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The Poison Pill in Japan: The Missing Infrastructure

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THE POISON PILL IN JAPAN: THE MISSING INFRASTRUCTURE

Ronald J. Gilson*

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I. INTRODUCTION

The coming of hostile takeovers to Japan has been anticipated, and anticipated, and anticipated. Each report of a reduction in the size of crossholdings among Japanese companies and in the size of Japanese bank stockholdings in their clients has given rise to an expectation that now, at last, hostile offers would emerge. It is not surprising that commentators looked forward, optimistically, to the arrival of a potentially disruptive takeover technique. The extended

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Japanese recession, together with management resistance to internally implemented restructurings and the barriers to externally imposed restructurings, has created the potential for substantial private and social gain from rationalizing production. Curtis Milhaupt reports that as of 2000, thirteen percent of the Tokyo Stock Exchange nonfinancial firms traded at below their liquidation value,[1] a phenomenon that in the United States led to a wave of bust-up hostile takeovers during the 1980s.[2] Nonetheless, in Japan the much anticipated hostile takeovers did not materialize. In turn, the absence of takeovers resulted in little clamor for defensive tactics; without a threat on the horizon, no demand for protection developed.

A number of events now suggest that the long wait for hostile transactions in Japan may be approaching its end. First, Japanese corporate law has been extensively amended since the early 1990s to make the structure of corporate governance more flexible and to enhance the potential for meaningful monitoring of management. For example, merger procedures have been simplified; a system for employee stock option compensation has been established; the creation of a holding company system through spinoffs has been legalized and facilitated; companies have been given the option of adopting a U.S. style board committee-based governance system as an alternative to the traditional statutory auditor system; and filing fees for derivative litigation have been reduced, resulting in a ten-fold increase in derivative litigation.[3]

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[1] 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] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS ch.9.E (2d ed. 1995); Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 FORDHAM L. REV. 161 (1992).

[3] Curtis Milhaupt details the pace and scope of corporate law reform. *See* MILHAUPT, *supra* note 1; Curtis J. Milhaupt & Mark D. West, *Institutional Change and M&A in Japan: Diversity Through Deals, in*

Second, a small amount of hostile activity has actually occurred. In 2000 and 2002, M&A Consulting, a Japanese takeover firm, initiated control contests directed at Japanese firms: in 2000, a hostile bid for Shoei Corporation, a real estate and electronic parts company, and in 2002, a proxy fight over dividend policy at Tokyo Style.[4] Both failed, "in large part because banks and institutional investors gave unconditional support to existing management when the unwelcome bidder appeared,"[5] just as they have in the past. Other efforts, but now by foreign bidders, have proven more successful. In 2000, the management of International Digital Communications ("IDC"), a midsized Japanese telephone company, accepted a stock swap with Nippon Telephone and Telegraph Corp. Britain's Cable & Wireless then made an uninvited competing bid offering slightly more cash than the value of the Nippon stock that IDC shareholders would receive under the transaction IDC management favored. IDC shareholders voted to accept the uninvited Cable & Wireless bid.[6] Also in 2000, Boehringer Ingelheim, a German pharmaceutical company made an unsolicited offer for the Japanese SS Pharmaceuticals ("SSP"). Boehringer succeeded in increasing its SSP holdings from approximately twenty percent to thirty-six percent, which amounted to a blocking position, and thereby gave the German company effective control.[7]

Third, informed observers, whose professional practices depend upon that status, are now sending a different signal. They now seem to be acting, rather than simply talking, as if these events actually herald the coming of Japanese hostile takeovers, which is an important signal. Professor Milhaupt reports that "many investment banks are no longer

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GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 295 (Curtis J. Milhaupt ed., 2003)

[4] *See* MILHAUPT, *supra* note 1.

[5] MILHAUPT, *supra* note 1, at 20.

[6] Robert G. Wray, *Japan: The Next M&A Frontier*, THE M&A LAWYER, March 2001, at 1.

[7] *Id.*; *see* MILHAUPT, *supra* note 1, at 11.

discouraging foreign clients from hostile bids, and large numbers of Japanese managers are seeking professional advice on defensive matters."[8] Of course, supply typically follows demand, and law firms now trumpet the belief that changes in the Commercial Code make poison pills possible in Japan.[9]

It is this last point—the coming of the poison pill to Japan—on which I focus on here. I have expressed the view that the broad sanction of the poison pill in the United States has been a mistake.[10] The opposing view, effectively championed by Martin Lipton, the poison pill's architect, is that the pill ultimately did not discourage hostile takeovers because courts came to play a mediating role that gave target boards the ability to secure a better price but in the end did not often lead boards to finally block an offer.[11] While I will take up the claim that experience has rendered the pill benign in the United States,[12] the stakes are much higher in Japan than they were in the United States. The combination of crossholdings, bank holdings and

[8] Milhaupt & West, *supra* note 3, at 322.

