership in any reconstituted company.<sup>17</sup>

In response to the new collective bargaining agreement between UAL and IAM, the pilots’ lead lender withdrew its financing for the bid.<sup>18</sup> The pilots’ union brought suit, alleging that sections B(1)(b) and C of the collective bargaining agreement were antitakeover provisions that violated the UAL board’s fiduciary duties under Delaware corporate law. After the Seventh Circuit resolved preemption issues,<sup>19</sup> a federal district court in Illinois held for the pilots, invalidating sections B(1)(b) and C under Delaware’s two-pronged *Unocal*<sup>20</sup> test for assessing defensive tactics. The court found that *Unocal*’s first prong, requiring a “threat” to the corporation, was not met because the UAL board did not adequately consider the contractual provisions or their likely effect on the pilots’ proposal.<sup>21</sup> The court also found that *Unocal*’s second prong, requiring that defensive measures be “reasonable in relation to the threat posed,” was not satisfied because the UAL board could not unilaterally revoke sections B(1)(b) and C.<sup>22</sup> Therefore, “the measures adopted by United [were] far more potent than defensive measures approved by Delaware courts as reasonable responses to a threat.”<sup>23</sup>

UAL and IAM appealed to the Seventh Circuit. Judge Posner, joined by Judge Flaum, affirmed the district court’s holding. Judge Posner noted the “abundant evidence” that the protective covenants “were adopted not to resolve a conflict between United and the machinists and thus head off a possible strike, as United and the machinists contend[ed] . . . , but to prevent the pilots from taking over the company.”<sup>24</sup> Once the protective covenants were identified as antitakeover devices, Judge Posner had no trouble finding their “unique lethality” to violate Delaware law: “[U]nlike the usual ‘poison pills’ the

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 1321–22.

<sup>18</sup> *Id.* at 1329.

<sup>19</sup> See *Air Line Pilots Ass’n, Int’l v. UAL Corp.*, 874 F.2d 439, 447 (7th Cir. 1989) (Posner, J.) (holding that the Railway Labor Act does not preempt state corporate law regulating antitakeover measures).

<sup>20</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

<sup>21</sup> *Air Line Pilots Ass’n, Int’l v. UAL Corp.*, 717 F. Supp. 575, 587 (N.D. Ill. 1989).

<sup>22</sup> *Id.* at 587–88.

<sup>23</sup> *Id.* at 588.

<sup>24</sup> *UAL*, 897 F.2d at 1400.

company could not rescind them. . . . They are the Domsday Bomb in the arsenal of corporate defensive measures.”<sup>25</sup>

Ironically, while the litigation was underway, the UAL board sold Hilton and Hertz and fired UAL’s CEO, just as the pilots had intended to do.<sup>26</sup> The pilots nevertheless tried leveraged buyouts again in 1989 and 1990, finally succeeding in 1994 after allying with their longstanding adversary IAM.<sup>27</sup> United became the largest employee-owned company in the country. But even \$5 billion in wage concessions could not put the company on firm footing. After a prolonged decline, United entered into bankruptcy protection in 2002<sup>28</sup> and remained there for three years.

## II. THE EMERGING PROBLEM OF EMBEDDED DEFENSES

To my knowledge, *UAL* is the only case to rule on the validity of an embedded defense — that is, a term embedded in a contract with a nonshareholder counterparty that has an antitakeover effect.<sup>29</sup> The result is that the validity of embedded defenses remains murky territory in corporate law. Going forward, Delaware courts will increasingly be asked to demarcate the contours of permissible embedded defenses. To understand why requires a brief history of the most famous (or infamous) takeover defense of the past twenty years, the poison pill. The pill was invented in the early 1980s but remained relatively weak for most of that decade due to Delaware Chancery Court cases forcing target boards to redeem (eliminate) poison pills under certain conditions.<sup>30</sup> In 1989, the poison pill reached its zenith with the implicit validation of the “Just Say No” defense in *Paramount Communications, Inc. v. Time Inc.*<sup>31</sup> But today, after fifteen years of providing bulletproof protection for a target board (as long as the board remained in place), the pill is under attack in the United States and around the world.

