

# POISON PILL IN JAPAN

Satoshi Kawai\*

I.	Introduction.....	12
II.	U.S. Poison Pill Characteristics.....	12
	A. Characteristics.....	12
	B. Comments from the Japanese Law Perspective ...	13
	1. Difficulty in Simultaneous Distribution .....	13
	2. Discriminatory Treatment Needs Justification .....	13
III.	Japanese Poison Pill .....	14
	A. Poison Pill When There Is No Threat of a Hostile Offer .....	14
	1. Veto-Option Pill.....	15
	2. Trust Pill.....	16
	3. Building a Theory to Support the Legality and Validity of Discriminatory Treatment Against the Offeror.....	17
	B. Poison Pill When There Is a Threat of a Hostile Offer .....	18
	1. Scheme Outline .....	18
	2. Advantages .....	19
	3. Disadvantages .....	19
IV.	Conclusion .....	20

---

\* Satoshi Kawai is a partner of Mori Hamada & Matsumoto, one of the biggest law firms in Japan. This paper is a summary of my presentation at the "Hostile M&A and the Poison Pill in Japan: Prospects and Policy" conference held on June 13, 2003 in Tokyo. It is written from a practitioner's point of view. As an alumnus of Columbia Law School (LL.M. 1995), it was my great honor to make this presentation at the conference and meet the other alumni at the reception. I am very grateful to Professor Curtis J. Milhaupt for giving me this fantastic opportunity.

## I. INTRODUCTION

Due to an extended economic downturn, Japanese corporations have started selling their cross-held shares, which has increased the amount of floating stock released into the market. Also, Japanese corporate law has undergone significant changes, including the relaxation of corporate restructuring and strengthening of corporate governance, making it more difficult for management to reject hostile offers with a significant premium. Based upon these two factors, the risk of hostile acquisition is now becoming "real" for Japanese corporations.

In response to the increased possibility of hostile acquisitions in Japan, academics and practitioners have been discussing defensive measures. In almost all cases, the discussions refer to defensive measures employed in the United States, with the poison pill being mentioned in particular because it is the most popular and effective type of defensive measure.

In this paper, I would like to discuss the legal issues relating to the poison pill in the context of Japanese law and present possible versions of the Japanese poison pill.

## II. U.S. POISON PILL CHARACTERISTICS

### A. Characteristics

I would first like to confirm the basic characteristics of the poison pill in the United States. For the purpose of this paper, I will focus on the so-called "flip-in" poison pill.

It is widely held that the flip-in poison pill ("pill") has the following features:<sup>1</sup>

(1) The pill is intended to increase the bargaining power of the board of directors of the target company ("target")

---

<sup>1</sup> See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 730-895 (2d ed. 1995) (explaining corporate law considerations in hostile transactions).

when the hostile offeror ("offeror") commences the tender offer.

(2) The pill is an option that is exercisable by all shareholders of the target other than the offeror upon the occurrence of a trigger event (i.e., the acquisition of a certain level of shares by the offeror).

(3) If the pill kicks in, significant dilution to the holdings of the offeror will occur as a result of the exercise of the options by the shareholders.

(4) The offeror cannot exercise the options ("discriminatory treatment").

(5) Options are attached to shares before the occurrence of a trigger event, and are automatically transferred and assigned with shares ("simultaneous distribution").

(6) The board of directors may redeem the options at its discretion at any time.

(7) If the target receives a "best offer," the board of directors is obligated to redeem the options.

## B. Comments from the Japanese Law Perspective

If the poison pill were to be introduced in Japan as it is in the United States, there would be several questions from the perspective of Japanese law.

### 1. Difficulty in Simultaneous Distribution

Under the Japanese Commercial Code, stock and options to issue stock (so-called "stock acquisition rights" or *shinkabu-yoyaku-ken*) are different securities. Even if stock and stock acquisition rights are issued to the same person, it is difficult to ensure they are automatically distributed together because such person may sell or dispose of the stock and stock acquisition rights separately.

### 2. Discriminatory Treatment Needs Justification

Even if the board of directors is obligated to redeem the options if there is a best offer, there is a possibility that discriminatory treatment might constitute a breach of the

principle of shareholder equality or the fiduciary duty of board members.

Traditionally, the principle of shareholder equality is one of the most important principles under the Japanese Commercial Code, although the scope of application of this principle is not so clear. Recently, some scholars have tried to limit the scope of its application to areas explicitly provided for by the Commercial Code.<sup>2</sup>

With regard to the application of the fiduciary duty of board members, it must be noted that the purpose of the poison pill is to increase the bargaining power of the board to obtain the best offer. In my opinion, if the board acts in the best interests of the shareholders as a whole, then such acts should not be considered a violation of fiduciary duty.