[9] It is beyond my ambitions here to track the critical Commercial Code changes that appear to validate a poison pill and the alternative forms that a Japanese poison pill might take. I note only that the fact that Japanese poison pills would differ formally from their U.S. progenitor demonstrates the importance of functional as opposed to formal convergence of corporate governance practices. *See* Ronald J. Gilson, *Globalization of Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001). For assessments of the pill structures allowed by the Commercial Code changes, see Satoshi Kawai, *Poison Pill in Japan*, 2004 COLUM. BUS. L. REV. 11; Arthur M. Mitchell, *The Poison Pill Comes to Japan-Part 1*, THE METROPOLITAN CORPORATE COUNSEL, March 2002, at 1; and Arthur M. Mitchell, *The Poison Pill Comes to Japan-Part II*, THE METROPOLITAN CORPORATE COUNSEL, April 2002, at 1.

[10] For recent expressions, see Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001); Ronald J. Gilson, *Lipton & Rowe's Apologia for Delaware: A Short Reply*, 27 DEL. J. CORP. L. 37 (2002).

[11] *See* Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 J. CORP. L. 1 (2002); Martin Lipton, *Pills, Polls and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002).

[12] *See infra* text accompanying note 46-48.

governmental stasis that has frozen Japanese corporate governance leaves hostile takeovers as one of the few external mechanisms for systemic change that existing institutions do not block or at least greatly impede. Most important, the institutional infrastructure that ultimately reduced the defensive impact of the poison pill in the United States does not now exist in Japan. Thus, the poison pill has the potential to be greatly more pernicious in Japan than it has been in the United States, both because of the absence of ameliorating institutions in Japan, and because the impact is likely to be greater because in Japan the forces for change in industrial organization outside the market for corporate control are significantly less strong than in the U.S.[13]

My assessment of the coming of the poison pill in Japan proceeds as follows. Part II lays the groundwork for the analysis by putting hostile takeovers, a quintessentially U.S. phenomenon, in an international and functional context. Part III takes up the general problem posed by defensive tactics and Part IV considers which participants in the corporate governance structure police the operation of the poison pill in the U.S. Part V then evaluates the implications of the U.S. experience for the development of the poison pill in Japan. Part VI concludes.

II. HOSTILE TAKEOVERS: THE INTERNATIONAL AND FUNCTIONAL CONTEXT

While the 1980s hostile takeover wave in the United States was viewed with horror outside the U.S. and U.K., international attitudes toward hostile takeovers have changed markedly in recent years. The change is most apparent in Europe. At the time when hostile takeovers emerged most forcefully in the U.S., the European attitude toward takeovers was extremely negative. In 1988, the CEO of Deutsche Bank offered a German view: hostile takeovers

[13] *See* Milhaupt & West, *supra* note 3, at 308-10.

were the "blunders of American capitalism."[14] The following year, François Mitterand, the President of the French Republic, described takeovers as "gangsterism and the law of the strongest."[15]

By 2001, European opinion had shifted dramatically. In June 2001 the proposed Thirteenth Directive on Takeovers that had emerged through the conciliation process reflected a central pro-takeover theme; following the British City Code on Takeovers,[16] the Directive prohibited target boards from taking any defensive action that interfered with the shareholders' ability to accept a hostile offer.[17] Surprisingly, the agreed upon text was defeated in the European Parliament by a tie vote, but the overall professional sentiment did not seem to change. Following the Parliament's deadlock, a "High Level Group of Company Law Experts," whose creation was promised to Parliament during the conciliation process to consider a number of issues left unresolved in the proposed Thirteenth Directive, was named and its charge extended to making a more general statement of what should be the Thirteenth Directive's operative principles. From the High Level Group's report, a revised directive would be crafted.

The High Level Group Report is a remarkable document. First, it demonstrates clearly how much the European attitude toward takeovers had changed. The Report's central concern was not the legitimacy of defensive tactics—that

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[14] Ernst-Ludwig Von Thadden, *On the Efficiency of the Market for Corporate Control*, 43 KYKLOS 635, 635 (1990) (citing FRANKFURTER ALLEGMEINE ZEITUNG, Dec. 23, 1988).

[15] *Id.* (citing LE MONDE, Feb. 14, 1989).

[16] The full text of the City Code is available at www.thetakeoverpanel.org.uk.