<sup>25</sup> *Id.*

<sup>26</sup> See *Air Line Pilots Ass’n, Int’l v. UAL Corp.*, 699 F. Supp. 1309, 1319 (N.D. Ill. 1988).

<sup>27</sup> See Flynn McRoberts, *United’s Undoing: A War Within*, CHI. TRIB., July 13, 2003, § 1, at 1.

<sup>28</sup> *Id.*

<sup>29</sup> In *Sutton Holding Corp. v. DeSoto, Inc.*, No. Civ. A 12051, 1991 WL 80233 (Del. Ch. May 14, 1991), Chancellor Allen of the Delaware Chancery Court found that a change-of-control provision in DeSoto’s pension plan, which would have prevented any reduction in benefits to the beneficiaries under the plan for five years after a change in control, “constituted a breach of the duty of loyalty that the members of the DeSoto board at that time owed to the company and its shareholders.” *Id.* at \*1. However, Chancellor Allen declined to provide the declaratory judgment that the insurgents sought due to a conflict between corporate law and issues of federal law. See *id.* at \*1–4.

<sup>30</sup> See, e.g., *Grand Metro. Pub. Ltd. Co. v. Pillsbury Co.*, 558 A.2d 1049, 1061–62 (Del. Ch. 1988); *City Capital Assocs. Ltd. P’ship v. Interco Inc.*, 551 A.2d 787, 800 (Del. Ch. 1988).

<sup>31</sup> 571 A.2d 1140 (Del. 1989).

In this country, shareholder activists have been bringing precatory shareholder resolutions for the past few years urging boards to eliminate their poison pills. In March 2006, Professor Lucian Bebchuk upped the ante by proposing a binding shareholder resolution to limit the ability of the CA (formerly Computer Associates) board to use its poison pill.<sup>32</sup> Although the Bebchuk proposal was not approved by CA shareholders, the very fact that the company was, in effect, forced by the court to place the proposal in its proxy materials<sup>33</sup> represented a victory for pill opponents. In another recent pill decision, Chancellor Chandler allowed plaintiffs to proceed against the News Corp. board for reneging on a “board policy” that limited its use of a poison pill.<sup>34</sup> In language that, if read literally,<sup>35</sup> would seem to alter the fundamental balance between the board and shareholders, the court held that “the board’s power — which is that of an agent’s with regard to its principal — derives from the shareholders, who are the ultimate holders of power under Delaware law.”<sup>36</sup>

The pill is also declining in other parts of the world. In the European Union, the long-awaited Takeover Directive was finally approved in December 2003. Article 9 of the Directive prohibits defensive actions against hostile bids, such as the installation of a poison pill, without a shareholder vote.<sup>37</sup> And in Japan, takeover “Guidelines” issued in May 2005 allow Japanese companies to adopt poison pills, but only if there is some mechanism for shareholders to eliminate them, such as an annual election of all the directors or a sunset provision.<sup>38</sup> Overall, it seems clear that the unfettered use of the poison pill is under attack in the United States and is no longer permitted, if it ever was, in the European Union and Japan.

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<sup>32</sup> See *Bebchuk v. CA, Inc.*, 902 A.2d 737, 738–39 (Del. Ch. 2006).

<sup>33</sup> See *id.* at 742.

<sup>34</sup> *UniSuper Ltd. v. News Corp.*, No. 1699-N, 2005 WL 3529317, at \*1 (Del. Ch. Dec. 20, 2005), *appeal denied*, 906 A.2d 138 (Del. 2006) (depublished).

<sup>35</sup> In a recent hearing, Vice Chancellor Lamb suggested that it should not be read so literally: “*UniSuper* is a decision by the Court of Chancery. It’s not a Supreme Court decision, and it isn’t necessarily true that the Supreme Court would agree, is it?” Transcript of Final Hearing at 36, *Bebchuk* (Civil Action No. 2145-N), available at [http://www.law.harvard.edu/faculty/bebchuk/Policy/CA\\_HearingTranscript.pdf](http://www.law.harvard.edu/faculty/bebchuk/Policy/CA_HearingTranscript.pdf).

