

2004

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Recommended Citation

Curtis J. Milhaupt, *Prescribing the Pill in Japan?*, 2004 COLUM. BUS. L. REV. 1 (2004).
Available at: https://scholarship.law.columbia.edu/faculty_scholarship/2100

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PRESCRIBING THE PILL IN JAPAN?

FOREWORD TO THE HOSTILE M&A CONFERENCE ISSUE

Curtis J. Milhaupt*

Contrary to popular belief, corporate Japan is changing—incrementally, to be sure, but changing nonetheless. One of the areas of greatest potential change is the legal and business environment for mergers and acquisitions (“M&A”), including hostile M&A. Recent amendments to Japan’s Commercial Code in the areas of stock swaps and divestitures are helping to facilitate M&A transactions.¹ At the same time, the constellation of shareholders in Japanese firms is changing as cross-shareholding declines and foreign investment increases. M&A activity in Japan has increased significantly in recent years.²

* Fuyo Professor of Japanese Law and Legal Institutions, Columbia Law School. I want to express my gratitude to the law firm Mori Hamada & Matsumoto for generously funding the conference, and particularly to the Columbia Law School alumni of the firm for their invaluable logistical support. Tony Zaloom, Of Counsel to Mori Hamada & Matsumoto, deserves special mention for conceiving the project and nudging it along at critical stages.

¹ For more detail on recent amendments to the Commercial Code and their impact on Japanese corporate governance, see CURTIS J. MILHAUPT, *A LOST DECADE FOR JAPANESE CORPORATE GOVERNANCE REFORM? WHAT’S CHANGED, WHAT HASN’T, AND WHY* (Columbia Law School Ctr. for Law and Econ. Studies, Working Paper No. 234, 2003).

² For example, in 1997, Japan had just 0.6% of world M&A transactions (measured by transaction value)—less, for example, than Bermuda and Malaysia. By the first quarter of 2002, Japan’s share had increased to 5.5% of the world total. Curtis J. Milhaupt & Mark D. West, *Institutional Change and M&A in Japan: Diversity through Deals, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS* 295, 303, 315-16 (Curtis J. Milhaupt ed., 2003).

While virtually all of the recent deals have been friendly, there have been several prominent examples of unsolicited bids, by both foreign and Japanese bidders. In the space of a few years, hostile takeovers of Japanese firms have gone from the unthinkable to the distinctly possible. It is possible that over the next few years, such transactions will become a small but meaningful feature of the Japanese corporate governance landscape. Perhaps not coincidentally, a recent Commercial Code amendment made a commonly used defensive measure in the U.S.—the shareholder rights plan (better known as the “poison pill”)—technically feasible for Japanese firms. The amendment permits the issuance by the board of directors—in most cases without shareholder approval—of an option-like financial instrument called a stock acquisition right (*shin kabu yoyaku ken*).³ Although still a matter of debate among Japanese scholars and practitioners (see especially the article by Satoshi Kawai in this issue), with proper planning, it appears that the share acquisition right could be used to replicate essential features of the U.S. poison pill defense.

On June 13, 2003, Columbia Law School’s Center for Japanese Legal Studies, with financial support from a major Japanese law firm, hosted a symposium in Tokyo entitled “Hostile M&A and the Poison Pill in Japan: Prospects and Policy.” The symposium was designed to achieve a deeper understanding of the current legal and business environments for hostile M&A and defensive measures in Japan, and to glean possible lessons from the U.S. experience with hostile takeovers. The papers that follow, authored by an extraordinary cast of Japanese and U.S. experts, are the offspring of the conference. As the director of the Center for Japanese Legal Studies, I am delighted that these insights are being widely disseminated to readers of the *Columbia Business Law Review*.

³ SHOHŌ, arts. 280-19 to 280-39 (Japan).

At least at a conceptual level, many of the recent amendments to the Japanese Commercial Code—including, but not limited to, those relating to M&A—reflect a greater concern for shareholder welfare (traditionally a focus of U.S. managers), and permit large Japanese firms to adopt governance structures—such as independent audit committees and formal separation of executive and non-executive directors—similar to those used in the United States. The U.S. experience with hostile takeover defenses is thus relevant not only for what it might suggest for Japan on the narrow topic of hostile acquisitions, but for the development of Japanese corporate law and governance more generally. As Chancellor Chandler's article in this issue illustrates, many of the important developments in Delaware corporate law relating to the duties of directors and the balance of power between shareholders and directors have emerged out of judicial decisions in the takeover context. To take one important example outside the scope of Chancellor Chandler's analysis, the Delaware Supreme Court's decisions in the cash out merger context have created significant incentives for boards to have independent committees, assisted by independent and sophisticated legal and financial advisors, to structure and negotiate transactions that pose significant risks to minority shareholders.⁴ In this way, M&A activity in the United States has served as an important catalyst for legal and structural evolution in corporate governance. Perhaps the same will be true of Japan.

