HOSTILE M&A AND THE POISON PILL IN JAPAN: A JUDICIAL PERSPECTIVE

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I am deeply grateful for, and honored by, the invitation to speak before such a distinguished group of lawyers, academics and judges. I come in my role as an American judge—more particularly, a trial court judge from the small state of Delaware—whose principal expertise is deciding cases involving corporate governance principles. I should emphasize that I am not here as an advocate for the American system of equity markets nor the American corporate regulatory enforcement system. Rather, I have been asked to speak about Delaware's experience with defense mechanisms associated with hostile corporate takeovers and acquisitions. Before turning to the particulars of my subject, however, I believe it is appropriate to give some background on the judicial system in the United States. It is my understanding that Japan has one judicial system spread throughout the nation, with one ultimate Supreme Court.[1] The United States, on the other hand, has a multiplicity of judicial systems, one for each of the fifty states, one for the national, or federal system, and others for territories, the military, and an entire system of administrative law judges. This decentralization of judicial authority has created a unique situation for corporate law in America.

The securities markets, since they cross state boundaries, are essentially the province of the national judiciary (the

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[1] *See* DOING BUSINESS IN JAPAN § 10.04 (Zentaro Kitagawa ed., 2003).

federal courts).[2] Corporate governance, however, has remained within the realm of state law. Each state provides the mechanisms by which a corporation or other business entity can be formed.[3] As a result, the corporation itself becomes a "citizen" of that state and is thus subject to its laws.[4]

Delaware has attained favored status as the leading state in which to incorporate within the United States.[5] Because of this, the Delaware Court of Chancery and Delaware Supreme Court have led the way in the development of corporate law.[6] The Court of Chancery is especially able to further the goals of corporate law because it is a court of equity.[7]

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 shareholders to participate in business operations. As a court of equity, the Court of Chancery evaluates each case on its merits and bases its decision on precedent, guided by principles of fairness, rather than inflexible application of statutes.[8]

With this background, I turn to one discrete example of the role of the Delaware Court of Chancery and Supreme

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[2] The bulk of federal legislation on regulation of securities markets is contained in the Securities Act of 1933, 15 U.S.C. § 77a–77aa (2000) and the Securities Exchange Act of 1934, 15 U.S.C. § 78 (2000). More recently the federal government has enacted the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

[3] *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 101-111 (2003).

[4] *See* BLACK'S LAW DICTIONARY 310 (4th ed. 1968).

[5] *See* Marcel Kahan & Ehud Kamar, *Price Discrimination in Corporate Law*, 86 CORNELL L. REV. 1205 (2001).

[6] *See* DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 1-4 (1998).

[7] *Id.*

[8] A court of equity is "at its heart a court designed to promote justice where strict application of traditional legal precepts might otherwise fail." *Id.* at § 1-11.

Court in our system of corporate governance. At the heart of the American system of corporate law is this fundamental difficulty: How should authority between the corporation's owners and its managers be properly allocated? The tension created in the law from this question is perhaps most dramatically portrayed in the decisions surrounding the evolution of the shareholder rights plan, commonly known as the "poison pill."[9] To provide a better understanding of this development in Delaware law, I digress briefly to explain its legal and economic history.

Beginning in the late 1970s, America experienced the beginnings of an industrial restructuring. New financing became available in the form of pension fund assets and "junk bonds,"[10] expanding the market's ability to fund change of control transactions.[11] This funding, by definition, was extremely risky and those who took advantage of it were a new breed of entrepreneurs. These entrepreneurs were vilified (by critics) as corporate raiders because of their ability to bully the upper echelons of large corporations into submission.

By the mid-1980s, America's industrial restructuring was in full swing. Companies with excess cash flow and inefficient operations, usually large conglomerates that had amassed unrelated ventures, became targets of a massive round of hostile takeovers, led by "raiders" or "greenmailers" intent on either busting up the conglomerate and selling its most valuable pieces or extorting value from the managers

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[9] Martin Lipton of Wachtell, Lipton, Rosen & Katz is generally credited as the inventor of the poison pill based on his authoring an early article discussing the proper reaction of a board facing a hostile takeover. *See* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 130 (1979). In a later memorandum, Mr. Lipton described what he called the "Warrant Dividend Plan," which was the precursor of today's poison pill. *See* Memorandum from Martin Lipton on Warrant Dividend Plan (Sept. 15, 1982) (on file with Mr. Lipton).