<sup>36</sup> *UniSuper*, 2005 WL 3529317, at \*6.

<sup>37</sup> Council Directive 2004/25, art. 9, 2004 O.J. (L 142) 12, 19 (EC). A June 2006 survey of the larger member states indicates that France, Spain, and the United Kingdom have opted into Article 9, while Germany and the Netherlands have opted out. FRESHFIELDS BRUCKHAUS DERINGER, PUBLIC TAKEOVERS IN EUROPE 17 (2006), available at <http://www.freshfields.com/publications/pdfs/2006/15414.pdf>.

<sup>38</sup> See MINISTRY OF ECON., TRADE & INDUS. & MINISTRY OF JUSTICE, GUIDELINES REGARDING TAKEOVER DEFENSE FOR THE PURPOSES OF PROTECTION AND ENHANCEMENT OF CORPORATE VALUE AND SHAREHOLDERS’ COMMON INTERESTS 9 (2005), available at [http://www.meti.go.jp/policy/economic\\_oganzization/pdf/shishin\\_hontai.pdf](http://www.meti.go.jp/policy/economic_oganzization/pdf/shishin_hontai.pdf).

As the pill declines, target boards will likely substitute into other defenses.<sup>39</sup> In fact, there is some anecdotal evidence that practitioners are already experimenting with next-generation defenses. The most notable example occurred after Oracle Corp. made a hostile bid for PeopleSoft, Inc. in June 2003. In response to the bid, PeopleSoft initiated a “Customer Assurance Program” (CAP), under which PeopleSoft customers would receive back between two and five times their money if any company acquired PeopleSoft and then reduced the support for PeopleSoft’s software products during the first four years of the customer’s contract. By August 2004, the potential liability under the CAP was approximately \$2 billion, more than one-third of PeopleSoft’s pre-bid market capitalization. Oracle challenged the CAP, alleging that it was an invalid takeover defense under *Unocal*, or more generally a violation of the board’s fiduciary duties.<sup>40</sup>

Note the similarities with *UAL*. A hostile bidder appears (the pilots’ union; Oracle). A nonshareholder constituency is threatened (the machinists’ union; PeopleSoft customers). The board enters into contracts with that constituency to protect it from the potential negative effects of a takeover, and these terms are then challenged by the bidder as a violation of Delaware corporate law (protective covenants; CAP). The most significant difference between these two cases is the outcome. In *UAL*, Judge Posner struck down the protective covenants. In the PeopleSoft case, Vice Chancellor Strine declined to rule on the CAP after an initial hearing and used the delay before resuming the trial to push the parties toward a negotiated deal.<sup>41</sup> According to one practitioner, the apparent attractiveness of embedded defenses, combined with the fact that the CAP never yielded a decision, “pretty much guarantees it will be revisited” by a future Delaware court.<sup>42</sup>

Other kinds of next-generation defenses are also appearing on the hostile takeover landscape. In 2004, hostile bid target Aventis, a French company, invented the *bons plavix*, or Plavix warrant, that would be triggered if Sanofi, the bidder, acquired Aventis and then lost patent protection on its own drug Plavix — a point of uncertainty during the deal. If triggered, the *bons plavix* would have given Aventis shareholders a much larger stake in the combined company than Sanofi intended. As in the PeopleSoft deal, Aventis and Sanofi settled,

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<sup>39</sup> See Arlen & Talley, *supra* note 3, at 602–05 (predicting “defense substitution” if the pill is weakened).

<sup>40</sup> For a detailed discussion of Oracle’s bid, see David Millstone & Guhan Subramanian, *Oracle v. PeopleSoft: A Case Study*, 12 HARV. NEGOT. L. REV. (forthcoming 2007), available at <http://ssrn.com/abstract=816006>.