[17] Proposal for a Thirteenth European Parliament and Council Directive on Company Law Concerning Takeover Bids, art. 9, 1996 O.J. (C 162) 5, COM(95)655 final, *revised by* 1997 O.J. (C 378) 10, COM(97)565 final. This proposal was ultimately rejected by the European Parliament. The current proposal, which maintains this position, was proposed in February 2002. Proposal for a Directive of the European Parliament and of the Council on Takeover Bids, O.J. (C 45) 1, COM(2002)534 final.

matter had been resolved in favor of shareholder choice.[18] Rather, the focus is on the structural barriers to takeovers in individual countries that prevent a level playing field within Europe for hostile takeovers. Companies organized in countries without a tradition of protective governance structures such as dual class common stock, voting caps, or the right of special classes of shareholders to name the directors, are at a substantial disadvantage. Companies organized in countries with protective structures can make hostile offers for companies organized in countries without them, but would be protected against hostile offers directed at them.

The High Level Group Report responds to the level playing field problem by proposing a "break through principle" that invalidates barriers to the exercise of voting control by the holder of a majority of the equity interests after a bidder acquires seventy-five percent of the equity of the target company (regardless of voting power), in effect limiting multiple voting rights to two to one.[19] Note that the High Level Group Report is dramatically more protakeover than the most favorable reading of U.S. takeover law, which would leave in place structural control devices that either predate a public offering or were approved by shareholders. Thus, at least professional opinion and the opinion of the European Commission had come a long way since 1988.

[18] The High Level Group Report affirmed the principle of shareholder choice: target shareholder approval was required before the target could take "any action which may result in the frustration of the bid . . . notably before the issuance of shares which may result in a lasting impediment to the offeror obtaining control." Indeed, the Report would not credit shareholder approval of the creation of a poison pill unless it came after the hostile takeover offer occurred. Jaap W. Winter et al., Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids in the European Union (Jan. 10, 2002), *available at* http://ssrn.com/abstract=315322 [hereinafter High Level Group Report]. In the U.S., of course, a poison pill can be created before any offer is made and without shareholder approval. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

[19] High Level Group Report, *supra* note 18.

So what changed? The key is understanding that corporate acquisitions function as an equilibrating mechanism. From this perspective, acquisitions are an important mechanism for economic change and hold out the promise of facilitating the particular economic change of greatest interest to the European Union—the creation of a single market.

To see this, think of a simple two-period model.[20] In period one, the economy is in organizational equilibrium. All assets are owned by the entity that can most effectively use them, conditional on existing organizational and industrial technology, on the politically dictated regulatory regime, and on the transaction costs of shifting the use of the assets either by moving them between entities or altering their use within an entity. Between periods one and two, a change in technology occurs that alters the most efficient distribution of assets. For example, the change may be scientific, creating economies of scope between two previously unrelated technologies, or it may be political, creating economies of scale as a result of a reduction in regulatory barriers to cross-border trade, or it may be transactional, reducing the cost of transferring assets between corporations by creating a new financing vehicle like junk bonds. Corporate acquisitions occur in period two as the market for assets responds to the shift in the efficient boundary of the firm. The idea is simply a market response to changes that implicate organizational form.

From this perspective, the market for corporate control is an equilibrating process that reallocates ownership of assets following a change in technology to the entity that then values them most highly. Hostile takeovers play a special role in this equilibration. Sometimes target management may resist the equilibration process. Part of the problem results from a good faith difference in views. For example, when the destabilizing change is industry wide, it may be particularly difficult to recognize its implications from inside

[20] This discussion draws on Gilson, *supra* note 2, at 163-64.

the industry.[21] But part of the problem also results from the fact that even efficient change creates dislocation. Target management is typically replaced, target facilities are often closed, and levels of employment may be affected. Hostile takeovers are at best Kaldor-Hicks, rather than Pareto efficient, and target management typically will be among the losers. Thus, resistance to equilibration is hardly surprising.

From this perspective, the change in European attitudes toward hostile takeovers is understandable. The expansion of the internal market, together with growing globalization, altered the efficient scale in many industries. Hostile takeovers have the potential to accomplish the necessary reallocation of assets without the delay and political posturing associated with government action.

The same potential helps explain the perennial expectation that hostile takeovers are about to come to Japan. Describing the lengthy Japanese recession, the Wall Street Journal recently reported that "a combination of ineffectual government and feeble corporate-restructuring efforts snuffed out growth, which has averaged just 1.1% annually in the past 11 years."[22] Thus, an assessment of defensive tactics generally, and poison pills in particular, should appropriately focus on whether they impede hostile takeovers from invigorating the equilibration process in Japan.

III. THE PROBLEM OF DEFENSIVE TACTICS

The recent amendments to the Commercial Code that make technically possible a poison pill—a device that, whatever its particular form, functions to substantially dilute a hostile bidder's holdings if the bidder's holdings exceed a triggering percentage—only frames the question of whether the poison pill will function to prevent hostile takeovers from playing an important equilibrating role.

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[21] *See* Randall Mark et al., *Alternative Mechanisms for Corporate Control*, 79 AM. ECON. REV. 842 (1989).