[10] A junk bond is a "high-risk, high-yield subordinated bond issued by a corporation with a below-standard industry rating." BLACK'S LAW DICTIONARY 174 (7th ed. 1999).

[11] Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 493 (2001).

before agreeing to sell back their stock.[12] Executives at the helm of large corporations found themselves unarmed and unable to defend against this surge of corporate takeovers, later termed "gangster capitalism."[13]

This industrial restructuring reshaped the American corporation. Former conglomerates were broken up to bring industry's focus back to specialization, narrowing a company's business to its realm of skill and expertise.[14] Entrepreneurs speculated that such specialization would lead to enhanced profitability resulting from financial and operational discipline and took advantage of the financing available to implement these ideas, ousting preexisting management in the process. In addition to specialization, the corporate raiders' strategy included gutting the company's excess cash flow and eliminating excess capacity for operations.[15] In short, deprived of their cushions of cash and capacity, companies were forced to perform more efficiently, with major shareholders overwhelmingly reaping the benefits of the newly distributed value.

Although efficiency was certainly a laudable goal, the idea of unsophisticated entrepreneurs successfully wielding junk bond financing and dethroning the corporate elite offended the sensibilities of many prominent executives and commentators. Some critics pointed out that it disrupted operational efficiency and emphasized immediate value over long-term corporate plans that ultimately might have increased value to the shareholders.[16] Others pointed out that viewing a corporation as the sum of it assets, which the corporate raiders could sell to the highest bidder, ignored the social cost of lost jobs and disrupted communities.[17]

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[12] *Id.* at 494.

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] The leading commentator for the pro-pill position is its inventor, Martin Lipton. *See* Martin Lipton, *Pills, Polls and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002).

[17] *See* Trevor S. Norwitz, *"The Metaphysics of Time": A Radical Corporate Vision*, 46 BUS. LAW. 377 (1991).

On the other hand, some commentators saw takeovers in a more positive light, praising them for bringing forced efficiency to the market and releasing the value of underutilized assets for more productive purposes.[18] Whether the effects of unwanted takeovers were positive or negative, corporate boards viewed them with alarm and began to search desperately for ways to defend against them. One of the earliest defensive measures was the poison pill.

In a typical modern poison pill, and here I must be overly simplistic for reasons of brevity, stockholder rights are triggered when one individual or entity acquires twenty to thirty percent of the company's shares.[19] Once triggered, these newly activated rights cause a massive dilution of an acquiring entity's stock position, thus making it prohibitively more expensive to complete the acquisition.[20]

Beginning in the early 1980s, as adoption of a poison pill rapidly grew more commonplace, the question was: Who will review or regulate this new device, a device cleverly designed to thwart hostile corporate takeovers and with the hidden potential to entrench management to the detriment of shareholders willing to sell?

With minor exceptions, the United States Congress had shown no interest in adopting a statutory framework to regulate corporate decision-making.[21] The Securities and

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[18] The leading commentator for the anti-pill position is Ronald J. Gilson. *See, e.g.*, Gilson, *supra* note 11.

[19] R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 6.47[B] (3d ed. 2002).

[20] The rights themselves do not cause dilution, but rather their exercise does. In the hands of all shareholders except the hostile acquirer, these rights when activated become convertible into the right to acquire the corporation's common stock at a significant discount from the market price. When the existing shareholders exercise these rights, large amounts of new stock are issued by the corporation, and the hostile bidder's position in the company is diluted. *See* Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 69-70 (1987).