<sup>41</sup> For a discussion of the Delaware litigation, see *id.* (manuscript at 17–21).

<sup>42</sup> Adam Salassi, *Put on Your Thinking CAPs*, CORP. DEALMAKER, May–June 2005, at 41, 41.

and the *bons plavix* was not triggered. But at least one observer was “totally convinced that this is a product that will be used again.”<sup>43</sup> In a similar vein, there are private reports that NeighborCare, an elderly care provider, offered its customers “money-back guarantees” in the event that it was acquired by hostile bidder Omnicare. As in the PeopleSoft and Aventis deals, NeighborCare and OmniCare reached an agreement before the customer guarantees were challenged in court.

### III. POTENTIAL BOUNDARY SOLUTIONS

As embedded defenses continue to proliferate, the time seems ripe to consider how, if at all, Delaware courts should regulate them. Delaware courts might invalidate virtually all nonredeemable embedded defenses on the ground that they are “Doomsday Bombs” that categorically run afoul of *Unocal*’s proportionality requirement. The district court seemed to take this approach in *UAL*.<sup>44</sup> However, if embedded defenses are per se invalid under Delaware corporate law, targets would have severe difficulty protecting “implicit contracts” after a hostile bid had been launched. In an influential article published just before Judge Posner’s *UAL* decision, Professors Andrei Shleifer and Lawrence Summers point out that a hostile takeover might increase shareholder wealth but reduce overall societal wealth if the acquirer breaches implicit contracts with other constituencies.<sup>45</sup> Professors Shleifer and Summers even use the airline industry as an example of their point that shareholder wealth might be maximized at the expense of labor.<sup>46</sup> Embedded defenses can formalize the implicit contract, thereby solving the Shleifer-Summers problem and ensuring that transactions go through only on Pareto-improving (or at least Kaldor-Hicks-improving) terms. For this reason it seems clear that per se invalidation of nonredeemable embedded defenses cannot be the socially optimal rule.

The opposite approach is also unsatisfying. Some academics argue that embedded defenses should be presumptively legal, either under a general theory of deference to the target board<sup>47</sup> or because, as a practical matter, embedded defenses are “unregulable.”<sup>48</sup> But if embedded

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<sup>43</sup> Steve Hoare, *Aventis’s ‘Poison Pill’ Raises Market Concerns*, LAWYER, May 3, 2004, at 5, 5 (internal quotation mark omitted). Interestingly, the *bons plavix* was invented by a New York City law firm, M&A specialist Sullivan & Cromwell.

<sup>44</sup> See *Air Line Pilots Ass’n, Int’l v. UAL Corp.*, 717 F. Supp. 575, 587–88 (N.D. Ill. 1989).

<sup>45</sup> See Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 34 (Alan J. Auerbach ed., 1988).

<sup>46</sup> See *id.* at 34–35.

<sup>47</sup> See Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 32–33 (2003).

<sup>48</sup> See Arlen & Talley, *supra* note 3, at 599–602. While Professors Arlen and Talley focus most of their analysis on pre-bid embedded defenses, if post-bid embedded defenses were subject to less

defenses were entirely permissible under Delaware law (that is, subject only to business judgment review), then target boards would have a blank check to install highly potent takeover defenses through this backdoor mechanism. What would have prevented UAL and IAM from triggering severe penalties in the event of a takeover — for example, ten-percent annual wage increases for ten years? Or what would have prevented PeopleSoft from issuing ten-times money-back guarantees if Oracle reduced the support for the product? The beauty of embedded defenses, from a certain perspective, is that the target board and its counterparty bargain entirely at the expense of the hostile bidder. At a conference held at Tulane Law School while PeopleSoft's CAP was being litigated, Steven Koch, head of Global Mergers and Acquisitions at Credit Suisse First Boston (which advised Oracle), told Vice Chancellor Strine, “[i]f [the CAP] is legitimate . . . I’m going to start running around pitching these contracts to all my clients.”<sup>49</sup> Per se legality of embedded defenses, then, threatens to shut down the takeover marketplace, at least in certain industries.