[22] Sebastian Moffett & Phred Dvorak, *After Long Decline, Japan's Economy is Stirring to Life*, WALL ST. J., Nov. 10, 2003, at A1.

Most simply, the amendments do not themselves address the obligations of the board when a hostile bid is actually made. The bidder will condition its offer on the target board redeeming the pill to avoid the dilution that would result from the offer's closing. Can the board simply decline to disarm the pill and thereby prevent shareholders from ever having the opportunity to accept or reject the bid? Because a poison pill is only the most effective defensive tactic, answering this question requires understanding the role of defensive tactics generally.

Whenever we observe a target firm deploying a defensive tactic, one or more of three motives will be present. First, target management may be acting out of self-interest. Whether motivated by keeping their own jobs or by protecting other stakeholders from the costs imposed by economic change, target management may try to preserve the status quo despite the fact that the shareholders would be best served by being allowed to accept the hostile offer.

Second, target management may be acting as the shareholders' bargaining agent. In this case, management is using defensive tactics to negotiate a higher price from the hostile bidder or to seek out a more favorable competitive bid.

Finally, target management may be using defensive tactics to influence the timing of the corporation's acquisition. Management may genuinely believe that selling the corporation at this time is not in the shareholders' interest and, critically, that shareholders will make the wrong decision even if management explains its views.[23] While the short run effect of defensive tactics undertaken for this reason is the same as with defensive tactics undertaken for self-serving reasons—the offer is defeated if the defensive tactics are successful—in this case the motivation is

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[23] *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to the Proportionality Review?*, 44 BUS. LAW. 247 (1989) (developing the concept of substantive coercion to cover circumstances when shareholders will reject management's advice even though management is right).

different: the managers believe they are acting to maximize shareholder value.

The fact that defensive tactics may have different motivations poses two central questions at the heart of assessing the potential impact of the poison pill. Most important, how is the process policed so that defensive tactics motivated by management self-interest are never allowed, defensive tactics motivated by an effort to secure the best price for shareholders are always allowed,[24] and defensive tactics motivated by a timing claim are carefully evaluated to prevent claims of timing from cloaking self-interested behavior? The critical operational question is the identity of the policeman.

As I have developed elsewhere,[25] the initial debate in the U.S. was driven by two interest groups who advanced diametrically opposite views. Takeover defense lawyers argued that board decisions with respect to tender offers should be treated like any other board decision concerning an acquisition proposal: the business judgment rule should operate to allocate the decision to deploy defensive tactics, including whether to adopt or redeem a pill, to the target board.[26] Academics, in contrast, advanced the view that tender offers are themselves an important corporate governance device, central to acquisitions operating as an equilibrating process. Efficient equilibration requires that shareholders make the ultimate decision concerning whether a hostile bid will succeed.[27] Interestingly, the two sides did

[24] While the appropriateness of this behavior seems self-evident now, in early years it was the subject of significant debate. *Compare* Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982), *and* Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982), *with* Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

[25] *See* Gilson, *supra* note 10.

[26] This view was most effectively advanced by Martin Lipton. For the classic formulation, see Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

[27] *See* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819

agree on one important thing: "courts should not determine the outcome of the largest business transactions in history."[28]

In the end, it was the court's role to decide who would police management's conduct in a hostile takeover.[29] Not surprisingly, they chose themselves despite the preferences of academics and practitioners. Since 1985, Delaware law has dictated that, in the end, the courts would decide whether a board decision not to redeem a poison pill would be credited.[30] While I have been critical of how the Delaware courts, especially the Delaware Supreme Court, have implemented the obligation they took on in the face of skepticism from both the bar and the academy, the impact of that rather poor performance has been more benign than the Delaware Supreme Court's rhetoric might lead one to expect. Even Martin Lipton, the poison pill's architect and a forceful expositor of the view that the pill gives the target the right to "just say no" to a hostile bid, recently stated: "[T]he incidence of a target's actually saying 'never' [to a hostile bid] is so rare as not to be a real-world problem."[31] As I will stress in Part IV.C., I believe Lipton's assessment understates the poison

(1981); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982).

[28] Gilson, *supra* note 10, at 496.

[29] Chancellor Chandler puts the issue more felicitously: "Corporate law seeks to balance the rights of the owners (shareholders) and the duties of management (officers and directors). Much of this balance is achieved by imposing fiduciary duties on management while granting only limited rights to shareholder to participate in business operations." William B. Chandler III, *Hostile M&A and the Poison Pill in Japan: A Judicial Perspective*, 2004 COLUM. BUS. L. REV. 45. Maintaining that balance, in this view, is the role of the courts. I note that this view is not without cost. Particularly with respect to takeovers, if the balance point announced by the court is not clearly observable to those structuring transactions, then the judicial role becomes that of Delphic oracle. This is not an easy job for judges, and results in, from my perspective, the cardinal judicial sin: doctrine that makes transaction planning harder rather than easier.