[21] Namely, that exception is the Williams Act of 1968, which governs tender offers. Pub. L. No. 90-439, 82 Stat. 454 (codified as amended at 15

Exchange Commission ("SEC") also expressed no interest in regulating takeover defenses such as the poison pill. Moreover, the United States Supreme Court had essentially sidelined federal judges and state legislatures with respect to such corporate governance matters.[22] Almost by default, state courts were left to fill this void and create dependable ground rules governing when corporate boards and management might employ takeover defenses as measures to deter, thwart, slow down, or even stifle an ever-increasing wave of hostile acquisitions.

As the state of incorporation of a substantial majority of United States corporations,[23] Delaware was thrust into the forefront to develop these ground rules. Nothing in Delaware's corporation law, however, explicitly allowed or prohibited takeover defenses such as the poison pill. Nor did Delaware's general corporate statute explicitly authorize a board or management to interfere with shareholders' desire to sell their shares if the board or management believed that such a sale would be injurious to the shareholders. Thus, the scope of a board of directors' or management's authority to interfere with the ability of shareholders to sell their stock was left to judicial development through the common law of fiduciary duty. By fiduciary duty, I mean the obligation of directors to take actions based solely on the best interest of the shareholders, and not for their own benefit.[24]

The question of directors' self-interest is particularly apt in the consideration of board-enacted defenses to corporate takeovers, since the lucrative and prestigious positions of the board members themselves (as well as the interest of the

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U.S.C. § 78n(e) (2000)). *See* Gilson, *supra* note 11, at 494; Lipton, *supra* note 16, at 1044.

[22] The Supreme Court in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479-80 (1977), extinguished the ability of federal judges to federalize substantive takeover law through securities laws and also limited the ability of state legislatures to adopt statutory regulation. *See* Lipton, *supra* note 16, at 1044-45.

[23] *See* Kahan & Kamar, *supra* note 5, at 1207.

[24] *See* Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

shareholders) may be at stake in a corporate takeover.[25] In sum, the advent of the poison pill and other takeover defenses (including share repurchase programs, asset sales or lock-ups, etc.)[26] posed the following public policy question: Who has the primary authority to decide whether a tender offer will be accepted? Should that authority lie with the directors of the company whose stockholders have received the offer or with the stockholders to whom the offer is actually directed?

When this central public policy debate was thrust center stage in the early 1980s, advocates for the competing views urged two starkly different answers upon Delaware's Court of Chancery and Supreme Court. Those who defended the power and authority of directors and management to manage "the business and affairs of the corporation"[27] contended that the directors and managers *alone* should be authorized to make such decisions, so long as they did so as a matter of business judgment, honestly, and in good faith.[28] In contrast, academics and shareholder activists urged the courts to preserve the authority of stockholders—the owners of the corporation—to decide whether to accept the terms of a proposed offer to purchase their property.[29]

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[25] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (stating that "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."); *see also* Bennett v. Propp, 187 A.2d 405, 409 (Del. Ch. 1962) (noting that "[courts] must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.").

[26] For an example of a share repurchase defense, see *Unocal*, 493 A.2d 946. For examples of asset sales and lockups, see *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

[27] DEL. CODE. ANN. tit. 8, § 141(a) (2003).

[28] *See, e.g.*, Lipton, *supra* note 16, at 1064.

[29] *See, e.g.*, Gilson, *supra* note 11, at 491.

At that time, the Delaware courts had only two standards of judicial review that applied to the decisions or actions of directors and managers of Delaware corporations. If a board was charged with a breach of its duty of care, that is, the failure to be adequately informed before making a decision, Delaware courts reviewed such actions under the deferential business judgment standard.[30] On the other hand, if the board or management was accused of acting in a self-interested manner, that is, disloyally, Delaware's courts applied a much more stringent "entire fairness" standard of review.[31] Under this more exacting fairness review, directors and managers have the burden of demonstrating that their actions or decisions were entirely fair both to the corporation and to its stockholders.[32] Those arguing for directorial

[30] This standard has been articulated as follows:

> The business judgment rule is an acknowledgement of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.

Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

[31] The Delaware Supreme Court spoke of the entire fairness standard in this manner:

> There is no 'safe harbor' for divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (citations omitted).