In a thoughtful analysis of PeopleSoft's CAP, Professor Jennifer Arlen proposes that uncertainty about the courts' approach to embedded defenses may be desirable because it promotes settlement and allows courts to make a fact-specific assessment of each new takeover defense.<sup>50</sup> I believe instead that a general approach should be specified ex ante because of the way in which embedded defenses often play out. Consider *UAL* itself: in the absence of explicit ex ante guidance, the next time around the UAL board would again have incentives to put in the protective covenants and see how they fared in court. Judge Posner recognized this concern in his decision. The only issue that divided the majority from the partial dissent was whether the case was moot: the protective covenants arguably had already expired by the time the case reached the Seventh Circuit on the merits. Although acknowledging that “the question [was] a close one,” Judge Posner held that the case was not moot because, by failing to decide, the court would permit the UAL board and IAM to insert the clause in their next collective bargaining agreement.<sup>51</sup>

The PeopleSoft case presents another illustration of the point. The potential liability under PeopleSoft's CAP accrued at a ferocious rate — approximately \$150 million per month by the end of the contest. In

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deference, managers and boards would have incentives to substitute into pre-bid embedded defenses.

<sup>49</sup> David Marcus, *Joie de Deal in New Orleans*, CORP. CONTROL ALERT, Apr. 2004, at 14, 15 (internal quotation marks omitted).

<sup>50</sup> See Jennifer Arlen, *Regulating Antitakeover Measures in the Presence of Embedded Defenses: Lessons from PeopleSoft Versus Oracle*, 12 HARV. NEGOT. L. REV. (forthcoming 2007).

<sup>51</sup> *UAL*, 897 F.2d at 1399.

Delaware, Oracle sought only an injunction against future use of the CAP because invalidating the existing liabilities would have required joining countless PeopleSoft customers to the litigation. Without ex ante rules, the next board in PeopleSoft's situation would have strong incentives to set up a similar embedded defense, which, at worst, would be enjoined prospectively. Although rules cannot be specified with complete precision, they would at least limit the board's ability to install embedded defenses in good faith, which has implications for the ability of the target to indemnify the board for its defensive maneuverings.<sup>52</sup> Thus, if a middle ground is to be achieved as a practical matter, it will require some kind of ex ante approach rather than ex post adjudication. The next Part proposes what such an approach might look like.

#### IV. A PROPOSED APPROACH TO EMBEDDED DEFENSES

In the closing lines of his opinion, Judge Posner stated, "Delaware law requires that defensive measures, and a fortiori defensive measures as irrevocable as these, be adopted with due concern for the interests of shareholders."<sup>53</sup> Where does this rule come from? The *Unocal* test, which Judge Posner purported to apply, explicitly states that boards may consider all constituencies, not just shareholders, in installing and maintaining takeover defenses.<sup>54</sup> Delaware doctrine imposes so-called *Revlon*<sup>55</sup> duties, requiring a board to focus exclusively on shareholder interests, only when a company is "for sale,"<sup>56</sup> but here the district court had not found that UAL was for sale.<sup>57</sup> Judge Posner seems to have injected something resembling *Revlon* scrutiny into reviewing the subset of takeover defenses that are irrevocable, regardless of whether the company was for sale. This approach is subtly different from the district court's approach, which engaged in a straightforward application of *Unocal* and cited *Revlon* only in passing.

Although Judge Posner's implicit carve-out from *Unocal* was not Delaware doctrine at the time, it seems to be where Delaware doctrine is heading today. The starting point in Delaware's evolution was *Quickturn Design Systems, Inc. v. Shapiro*,<sup>58</sup> which examined the va-

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<sup>52</sup> Section 102(b)(7) of the Delaware General Corporation Law permits the company to indemnify its directors for breaches of the duty of care unless the actions are "not in good faith." DEL. CODE ANN. tit. 8, § 102(b)(7) (2001 & Supp. 2004).