Indeed, the prospect of hostile M&A and the installation of defensive mechanisms in Japan raise a host of important legal issues, including most fundamentally the proper roles of directors, shareholders and the courts in responding to contests for corporate control. Although Japanese courts have confronted this key question in isolated past instances, they did so at a very different stage in Japan's economic development—a time when prevailing standards of appropriate managerial behavior vis-à-vis shareholders were

⁴ See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

quite different than they are today. Moreover, the standard of judicial review emerging from these cases is not particularly relevant to a pill-like defense.⁵ More broadly, hostile M&A and defensive measures have implications for Japan's entire system of corporate governance, including its traditional focus on the protection of employees and the relatively weak position of the capital markets in monitoring firms, as least in relation to the "main bank" system.

Before turning to the articles in this issue, two conference presentations that are not published here deserve mention. At the conference, Nobumichi Hattori, until recently a managing director of Goldman Sachs (Japan) Ltd. and the author of a well-known book on Japanese mergers and acquisitions, provided data showing that hostile M&A activity around the world generally increases following financial crises, and is fuelled by poorly performing stock markets in which an acquirer's shares might command a favorable exchange ratio in relation to those of a target. Hattori argued that since these conditions appear to prevail in Japan today, there is significant potential for hostile deals to emerge.

The second speaker at the conference, Yoshiaki Murakami, President of M&A Consulting, Inc., is a well-known shareholder activist who has launched proxy fights and bids for Japanese firms whose managers appear to be hoarding cash or otherwise underutilizing assets. Murakami is something of a pioneer in the wilds of traditional Japanese-style management, although he has yet to discover a path to victory.⁶ In his remarks, Murakami emphasized that poison pills and other takeover defenses should be

⁵ See, e.g., *Shūwa K.K. v. K.K. Chūjitsuya*, 1317 HANREI JIHŌ 28 (1989), translated in *JAPANESE LAW IN CONTEXT: READINGS IN SOCIETY, THE ECONOMY, AND POLITICS* 502 (Curtis J. Milhaupt et al. eds., 2001) (invalidating a board's issuance of shares to a white knight in the face of a hostile bid where the "primary purpose" of the allotment was to dilute the bidder's stake, not to raise funds for the corporation).

⁶ Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2212-14 (2001).

evaluated, not in light of how well they buffer management from erstwhile hostile acquirers, but by the extent to which they benefit shareholders. He posited that any defensive measure should be judged against three tests: (1) Does it increase shareholder value?; (2) Does it improve corporate governance?; and (3) Is it fair to shareholders? He expressed skepticism, given cross-shareholding arrangements and the dominance of boards by insiders, that the poison pill is needed in the Japanese context. The likely prospect, he argued, was that the pill would be used simply to entrench management.

Turning to the articles in this volume, Satoshi Kawai, a partner of Mori Hamada & Matsumoto, analyzes issues presented by poison pills under Japanese law. The two primary legal obstacles to implementation of the pill in Japan are (1) that stock acquisition rights are formally separate from shares of stock, so it is difficult to ensure that the two financial instruments are automatically distributed together under a rights plan, and (2) discrimination against the hostile bidder that is central to the operation of a poison pill may conflict with the deeply engrained principle of equal treatment of shareholders (*kabunushi byōdō gensoku*) under Japanese corporate law. Kawai suggests several forms that the poison pill may take in Japan to overcome these obstacles. Each of the structures he suggests has potential advantages and disadvantages, but the analysis remains hypothetical because none has yet been tested in the courts.

In the next article, Professor Ronald Gilson of Columbia Law School provides important institutional context in which to evaluate the phenomenon of hostile takeovers. He notes that previously negative attitudes toward hostile acquisitions in Europe (similar to those currently prevailing in Japan) have softened as the role of such transactions in corporate restructuring has become more widely appreciated. Theoretically, Professor Gilson argues, hostile M&A can be viewed as an “equilibrating device” that moves corporate assets to more productive uses following technological or macro-economic changes. Given the massive misallocation of resources in economically bedraggled Japan, Professor

Gilson provides a theoretical lens through which to view hostile M&A as one of the fixes for the country's problems. Professor Gilson emphasizes that poison pills in the United States are not used simply to block hostile bids, since independent directors, courts, and institutional investors all play a role in policing misuse of defensive tactics. He suggests that in Japan, this policing role will fall largely to the courts, as the other institutions remain underdeveloped.