[30] *See* Gilson, *supra* note 10, at 496-97 (discussing Delaware Supreme Court decisions in *Household International* and *Unocal*).

[31] Lipton, *supra* note 11, at 1065.

pill's continuing impact; however, I agree that the result has been better than one could have feared. Thus, assessing the impact of the Commercial Code amendments that now make the pill possible in Japan requires an understanding of the infrastructure in the U.S. that prevented the pill from operating according to its formal terms. On its face the pill authorizes the board to invoke a poison pill to block a hostile takeover and thus to create a serious barrier to the operation of the market for corporate control. Something outside the pill itself—and therefore outside the Commercial Code amendments—prevented the pill from achieving its destructive potential.

IV. WHO POLICES THE PILL IN THE U.S.?

As we have seen, three different institutions—independent directors, shareholders, and the courts—have the capacity to police the actual operation of the poison pill to prevent it from being used to preserve management's position, and to assess management's good faith belief about the right time to sell the company. A critical feature of the infrastructure that constrained the operation of the poison pill in the United States is that all three institutions performed that function.

A. Independent Directors

Independent directors are the first barrier to the use of a poison pill to block, as opposed to negotiate, a hostile takeover bid. Three changes over the years since the Delaware Supreme Court sanctioned the poison pill[32] have catalyzed the role of independent directors as a constraint on management self-interest in responding to a hostile takeover bid.

First, independent directors increased in both number and degree of independence. Long before Sarbanes-Oxley and the new stock exchange rules on independence, most large U.S. public corporations had a majority of outside, non-

[32] Moran v. Household Int'l. Inc., 500 A.2d 1346 (Del. 1985).

employee directors. At the same time, outside directors came to be more independent. Directors who did business with the corporation as supplier or professional adviser gave way to directors who had no financial ties to the corporation.

Second, the Delaware courts articulated a clear normative statement about the role that independent directors should play in evaluating a hostile takeover bid. Independent directors, the courts stated pointedly, are not merely advisors to management with no stake in the outcome when confronted with a hostile bid. In the takeover area, courts came to expect independent directors to be the real decision makers and "to be the controlling parties in a target company's conduct of its defense. Only when the directors appear to have abdicated their role to management —think of *Van Gorkom*, *Macmillan*, and *QVC*—will the court intervene."[33]

Finally, public opinion and the opinions of independent directors changed concerning hostile takeovers themselves. As the gains that result from hostile takeover driven restructuring became widely understood, the structure of executive compensation changed in a fashion that reduced management resistance to takeovers. So long as management compensation had a relatively small equity component, entrenchment was a value maximizing strategy for management—a hostile takeover that benefited shareholders by paying them a premium for their shares did not benefit managers, who lost their jobs. During the period in which hostile takeovers became a fixture of the U.S. corporate landscape, the portion of managerial compensation that was equity based increased markedly. From 1980 to 1994, equity-based compensation as a percentage of total CEO compensation increased from twenty percent to almost fifty percent.[34] The shift to equity-based compensation accelerated in the 1994 to 2001 period, with option-based

[33] Gilson, *supra* note 10, at 512 (citations omitted).

[34] Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 112 Q. J. ECON. 653 (1998).

compensation more than doubling over that period.[35] The result was to align the incentives of management and shareholders with respect to company operations generally, but especially with respect to takeovers; a premium offer benefited both.[36]

Thus, independent directors came to understand that they were to be the central decision makers in dealing with a hostile offer and to recognize that hostile takeovers were part of the proper functioning of the capital market rather than an attack on the corporate citadel. The circle was closed by a shift in the form of management compensation that reduced the pressure on outside directors by reducing the financial threat hostile takeovers posed to management. As a result, both directors and management were less likely to use the poison pill as an entrenchment device as opposed to a bargaining tool.

B. Courts

The story of the Delaware court's development of the law of hostile takeovers is too long and tortured to be recounted here.[37] A fair reading of that path provides some support for Martin Lipton's assessment that target boards in the end have not often used the pill to block a hostile bid. Despite the Delaware Supreme Court's frustratingly fuzzy and inconsistent rhetoric, the chancery court's decisions still

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[35] Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3 (2002).

[36] While explaining what went wrong with U.S. governance as we approached the turn of the century is far beyond my ambitions here, I note that it is textbook economics that an increase in the intensity of management incentives requires a corresponding increase in the intensity of monitoring of their performance. *See* PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION, AND MANAGEMENT ch.6 (1992). This did not happen.