[32] They further articulated the aspects of entire fairness by saying:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured,

discretion saw consideration of a takeover defense as merely one more business decision that the board, not the courts, was better equipped to make. Therefore, they urged the more deferential business judgment standard of review. Those arguing in favor of expanded shareholder rights viewed any defensive measure taken by the board as potentially tainted by the interest of the board in entrenching its own position, thus triggering the much more stringent entire fairness standard of review.

When the takeover wave forced Delaware's courts to face this fundamental public policy question in 1985, they responded in a way that neither of the contending camps of advocates expected. In 1985, the Delaware Supreme Court decided four cases—*Smith v. Van Gorkom*,[33] *Unocal Corp. v. Mesa Petroleum Co.*,[34] *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[35] and *Moran v. Household International Inc.*[36]—that effectively answered this public policy question in the following manner: The board of directors would be authorized to make the decision whether stockholders, who have received an offer from a third party, may accept that offer without interference, but the director's actions will be subject to a new *intermediate* level of judicial scrutiny if those actions interfere with stockholder choice.

> negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Id. (citations omitted).

[33] 488 A.2d 858 (Del. 1985).

[34] 493 A.2d 946 (Del. 1985).

[35] 506 A.2d 173 (Del. 1986).

[36] 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

More specifically, in the *Unocal* decision, the Delaware Supreme Court recognized the appropriateness of takeover defenses and the right of directors to deploy them for fending off unwanted hostile acquisitions. The Court announced that such defensive actions would be reviewed under enhanced judicial scrutiny—an objective *ex post* review by the court to assess whether a board's use of a particular defensive measure was "reasonable in relation to the threat posed."[37]

This form of intermediate judicial scrutiny was more intense and exacting than the traditional business judgment standard that typically applied to a board's decision making but stopped short of a finding of *per se* self-interest, which would have triggered the most stringent entire fairness standard. Then, in *Moran*, the Delaware Supreme Court refused to invalidate the poison pill, finding that there was sufficient flexibility in the Delaware statute to permit a corporate board to issue "rights" to its stockholders.[38] When activated, these "rights" operate to severely dilute the interests of a potential hostile acquiror such that it becomes prohibitively expensive for the acquiror to continue with its tender offer, absent negotiation with the target's board to redeem the rights before they activate.[39] The pill, therefore, worked to slow down the tender offer process, affording directors and managers of the target company time in which to explore alternative offers to enhance shareholder value or to negotiate with the hostile acquiror to obtain a better price.[40]

Of course, the courts recognized that the flexibility of the Delaware statute to authorize the issuance of such rights did *not* mean that the Legislature had anything like the poison pill in mind or had even contemplated the concomitant power of a board to block a tender offer through the use of a pill device.[41] However, statutory law did give boards the power

[37] *Unocal*, 493 A.2d at 955.

[38] *Moran*, 500 A.2d at 1353.

[39] *See* Lipton, *supra* note 20, at 69-70.

[40] *See* Lipton, *supra* note 16, at 1047.

[41] *See Moran*, 500 A.2d at 1351-53.

to approve merger agreements; indeed, it required such approval before the proposed transactions were submitted to stockholders for a vote.[42] But any authority of directors to inject themselves *between* tender offerors and stockholder offerees by issuing "rights," with the admitted purpose of blocking the tender offer, was unclear.[43]

Stockholders of Delaware corporations undoubtedly sell at times for prices the directors may believe are too low. But it was not thought to be the right or duty of directors to advise stockholders about when to sell or at what price to sell their property. For that matter, nothing in federal law nor Delaware's statutory law empowered corporate directors to destroy the ability of a willing buyer to complete a purchase of shares from a willing seller. In *Moran* and later cases, however, the Delaware courts embraced the idea that an all-shares tender offer that might result in a change in corporate control could, in certain circumstances, threaten the interests of the target company and its stockholders sufficiently to justify the directors' adoption of a poison pill that precluded the tender offer.[44] Why did judges embrace this idea? It was because courts recognize that it is the role of the board to maximize the value of the corporation.[45] In seeking to maximize value to all shareholders, boards may at times legitimately act to limit a shareholder's decision, including the decision to tender his ownership interest for sale.