<sup>53</sup> *UAL*, 897 F.2d at 1400.

<sup>54</sup> See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (permitting boards to adopt takeover defenses to protect "creditors, customers, employees, and perhaps even the community generally," in addition to shareholders).

<sup>55</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

<sup>56</sup> *Id.* at 182.

<sup>57</sup> See *Air Line Pilots Ass'n, Int'l v. UAL Corp.*, 717 F. Supp. 575, 584 (N.D. Ill. 1989).

<sup>58</sup> 721 A.2d 1281 (Del. 1998).

lidity of the “slow hand” poison pill.<sup>59</sup> The Delaware Chancery Court applied *Unocal* to invalidate Quickturn’s slow hand pill, finding that it was not reasonable in relation to the threat posed.<sup>60</sup> The Delaware Supreme Court affirmed, but on much broader grounds:

One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. . . .

. . . .

. . . “[T]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.”<sup>61</sup>

Read literally, the Delaware Supreme Court’s opinion in *Quickturn* would seem to invalidate a board’s contractual commitments that cannot possibly be invalid — for example, a ten-year lease.<sup>62</sup> In the aftermath of *Quickturn*, commentators speculated that there must be some kind of firewall, then, differentiating between contractual precommitments that impermissibly bind a future board and contractual precommitments that do not.<sup>63</sup> One potential firewall is between restrictions on “enterprise” decisions (involving the internal operation of the business), which would be per se valid, and restrictions on “ownership” decisions (involving the right of shareholders to dispose of their stock), which would be per se invalid.<sup>64</sup> This would be a natural way to distinguish the ten-year lease from the slow hand poison pill. However, Professor Stephen Bainbridge rightly criticizes this proposed firewall as unworkable.<sup>65</sup> Take *UAL*: if a protective covenant embedded in a collective bargaining agreement destroys the financing for a hostile bidder, is it an enterprise decision or an ownership decision? Or PeopleSoft: if a customer assurance program encumbers the target

<sup>59</sup> See *id.* at 1290–92; see also *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 27 & n.2 (Del. Ch. 1998). A slow hand provision prevents a new board from redeeming the target’s poison pill for a certain amount of time after a change in board control — in Quickturn’s case, six months. *Quickturn*, 721 A.2d at 1287.

<sup>60</sup> See *Mentor*, 728 A.2d at 50–51.

<sup>61</sup> *Quickturn*, 721 A.2d at 1291–92 (emphasis omitted) (quoting *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994) (emphasis added)).

<sup>62</sup> See WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 573 (2003); see also John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323, 1331 (2001) (arguing that reading *Quickturn* to prohibit standard covenants in corporate contracts “would be absurd”).

<sup>63</sup> See, e.g., Bainbridge, *supra* note 47, at 21.

<sup>64</sup> See generally E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997) (explaining the distinction between enterprise decisions and ownership decisions).

<sup>65</sup> See Bainbridge, *supra* note 47, at 35 (arguing that the distinction would be “difficult to draw” in cases such as change of control provisions in bond indentures).

company with a potential liability equal to one-third of its market capitalization, is it an enterprise decision or an ownership decision? These examples illustrate Professor Bainbridge's point.

In the recent case of *UniSuper Ltd. v. News Corp.*,<sup>66</sup> Chancellor Chandler finally provided some initial guidance on the contours of the firewall between permissible and impermissible precommitments. *UniSuper* involved the October 2004 reincorporation of News Corp. from Australia to Delaware. News agreed with certain of its institutional shareholders to a "board policy" that any poison pill adopted by the News board would expire after one year unless shareholders approved an extension. One month later, Liberty Media appeared as a potential hostile acquirer for News. The News board promptly installed a poison pill and announced that it "might or might not" hold to its board policy on pills.<sup>67</sup> Sure enough, in November 2005, the News board extended the pill in contravention of its earlier stated board policy.<sup>68</sup> Shareholders filed suit alleging breach of contract, among other claims. The board contended in response that its "board policy" impermissibly tied its hands and therefore was unenforceable under *Quickturn* and related cases.<sup>69</sup> The Delaware Chancery Court refused to dismiss the contract claim. The court drew a distinction between precommitments that reflect shareholders' preferences, which are valid, and precommitments that take power out of shareholders' hands, which are invalid.<sup>70</sup>