[37] The early doctrinal history is developed in GILSON & BLACK, *supra* note 2, ch.17; the more recent history is recounted in Gilson, *supra* note 10. Chancellor Chandler's contribution to this Symposium presents a nuanced account of the story from the perspective of the courts. Chandler, *supra* note 29.

fairly suggest that the validity of defensive tactics will be independently assessed, even if one cannot avoid the intuition that the opinions are rhetorically camouflaged for the benefit of the supreme court. Management justification of efforts to block a hostile bid based on a claim that the stock market undervalues the corporation's shares or that shareholders will be confused by the offer will typically, but not uniformly, evoke judicial inquiry into the source of those problems. Perhaps most important, the courts have clarified one critical premise: the touchstone for decision is shareholder value. This does not mean that other stakeholders are unimportant, but only that their importance is viewed through the prism of equity value.[38] As Chancellor Chandler points out, this constrains, but does not eliminate, managerial discretion;[39] stakeholder concern can still surface through management claims of a long run strategy not appreciated by the market.

Thus, despite the Delaware Supreme Court's rhetorical deference to director power to deploy defensive tactics, the chancery court continued to make factually rich assessments of whether target boards were using the pill to negotiate or to entrench,[40] surely emboldened by the fact that the Delaware Supreme Court has yet, now more than fifteen years after validating the poison pill, to directly address whether a target board of directors can simply decline to redeem a poison pill based on the belief that the company is worth more. On balance, the Delaware courts have constrained the mischief that the poison pill could have caused.[41]

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[38] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[39] Chandler, *supra* note 29.

[40] The Chancery Court opinion in *Chesapeake Corp. v. Shore* is a clear example of this phenomenon. 771 A.2d 293 (Del. Ch. 2000).

[41] To be sure, as I have urged elsewhere, it would have been better if the Supreme Court had actually played the role it gave itself in *Household International*, but it could have been worse too.

C. The Shareholders and the Market

Independent of legal rules, institutional investors have come to impose a market constraint on a target's ability to use the poison pill to block a takeover bid. The simple fact is that institutions hold a large percentage, often a majority, of the stock of publicly traded U.S. companies. While it is commonplace to note the importance of the large public pension funds, like the California Public Employees Retirement System and TIAA-CREF, large mutual funds also hold very large positions. For example, FMR, the adviser to the Fidelity family of mutual funds, alone holds stakes of five percent or more in 288 of the largest 1000 American public corporations in 2000 and 2001.[42] Although less vocally than the public pension funds, large mutual funds also have come to oppose the use of poison pills without shareholder approval. Fidelity's voting policies state:

> If, without shareholder approval, a company's Board of Directors has instituted a new poison pill plan, extended an existing plan, or adopted a new plan upon the expiration of an existing plan during the last year, we generally withhold votes on the election of directors at the Annual Meeting following such action.
>
> Fidelity may vote in favor of a rights plan with "sunset" provisions: if the plan is linked to a business strategy that will—in our view—likely result in greater value for shareholders, if the term is less than five years, and if shareholder approval is required to reinstate the expired plan or adopt a new plan at the end of this term. . . .

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[42] Gerald F. Davis & Mina Yoo, *The Shrinking World of the Large US Corporation: Common Ownership and Board Ties*, 1990-2001 (June 2003) (published in French in GERER & COMPRENDRE, December 2003).

> We generally support shareholder resolutions requesting that shareholders be given the opportunity to vote on the adoption of rights plans.[43]

Other large fund families, like Vanguard, take similar positions.

Large shareholder antipathy to a target company's ability to use a poison pill to block a hostile bid favored by shareholders operates to very substantially limit target management's ability to block a hostile bid out of self-interest. For those companies that do not have staggered boards, which still includes more than forty percent of U.S. public companies,[44] a proxy contest to replace directors who decline to redeem a poison pill in fact may operate more quickly than a judicial challenge to the board's action even with more shareholder oriented judicial review; the process of evaluating alternative strategies and seeking alternatives to the bid, allowed under even the chancery court's most pro-stockholder formulation, still allows delay that could easily run six or more months. And even where staggered boards are in place, a strategy of disregarding the views of a majority of shareholders, while lawful when stated out of context,[45] is hardly attractive as a matter of investor relations.

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[43] Summary of Proxy Voting Guidelines, *at* http://personal.fidelity.com (last visited Nov. 13, 2003). There is evidence that poison pills are most effective when coupled with a staggered board because the board structure prevents an immediate proxy fight to replace the board in favor of directors who will redeem the poison pill. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887 (2002). Fidelity's voting policies also dictate votes in favor of proposals to eliminate staggered boards.

[44] Bebchuk et al., *supra* note 43, at 896.

[45] *See* TW Services, Inc. v. SWT Acquisition Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. 1989) (Board not required to redeem a poison pill even though eighty-eight percent of the target shareholders have tendered their shares).