To understand this rationale, we should first explore which factors a board may properly consider in determining how best to maximize value. There is a fundamental split in the view of what constitutes value, both among commentators and among the statutory and judge-made law in the various jurisdictions within the United States. This

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[42] DEL. CODE ANN. tit. 8, § 251 (2003).

[43] *See* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1074 (Del. Ch. 1985).

[44] *Moran*, 500 A.2d at 1356-57.

[45] *See* Revlon, Inc. v. MacAndrews, 506 A.2d 173, 182 (Del. 1986); McMullin v. Beran, 765 A.2d 910, 918-19 (Del. 2000).

fundamental split has to do with the value of the corporation to the shareholders, on the one hand, and what I shall call the "social" value of the corporation, on the other. The latter includes the benefits and costs to the community at large resulting from the continued operation of the corporation. Some commentators argue strenuously that boards should be able to reject a takeover attempt that would result in plant closings or employee layoffs, regardless of, or in addition to, the effect of the takeover on the value realized by the shareholders.[46]

One of the advantages of the federal system in the United States is that each state's law serves as a kind of testing ground to try out the effects of theories such as these. Corporation law has infused directors' fiduciary duties with requirements to pursue the best interest of the corporation's *stockholders*, recognizing the fundamental objective of the corporate form as the maximization of shareholder wealth,[47] even though some states may allow boards to justify defensive measures based on social concerns.[48] Directors are permitted to consider the interests of other constituencies (such as creditors, employees, and the local community in which the company operates), but Delaware law emphasizes that they should consider these other interests *only* to the extent that they affect stockholder interest.[49] This position obviously aligns the Delaware courts with the school of thought holding that the corporation's sole purpose is to achieve the best financial return for the present group of stockholders. This position implicates a much deeper question: Were directors required to consider the best interests of the present group of stockholders in the short-term, or the best interests of hypothetical stockholders who had entrusted their capital to the firm indefinitely? In other words, could directors deny the present stockholders a

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[46] *See, e.g.*, Norwitz, *supra* note 17.

[47] *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

[48] *See, e.g.*, 15 PA. CONS. STAT. § 515(a)(1) (2003).

[49] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955-56 (Del. 1985); *Revlon*, 506 A.2d at 182.

premium on the grounds that they were pursuing a long-term strategy that would potentially generate greater returns for future stockholders?

Delaware courts have found at least two rationales justifying defensive measures in the interests of ensuring maximum value to stockholders: (1) the fact that stockholders may be unaware of alternatives to the takeover that may be more valuable than the offer received, and (2) concerns that the coercive effects of a takeover attempt might render a stockholder's apparently free decision to tender his shares illusory.[50] The courts feared that stockholders might be stampeded into accepting an unfairly low offer to buy simply because their disaggregated status makes it difficult for them to generate and accept alternative transactions.[51] In addition, it was feared that tender offers could be structured in a coercive way, designed to cause stockholders to agree to sell for fear that, if they did not sell, they may be left owning an even less valuable property interest at a later time.[52] For these and other reasons, the Delaware courts were unwilling to deny directors and managers all authority to block tender offers.

Nevertheless, the Delaware judiciary was not willing to give directors a completely free hand to interfere with stockholders' ability to sell their shares. There was a fear, for example, that corporate managers and directors might seek to block tender offers in order to retain their own lucrative executive positions. This, then, was the Court's dilemma: How to permit the board to structure legitimate defenses against takeovers in order to maximize shareholder value, without permitting the board to serve its own self-interest by entrenching itself at shareholders' expense?

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[50] *See* AC Acquisition Corp. v. Anderson, Clayton Co., 519 A.2d 103, 113-14 (Del. Ch. 1986); Unitrin Inc. v. American General Corp., 651 A.2d 1361, 1384-85 (Del. 1995); City Capital Assoc. v. Interco, Inc., 551 A.2d 787, 797 (Del. Ch. 1988).

[51] *See AC Acquisition Corp.*, 519 A.2d at 113-14.

[52] *City Capital Assoc.*, 551 A.2d at 797; *AC Acquisition Corp.*, 519 A.2d at 113-14.