And so with two steps forward (*Quickturn*) and one step back (*UniSuper*), Delaware seems to be meandering toward Judge Posner's approach in *UAL*. There is, of course, some distance still left to cover. *UniSuper* involved an explicit shareholder preference, while in *UAL* Judge Posner was required to infer what shareholders would have wanted. But the core principle of looking to shareholder interests to assess the validity of a takeover defense that acts as a precommitment device is the same. The Delaware courts should close the remaining ground to Judge Posner's approach in *UAL* by adopting the following black-letter doctrine: standard *Unocal* analysis for traditional takeover defenses, but something resembling *Revlon* analysis for embedded takeover defenses because of their "unique lethality."<sup>71</sup> Put differently, "Doomsday Bomb" takeover defenses should not be per se illegal, but

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<sup>66</sup> No. 1699-N, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005), *appeal denied*, 906 A.2d 138 (Del. 2006) (depublished).

<sup>67</sup> *Id.* at \*3.

<sup>68</sup> *Id.*

<sup>69</sup> *See id.* at \*7.

<sup>70</sup> *See id.* at \*7-8.

<sup>71</sup> *UAL*, 897 F.2d at 1400. A corollary to this proposed rule is that defenses that have been approved by shareholders, whether implicitly (for example, by IPO) or explicitly (for example, by shareholder vote), carry a strong presumption of legality.

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they should receive a hard look from the courts regarding whether they maximize shareholder value.

This approach would provide an appropriate middle-ground solution to the problem of embedded defenses. Boards would still have broad discretion to use traditional defenses, such as the poison pill and staggered board, subject only to *Unocal* analysis. But if the board chose to install embedded defenses, it would have the burden of demonstrating that those defenses maximize shareholder value. This standard, something akin to *Revlon* duties, is by no means outcome determinative. In *UAL*, Judge Posner considered, but rejected, the possibility that the protective covenants were adopted “to resolve a conflict between United and the machinists and thus head off a possible strike”<sup>72</sup> — a maneuver that, if true, could certainly be consistent with a shareholder wealth-maximization objective. Similarly, PeopleSoft repeatedly claimed that the CAP maximized shareholder value by preserving the customer base, a claim that Vice Chancellor Strine seemed to take seriously.<sup>73</sup> The shareholder wealth-maximization standard is a hard look, as demonstrated in *UAL*, but is not dispositive.

#### CONCLUSION

This Commentary makes a descriptive claim and a normative claim. The descriptive claim is that Judge Posner’s *UAL* decision mischaracterized the Delaware corporate law of 1990 but foreshadowed how Delaware law would develop over the next fifteen years. Based on *Quickturn* and *UniSuper*, Delaware seems to be heading toward *Unocal* scrutiny for traditional defenses but toward a shareholder-focused test resembling *Revlon* duties for embedded defenses. The normative claim is that the Delaware courts should finish the job by drawing heavily from, if not adopting explicitly, Judge Posner’s approach in *UAL*. In the arena of embedded defenses, there are reasons to prefer ex ante rules to ex post adjudication. As the poison pill declines and practitioners continue experimenting with the next generation of takeover defenses, the Delaware courts should take — not avoid — opportunities to establish a clear regulatory approach to embedded defenses. As is often the case, Judge Posner was ahead of his time in *UAL*. Delaware would be wise to follow his lead.

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<sup>72</sup> *Id.*

<sup>73</sup> At the Tulane conference discussing the then-pending deal, Vice Chancellor Strine asked in response to critics of the CAP: “How do you play out the hostile bid process and keep your customer base?” Marcus, *supra* note 49, at 15 (internal quotation marks omitted).