In summary, the U.S. experience has been that a poison pill has not frequently blocked a hostile bid, once made, from being considered by the shareholders. The pill will give target management that opposes the bid time to explain its position, to negotiate with the hostile bidder, or to develop an alternative strategy or bidder. Three critical corporate governance institutions—independent directors, the Delaware courts, and the capital market—combine to cause the pill to operate largely as a negotiating tool, rather than as a means to maintain company independence. Without this institutional infrastructure, however, it is a fair assessment that the poison pill would have materially interfered with the equilibration process that the United States experienced during the 1980s and early 1990s.

Despite this appraisal of the poison pill's impact in operation, it is important not to overstate just how benign the pill turned out to be. In this respect, two qualifications are especially important. First, when coupled with a staggered board, the pill is an effective defense, and the empirical evidence suggests that in this context the pill has allowed management in an economically significant number of cases to prevent shareholders from making a decision about whether to accept a hostile bid.[46] Second, we simply do not know whether courts now would allow a target corporation to decline to redeem a poison pill in the face of the kind of offer that played a significant role in the 1980s equilibration process: a junk bond financed bust-up offer made by takeover entrepreneurs whose strategy is to sell the parts of the company to more efficient users of the target's assets. Because such a bid contemplates a major change in corporate strategy, may involve forms of payment that are more difficult to value, and may be made by individuals who are not part of the business mainstream, it is difficult for the courts, and I expect for the target directors, to sort out management's actual motive for resisting the offer. It is in this circumstance that a clearer standard—like the chancery court's position before *Time-Warner* that, after a target board

[46] Bebchuk et al., *supra* note 43.

has had the time to explain, negotiate and seek out another bidder, the shareholders have the chance to accept or reject the bid[47]—is a better outcome. And it is in this circumstance, likely of real economic importance because of the need for outsiders to make the kind of changes that are difficult for insiders to see, and where the transaction functions most plainly as an equilibrating mechanism, that the pill may still be a serious economic problem.[48]

V. IMPLICATIONS OF THE U.S. EXPERIENCE FOR THE POISON PILL IN JAPAN

The United States experience can provide some guidance for how Japan deals with the Commercial Code's authorization of a poison pill. To be sure, there are important limits on the relevance of the American experience to Japan. Japanese industrial organization and Japanese corporate governance differ markedly from that of the United States, which surely limits the extent to which the U.S. experience is transferable. Nonetheless, poison pills are a U.S. phenomenon, so it is the only source of experience that is available. Thus, while remaining attentive to the difficulties of generalizing from a single country's experience in the face of important inter-country differences, we have to take guidance from wherever we find it, albeit with a grain (or pillar) of salt.

The first, and most important, point is hardly limited to the pill. Allowing the capital market to operate as a mechanism to force corporations to respond to external environmental change is an important macroeconomic factor. It is especially important when other change inducing mechanisms, most notably government, may not only be ineffective, but may be affirmative barriers to change. In this setting, the role of institutional infrastructure to cabin

[47] *See* City Capital Assocs. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988).

[48] I am grateful to Steve Fraidin for his repeated reminders of this point.

the operation of the pill somewhere short of its capacity is critical.

This argument, of course, is not economics, but political economy. Mancur Olson famously predicted that interest groups with stakes in the current structures of economic organization will act to preserve the status quo and the size of their piece of the pie even if their actions actually reduce the overall size of the pie.[49] Thus, it may be politically naïve to imagine that those who favor the status quo will be unable to prevent a reduction in the pill's effectiveness. Certainly the experience in the United States, especially at the state level, counsels that politics played an important role in setting the policy with respect to defensive tactics.[50]

The second point is that the pill has "worked" in the United States—that is, it has been largely but not exclusively used to support seeking a better deal for the shareholders rather than simply to block a bid—because independent directors, courts, and active institutional investors have all combined to police the uses to which the pill actually is put. The next step, then, is to assess what institutions can play that ameliorating role in Japan.

Here the courts win by default. Traditional Japanese corporate governance does not contemplate independent directors of the character that has proven so important in the operation of the poison pill in the U.S. And while recent Commercial Code amendments allow Japanese corporations to elect a U.S. style governance structure with outside directors staffing governance committees, there is reason to be skeptical of the impact of the change. First, Japanese corporate law does not require an "outside" director to be "independent" in the sense that term is used in the U.S.[51]

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[49] *See* MACUR OLSON, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES (1982).

[50] In this respect, it likely has been beneficial that Delaware's race, whether to the top or the bottom, has been with the Federal government, not with other states. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); GILSON & BLACK, *supra* note 2, ch.23.

[51] *See* SHŌHŌ, art. 188 (Japan). The distinction between "outside" directors as defined by the Japanese Commercial Code and "independent"

Furthermore, early reports suggest a limited response to the invitation to adopt a U.S. governance structure. As of mid-June, only thirty-six listed Japanese companies had committed to adopting the new governance structure.[52] Even for that group, the U.S. experience strongly suggests that the effectiveness of even independent directors depends on a shared vision of their function that depends on the situation and requires time to develop.