Ultimately, the Delaware Courts forged a compromise. The Court of Chancery and the Supreme Court in the *Moran* decision upheld the statutory validity of the poison pill. That affirmance, however, came with a caveat: Delaware courts will override directors who use the poison pill unreasonably and risk depriving stockholders of opportunity to sell their shares at a premium to the market price.[53] The most striking feature of the *Moran* and *Unocal* decisions was the Delaware courts' departure from the deferential business judgment "rationality" review, and the substitution of a new, enhanced form of substantive "reasonableness" review. This intermediate form of judicial review signaled a determination by the Delaware courts that directors, as fiduciaries, did not have the same breadth of authority to block a tender offer as they had to determine the corporation's ordinary business strategy.

This is the history of the development of the poison pill defense and its acceptance by the Delaware courts. That acceptance, however, did not signal an end to the underlying debate regarding the fundamental nature of the corporation and its purposes in society. In the years from 1984 until the late 1990s, the Court of Chancery struggled to define the circumstances under which a board's use of a poison pill would be reasonable. For example, my predecessor, former Chancellor Allen, held in *City Capital Associates v. Interco*,[54] that there were limits to a board's fiduciary power to stymie a fully funded all-shares cash tender offer. Chancellor Allen held that it was permissible for a board to employ the pill as a delaying mechanism, affording the board time to develop an alternative transaction or to inform stockholders why the board believed the tender offer should not be accepted.[55] But once those purposes have been achieved, Chancellor Allen held that the board had exhausted the proper limits of its authority to maintain the pill. At that point the stockholders

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

[54] 551 A.2d 787 (Del. Ch. 1988).

[55] *Id.* at 798.

had the ultimate right to decide whether to accept the offer.[56] This limitation was an *equitable* (or fiduciary) constraint on directorial power, not a statutory limitation. In essence, the court was interpreting the fiduciary obligations of directors in a way so as to constrain action taken by them, even if well-motivated and well-informed. The ultimate authority, under this view, resided in the owners of the corporation, the stockholders.

The doctrinal innovation of *Interco*, however, was abruptly cut short by *Paramount Communications, Inc. v. Time, Inc.* ("*Time-Warner*") where the Supreme Court opined that *Interco* and similar Court of Chancery decisions regarding the use of the pill had not properly understood the Supreme Court's *Moran* and *Unocal* decisions.[57] More than disapproving the equitable limitations on directors' use of the pill expressed in *Interco*, the Supreme Court's *Time-Warner* decision made it clear that directors have the fiduciary discretion to reject a lucrative acquisition proposal that would benefit current stockholders. Instead, directors may pursue a long-term corporate strategy if they believe that such strategy will generate even greater wealth for the stockholder who is willing to be patient for a long enough time.[58]

From the *Time-Warner* decision until the present, Delaware courts, however, have for several reasons managed to sidestep the basic question of whether a board, properly informed and acting in good faith, may legitimately deploy a pill so as to *permanently* block a tender offer.[59] Indeed, there

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[56] *Id.*

[57] Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).

[58] *Id.* at 1150 (stating that directors "are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon"; furthermore, a board of directors, except in instances where *Revlon* applies, "is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover").

[59] This question, the "just say no" question, was not addressed by the Supreme Court in its *Time-Warner* decision. *See* Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal As a Conscious Effort to Make*

have been few opportunities to answer this fundamental question, primarily because merger and acquisition disputes usually work themselves out before a judicial resolution can occur. For one thing, direction and execution have become increasingly sensitive to stockholder concerns and more open to completing transactions with an initially hostile bidder if, in the end, the merger appears to be the best way to maximize shareholder value.[60] In addition, the threat of judicial intervention no doubt also plays a role in directors' heightened sensitivity to stockholders, as does greater activism on the part of institutional investors. Therefore, even though certain cases arose in the Delaware Courts that "held out the promise of further guidance," such opportunities "usually disappeared without the need for a ruling."[61]