William Chandler III, Chancellor of the Delaware Chancery Court, discusses the role of the Delaware courts in the U.S. system of corporate governance, using the decisions of the Chancery Court surrounding the evolution of the poison pill as an example. He notes that when hostile acquisitions began in the U.S. in the late 1970s and early 1980s during a restructuring wave, they were soon followed by the creation of the poison pill as a defensive measure. These developments posed a fundamental question not answered by existing legislation: Who would review the use of this new device? Chancellor Chandler shows that with little legislative guidance on vital issues such as the balance of power between shareholders and directors in responding to contests for corporate control, the Delaware courts gradually developed a workable common law of corporations in incremental steps, preserving flexibility and the opportunity for re-evaluation. He suggests that the Japanese judiciary may now face a similar challenge.

In the final article, Hideki Kanda of the University of Tokyo Faculty of Law, one of Japan's leading corporate law scholars, responds to Professor Gilson and Chancellor Chandler, while offering his own perspective on the Japanese situation. He points out that empirical evidence on the benefits of both hostile M&A and defensive tactics is ambiguous. This empirical ambiguity makes hostile takeovers one of the most difficult issues in corporate law and policy. To illustrate, he points out the wide range of responses to hostile deals under national laws, from unfettered shareholder authority in the U.K. to board veto power in the Netherlands. Kanda agrees that hostile M&A in Japan may increase in the future, and that defenses

against unsolicited bids may become widespread. If this occurs, Kanda agrees with other authors that Japanese courts will be forced to address difficult questions about the balance of power between directors and shareholders without any clear guidance from the Commercial Code. This doctrinal vacuum, in Kanda's view, may cause the Japanese Diet (legislature) to develop bright-line rules on these questions.

So the consensus among conference participants is that current conditions in Japan may well lead to an increase in hostile M&A activity, and in turn, to the widespread adoption of takeover defenses such as the poison pill. Although Japanese experts are giving serious consideration to the U.S. experience as an important reference point, the articles in this issue suggest the danger of merely copying the technical features of the U.S. poison pill without considering the different institutional contexts in which defensive measures operate in the U.S. and Japan. The Japanese now face the dual challenge of devising hostile takeover defenses that are appropriate to Japanese legal and market conditions, while fostering institutions, such as the courts, to ensure that the poison pill operates to protect and enhance shareholder welfare rather than to entrench management.

Before figuratively turning the podium over to the authors of the articles that follow, I want to mention several important issues (from my perspective, anyway), which are not reflected in the conference proceedings. First, the discussion in the articles understandably focuses on the role of the judiciary in policing implementation of the pill. Japanese courts, like their U.S. counterparts, will almost certainly play a key role in reviewing the pill's use in clashes between corporate incumbents and insurgents. Yet an exclusive focus on the courts misses two important institutions that are likely to be significant in policing both hostile takeovers and the use of the pill: the bureaucracy and the capital market. At least some market players seem to fear negative reactions from regulatory authorities, particularly the Ministry of Finance ("MOF"), for launching

hostile acquisitions. One high-level manager of a U.S. investment bank in Tokyo colorfully suggested to me after the conference that “if we financed a hostile deal here, the next day we would be called in to have our knee caps broken by MOF.” While an anecdote hardly proves that regulators are discouraging unsolicited bids for Japanese firms, we should not completely overlook regulators as we survey the institutional landscape for hostile M&A in Japan.

Potential for regulatory backlash aside, the capital market itself still seems reluctant to breach the line between friendly and hostile bids, for reasons that apparently have little to do with economics. For example, it is common knowledge that a significant number of firms are trading on the Tokyo Stock Exchange at prices below their net asset values. Despite the obvious potential to profit by acquiring control of these firms, almost no attempts have been made. Why? Either transaction costs are too high or stigma about such deals persists.⁷ And what of the first Japanese firm to adopt a pill? Do Japanese managers sufficiently fear backlash from their existing shareholders, the capital markets or the financial press to refrain from employing the share acquisition right as a defensive measure? Or does the impact of the norm cut the other way, so that managers who deploy the pill will be applauded for staving off socially harmful activity at a time of economic vulnerability for Japan? We don't know the answer, but the question, I believe, is interesting and important.

The foregoing points reinforce the two major themes emerging from the conference: First, the pill will develop—and must be understood—in the Japanese context. It cannot be copied, judicial standards of review and all, from the United States. Second, it would be unfortunate for Japan if the pill simply served as a replacement or booster shot for

⁷ See Milhaupt & West, *supra* note 2. Probably it is a combination of the two. In numerous discussions over the past several years, Japanese and non-Japanese investment bankers have told me they fear that involvement in a hostile deal (at least the first one!) would damage their reputations in the Japanese market. All of them, however, seem quite eager to be involved in the second hostile deal.

the historically potent but gradually declining nonlegal barriers to a market for corporate control in Japan, such as cross shareholding practices.

Japanese corporate law and governance are indeed changing. Events may be pressing all constituencies to rethink some fundamental questions about their roles in the Japanese firm. I hope this conference issue contributes to that process of change and re-evaluation.