We can thus expect that the burden of assuring the sensible operation of the poison pill will fall to the Japanese courts, just as it did to the Delaware courts. And it would be a serious mistake to underestimate the weight of that burden. Because the Commercial Code amendments that now allow a poison pill in Japan are technical rather than substantive, the Japanese court will be operating without legislative guidance. Thus it will be up to the courts to write, through the accretion of judicial decisions, a poison pill "code" that will give transaction planners for both bidders and targets guidance concerning the operational rules of a Japanese market for corporate control. This was the mantle that the Delaware courts took up more than fifteen years ago, and which they have yet to fully discharge; most starkly, we still do not know whether a target board, whose reason for blocking an offer is simply that the shareholders may disagree with the board over the company's "fundamental value" or the appropriate time to sell the company, may block the offer by declining to redeem a poison pill.[53] If this is the performance of the commercial court with the most takeover experience of any in the world, the Japanese courts confront a serious challenge.

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directors as contemplated under U.S. law is discussed in Ronald J. Gilson & Curtis J. Milhaupt, Choice as Regulatory Reform: The Case of Japanese Corporate Governance (Feb. 2004) (working paper, on file with the author).

[52] David Pilling, *Japanese Shifting to Global Standards*, FIN. TIMES, June 16, 2003, at 1.

[53] Chancellor Chandler nicely explains how the Delaware Supreme Court has managed this dance. Chandler, *supra* note 29.

When I delivered a precursor to this Article at the Symposium in Tokyo, I commented that assigning to Japanese courts the role of creating a code, as opposed to applying a legislatively enacted code to the cases before them, seemed an oddly common law pattern in a legal system whose roots lie in the civil law. Professor Kanda rightly rebukes this reliance on formal differences between legal systems, reminding us that the divergence between different common law jurisdictions and between different civil law systems may be as large as the divergence between the two legal systems.[54]

At the Symposium, I also suggested that the abuse-of-rights doctrine, invoked so broadly by the Japanese courts to protect expectations of lifetime employment from a statute that as a technical matter dictates employment-at-will,[55] could be used as a model to develop case law that provides a nonstatutory constraint on the use of the poison pill to block needed economic change. Professor Kanda again properly corrects my superficial analysis of Japanese law. My attraction to the Japanese courts' experience with the abuse-of-rights doctrine was simply the court's creation of a judicial doctrine that restricted the operation of a statute that on its face was not restricted, which is the functional task the courts will confront in constraining the operation of the poison pill. Professor Kanda reminds us that what is important is not the particular judicial doctrine—on reflection, it seems odd for me to have imagined that the Japanese courts would import a largely labor law doctrine into company law—but that a doctrine be available to serve as a vehicle for the effort. As he suggests, the Commercial Code in sections 280-10 and 280-39(4) explicitly invites the necessary doctrinal development by providing that

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[54] Hideki Kanda, *Does Corporate Law Really Matter in Hostile Takeovers?: Commenting on Professor Gilson and Chancellor Chandler*, 2004 COLUM. BUS. L. REV. 67.

[55] *See* KAZUO SUGENO, JAPANESE EMPLOYMENT AND LABOR LAW 395-98 (Leo Kanowitz trans., 1992); Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508, 525-26 (1999).

"significantly unfair" stock issuances may be set aside.[56] Certainly the term "unfair" is sufficiently empty that it can be filled with whatever substance the court concludes is appropriate.

I offer a final, and now appropriately tentative, speculation concerning the development of judicial constraints on the operation of the poison pill. Recently, the Japanese courts have struck down the issuance of shares to a bidder favored by target management based on an assessment that the issuance's primary purpose was to protect target management. While the willingness of the courts to strike down defensive action is encouraging, I believe analysis of motivation will prove insufficient in Japan, just as it did in Delaware,[57] to distinguish between appropriate and inappropriate defensive tactics.

VI. CONCLUSION

The Commercial Code amendments that in effect authorize Japanese corporations to adopt a poison pill launch a major economy on a problematic course made even more difficult because, after some dozen years of recession, meaningful economic reform now seems to be taking hold. The market for corporate control holds the promise of accelerating that recovery by providing a reform vector that is not constrained by governmental rigidities. The U.S. experience with the poison pill provides some guidance for that enterprise. Of course, that guidance will have to be refracted through the prism of Japanese institutions to be useful, but even one data point is better than none. From the perspective of an interested academic viewing the Japanese corporate governance from a distance, it will be fascinating to watch the poison pill experience replayed in another system. For those of us who have been critical of how the Delaware courts have dealt with the poison pill, having a second data point will be extremely interesting.

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[56] Kanda, *supra* note 54, at 73.

[57] *See* Gilson, *supra* note 27.