From this period of judicial activity and debate, however, two concepts have emerged that are worthy of emphasis—concepts that were consciously employed by the Delaware judiciary in forging the compromise described earlier. These concepts have been succinctly described by my colleague, Vice Chancellor Strine, as a doctrinal duet—"substantive coercion" and the "proxy out."[62]

Substantive coercion is an idea developed by Professors Gilson and Kraakman.[63] It holds that "a tender offer can pose a threat to stockholders simply because the stockholders may mistakenly reject the board's view that the offer is not adequate."[64] The stockholders may also find an inadequate tender offer attractive because such an offer almost always creates the opportunity to sell the shares at a

the Delaware Courts Confront the Basic "Just Say No" Question, 55 STAN. L. REV. 863, 874 (2002).

[60] *Id.*

[61] *Id.* at 874-75.

[62] *Id. passim.*

[63] Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).

[64] Strine, *supra* note 59, at 875; Gilson & Kraakman, *supra* note 63, at 259-60.

price above the current market price. Professors Gilson and Kraakman recognized that the substantive coercion justification could easily be misused by boards. They therefore suggested that the threat of substantive coercion could justify only a very time-limited use of the pill that was proportionate to the threat posed.[65] In other words, the pill could only be used for a discrete period sufficient to give a board the time to develop a high-value opportunity for presentation to the stockholders or time for the board to explain to stockholders why the company's future was brighter than the present offer reflected. Once a sufficient amount of time had elapsed for the board to respond in one of these manners, the threat of substantive coercion—that is, the threat that stockholders will mistakenly accept a fully funded, all-shares offer—could not justify using the pill to block the offer.

The Delaware Supreme Court adopted Professors Gilson and Kraakman's "substantive coercion" concept as a valid, cognizable threat from which boards may protect stockholders. The court did not, however, address Gilson and Kraakman's important qualification that "substantive coercion" was a mild threat and could not legitimately justify a "just say no" defense.[66] In the *Time-Warner* decision, and subsequently in the Delaware Supreme Court's *Unitrin v. American General Corp.*[67] decision, substantive coercion was relied upon to sustain a board's determination *never* to redeem the pill in response to a bid whose only threat to stockholders was the inadequacy of its price.[68] In both *Time-Warner* and in *Unitrin*, the Delaware Supreme Court appeared to accept the view that directors, in general, are wiser than stockholders in determining the appropriate time

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[65] *Id.* at 268-69. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 n.17 (Del. 1989) (adopting Gilson and Kraakman's "substantive coercion" concept).

[66] *See* Strine, *supra* note 59, at 875.

[67] 651 A.2d 1361 (Del. 1995).

[68] *Id.* at 1385.

and price at which to sell the company's stock.[69] By adopting the substantive coercion rationale, the Delaware Supreme Court affirmed the primacy of decision making by directors in the tender offer acceptance context.

The corollary concept, aptly termed the "proxy out" by Vice Chancellor Strine, fits together nicely with the substantive coercion concept. The proxy out concept was the recognition that stockholders could elect new directors to redeem the pill—providing an ultimate escape from the pill.[70] If a hostile bidder for a company is able to elect a pro-tender offer slate of directors, then that newly elected slate of pro-tender offer directors could simply redeem the pill and allow the offer to proceed. In this way, the proxy out enabled the Delaware courts to conclude that a board's use of the poison pill was not completely preclusive of the stockholders' right to tender their stock to a willing buyer. This preference for directorial elections over tender offers as a method for resolving takeover disputes has been both praised and criticized.[71] Regardless of the merits of these competing positions about Delaware's preference for elections, the substantive coercion and proxy out concepts gave the Delaware Courts a means of sidestepping, for the moment, a direct confrontation with the "just say no" defense.

Substantive coercion made it easy for boards to identify a cognizable threat to stockholders, thereby justifying deployment of the poison pill and satisfying the first part of *Unocal's* two-part reasonableness test. The "proxy out" enabled boards to meet the second element of that standard as well, which requires directors to show that their use of the pill was proportionate to the threat and not preclusive or otherwise unreasonable.[72] Acquirors stymied by the pill could simply elect a new board of directors that could redeem

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[69] *See* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521 (2002).