Given that discriminatory treatment does not constitute a breach of the principle of shareholder equality or fiduciary duty, I would like to explain three possible types of Japanese poison pills below.

### III. JAPANESE POISON PILL

In examining defensive measures under Japanese law in response to (possible) hostile offers, from a practical point of view, it is useful to distinguish two cases—when there is and when there is not a threat of a hostile offer.

#### A. Poison Pill When There Is No Threat of a Hostile Offer

The board of directors of a corporation may consider introducing a poison pill when there is no threat of a hostile offer. In this case, the introduction of the poison pill is purely preparatory and meant to deter actual hostile offers. In this case, I would like to examine two schemes for the Japanese poison pill.

---

<sup>2</sup> See SHIGERU MORIMOTO, *CORPORATE LAW* 120 (2d ed. 1995); KENJIRO EGASHIRA, *LAWS OF STOCK CORPORATIONS AND LIMITED LIABILITY COMPANIES* 117-19 (2d ed. 2002).

## 1. Veto-Option Pill

The concept of the veto-option pill is based upon the recent amendments to the Commercial Code, which relaxed regulations on preferred stock.<sup>3</sup>

### (i) Scheme Outline

Before the threat of a hostile acquisition is posed, a corporation issues to certain friendly shareholders, by way of third-party allocation, stock acquisition rights that issue preferred stock with veto rights on certain important business matters. The issue price of the stock acquisition rights may be free or for charge. It is highly likely that a special resolution of the general meeting of shareholders will be required because the veto rights feature of such stock acquisition rights will be considered as "especially favorable."<sup>4</sup> Stock acquisition rights are exercisable upon the occurrence of a certain trigger event. The board of directors may redeem the stock acquisition rights at its discretion at any time.

### (ii) Advantages

If a corporation issues this type of stock acquisition right, it will have a strong deterrent effect on hostile takeovers. If the veto-option pill is adopted, stock acquisition rights will not have to be distributed simultaneously with shares. Moreover, the veto-option pill can avoid the disputed issue of discriminatory treatment since, under this scheme, only third parties who have such stock acquisition rights may exercise them.

---

<sup>3</sup> A corporation may issue stock which grants its holders veto rights on certain matters that are specified in the Articles of Incorporation. SHOHÔ, art. 222 (Japan).

<sup>4</sup> The issuance of the stock acquisition rights on especially favorable terms requires two-thirds or more affirmative resolution ("special resolution") at the shareholders' meeting. SHOHÔ, art. 280-22 (Japan).

### (iii) Disadvantages

On the other hand, the veto-option pill has a number of disadvantages. First of all, under this scheme, the issuing corporation potentially gives holders of such stock acquisition rights "super powers," risking an adverse impact on corporate governance and the stock price. It is possible that the board of directors would act to maximize the interests of these holders rather than the interests of the general shareholders.

Second, if the offeror and holders of such stock acquisition rights come to a private agreement, there will no longer be a deterrent effect, possibly being detrimental to the general shareholders.

Third, from the perspective of accounting responsibility, it is difficult for financial institutions to explain the legitimacy or justification for holding such stock acquisition rights. In addition, if such stock acquisition rights were allocated to a person related to a director or an officer of the corporation, there would be considerable risk that the purpose of the issuance of such stock acquisition rights would be deemed to protect such director's or officer's own interests and would be considered invalid as an unfair issuance. Thus, it would be quite difficult to find a suitable party to whom such stock acquisition rights could be allocated.

## 2. Trust Pill

In light of the practical difficulties of the veto-option pill, the trust pill has been proposed by Mori Hamada & Matsumoto. The original intention of the trust pill was to import to Japan as many of the substantive features of the traditional flip-in poison pill as possible.

### (i) Scheme Outline

An issuing corporation issues stock acquisition rights to a special purpose company ("SPC") pursuant to a special resolution of the shareholders' meeting, and the SPC entrusts the stock acquisition rights to a trust bank as a securities management trust. The beneficiaries of the trust

are the registered shareholders as of the end of the fiscal year immediately prior to (or a predetermined date immediately after) the occurrence of a certain trigger event, except for the offeror and its related parties. The beneficiary rights can be exercised separately by the beneficiaries or collectively by the trust administrator. Stock acquisition rights may be exercised upon the occurrence of a certain trigger event, giving beneficiaries the opportunity to request the issuance of new shares at a discount. The board of directors may redeem the stock acquisition rights at any time.