[70] Strine, *supra* note 59, at 876.

[71] *See, e.g.*, Gilson, *supra* note 11; Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

[72] Strine, *supra* note 59, at 877.

the pill.[73] And so, by this approach, use of the pill could not be viewed as a fatal obstacle to a hostile bid and, thus, injurious to the interests of target company stockholders.

As mentioned earlier, Delaware's corporation law statute provides no explicit authorization for boards of directors to deploy a poison pill to thwart a hostile tender offer. Nor does it contain explicit language empowering directors to prevent stockholders from selling their shares if directors believe the sale would be harmful to them. The full scope of a board's power to interfere with stockholders' ability to sell their shares has been left for judicial development through the common law of fiduciary duty. The Delaware judiciary has fashioned its own compromise answer to this central question, adopting the doctrinal duet of substantive coercion and the proxy out in a manner that side-stepped the fundamental question, yet assured that directors are not afforded unchecked authority to block a tender offer.

Critics of Delaware's approach point out that the election process is not as efficient as the marketplace and that stockholders should be allowed to decide for themselves, perhaps after the directors have had a reasonable amount of time to tell their side of the story, whether to accept the present value of a tender offer.[74] A principal policy reason behind this view is that the election process itself is degraded when elections become the "weapon" in a takeover battle.[75] Shareholders do not have perfect information, and directors maintain the ability to control the mechanisms of

[73] As a practical matter, replacing the board may be less "simple" than it first appears, especially in the case of classified boards. *See* DEL. CODE ANN. tit. 8, § 141(d) (2003). The possibility of redemption of the pill following a proxy contest has led to the development of "dead-hand," "no-hand," and "slow-hand" pills that attempt to limit the ability of a newly-elected board to redeem the pill. Such pills have met with stiff opposition in the Delaware courts as an inappropriate restriction on directorial authority. *See* Quickturn Design Systems v. Shapiro, 721 A.2d 1281 (Del. 1998); Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998).

[74] Gilson, *supra* note 11, at 503-04.

[75] *Id.* at 505.

proxy contests or shareholder meetings.[76] Making director elections the battlefield for a takeover can only act to hurt the sanctity of the election process. Since elections are what legitimate the separation of power between shareholders and directors, any judicial requirement that may degrade the election process should not be encouraged.[77] Other critics insist that, because of the presence of staggered boards at many American corporations, it is commercially impractical for acquirors to incur the expense, substantial delay, and market risks required to acquire a target over the two election cycles necessary to obtain majority control.[78] These critics contend that if the Delaware courts hold that the opportunity to elect a different board over a two election cycle is in itself sufficient to render the pill's use innocuous under the *Unocal* standard, then the reasonableness review promised by the *Moran* decision will have been drained of any meaningful content.[79]

The Court of Chancery and the Delaware Supreme Court in the early 1980s faced a complex public policy question. It was a question on which the legislative branch of our government had offered no meaningful guidance. The stakes were very high, as a particular judicial answer to this policy question might have large, yet uncertain, effects on new innovations in the market for corporate control. In a period of such great uncertainty, and with so little guidance on vital policy issues from the other branches of government, the Delaware Courts developed the common law of corporations with respect to takeovers in a gradual, incremental manner. The courts took measured steps to allow for adjustments and changes in direction.

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[76] *Id.* at 505-06.

[77] *Id.* at 506.

[78] Certainly this problem is exacerbated when the board is staggered, but it also exists to a similar degree in non-staggered boards, particularly when an acquisition is proposed shortly after the corporation's annual meeting. Even without a staggered board, replacing directors by written shareholder consent (*see* DEL. CODE ANN. tit. 8, § 228 (2003)) is often a practical or actual impossibility.

[79] Gilson, *supra* note 11, at 500.

Japan's judiciary may soon face a situation similar to the one faced by the Court of Chancery in the early 1980s. The introduction of the poison pill as a takeover defense will most likely create tension within the business, legal, and investment communities, requiring the courts of Japan to resolve that tension. It is my hope that Delaware's experience in responding and adapting to the poison pill will prove helpful to you as Japan embarks down this path.