Thus, the trust pill adheres to the basic concept of the "flip-in" poison pill. Since the ordinary shareholders become beneficiaries of stock acquisition rights under this scheme, the board of directors can, as fiduciary and agent of the general shareholders, negotiate with the offeror with more leverage. It would therefore be possible to demonstrate that the issuance of the stock acquisition rights is not being made to protect the interests of the board of directors. In addition, by adopting a trust pill, stock acquisition rights would no longer need to be distributed with shares. Further, by requiring stock acquisition rights to be redeemed if the board determines there is a best offer, unjust hostile takeovers will be deterred to the extent necessary to maximize the shareholders' interests.

### (ii) Disadvantages

Again, looking at this scheme as a whole, the offeror is subject to substantial discriminatory treatment, leading to the question of whether the issuance of these stock acquisition rights is legal and fair.

### 3. Building a Theory to Support the Legality and Validity of Discriminatory Treatment Against the Offeror

In my opinion, the trust pill should not be considered a violation of the principle of shareholder equality or fiduciary duty of the board for two reasons:

### (i) Structural Reason

In the case of a trust pill, the offeror is not a beneficiary under the trust agreement, since the trust agreement is executed between the SPC and the trust bank, not the issuing company. Therefore, in this respect, the principle of shareholder equality is not applicable. In addition, as the trust pill is not targeted at any specific shareholder at the time of issuance, and as all shareholders are subject to the same restrictions after issuance, all shareholders are treated equally.

### (ii) Substantive Reason

If any dilutive effect arises as a result of the issuance and exercise of these stock acquisition rights, it is assumed that the offeror will suffer an adverse impact. However, since the board of directors bears an obligation to redeem the stock acquisition rights if it receives a best offer, it is possible for the offeror to avoid this dilutive effect as long as it presents the best offer. In this sense, the trust pill is not unreasonable. Substantively, one may argue that the trust pill is both necessary and sufficient to maximize the interests of general shareholders.

## B. Poison Pill When There Is a Threat of a Hostile Offer

Lastly, I would like to examine the adoption of the poison pill when a threat is actually posed. This type of poison pill can be referred to as the "immediate-issue pill."

### 1. Scheme Outline

The target issues stock acquisition rights by allocating them to shareholders for no consideration, enabling shareholders to obtain new shares at a significant discount; provided, however, that the offeror cannot exercise such stock acquisition rights. The board of directors may redeem such stock acquisition rights at any time.



## 2. Advantages

The issuance of the immediate-issue pill would be relatively easy; only a board resolution would be required since the allocation is to all general shareholders. By declaring the allocation and issuance before the offeror completes its tender offer, it is possible to deter the offeror from unilaterally carrying out takeover procedures and bring it into negotiations. No mechanism is required to transfer and assign stock acquisition rights automatically with shares after their issuance since, under this scheme, the threat is already posed.

## 3. Disadvantages

Again, this pill also needs to overcome the issue of discriminatory treatment—will this pill constitute a violation of the principle of shareholder equality? As the stock acquisition rights are issued in the case of an emergency after it is evident there is a hostile offer, the problem of whether the issuance is fair and legal is more serious than a trust pill, which is issued when there is no threat of a hostile offer. The immediate-issue pill may be regarded as an unfair issuance if the primary purpose rule<sup>5</sup> is applied because the issuance of stock acquisition rights<sup>6</sup> in this case is unrelated to funding needs. However, the validity and applicable scope of the conventional primary purpose rule are not clear. Further, since the issuance of stock acquisition rights is not, by definition, necessarily related to funding, an argument

---

<sup>5</sup> Under the primary purpose rule, the legality of the issuance of the new shares is determined by the main purpose of such new issue. Practically speaking, under this rule the issuance of new shares without funding needs will likely be considered an unfair issuance to maintain the control of the corporation. See EGASHIRA, *supra* note 2, at 574.

<sup>6</sup> Professor Egashira of University of Tokyo thinks that the primary purpose rule is applicable to the issuance of the stock acquisition rights. See EGASHIRA, *supra* note 2, at 611.

can be made that the primary purpose rule cannot be applied to the issuance of stock acquisition rights.<sup>7</sup>

With respect to the deterrent effect, since the issuance of this pill is made after the commencement of a tender offer, it is not a deterrent in a strict sense.

#### IV. CONCLUSION

Among these three types of the poison pill that could be employed in Japan, the trust pill would be the most practically effective defensive measure. In light of increased popularity of buyouts and liquidation of cross-held shares, it would not be surprising if a Japanese corporation adopts the trust pill in the near future.

---

<sup>7</sup> Professor Kanda of University of Tokyo thinks that funding needs should not be required for the issuance of the stock acquisition rights. *See* HIDEKI KANDA, *CORPORATE LAW* 213 (4th ed. 2003).