DOES CORPORATE LAW REALLY MATTER IN HOSTILE TAKEOVERS?: COMMENTING ON PROFESSOR GILSON AND CHANCELLOR CHANDLER

Hideki Kanda*

I. INTRODUCTION

These brief comments respond to the papers by Professor Gilson[1] and Chancellor Chandler.[2] I focus on the differences between Delaware law and Japanese law and differences in academic literature between the United States and Japan concerning takeover defenses adopted by the board of directors of target firms. The following discussion assumes that the relevant target firms are publicly held corporations, typically corporations listed on a stock exchange. Part II compares takeover situations in both Delaware and Japan, and in U.S. and Japanese academic literature. Part III comments on the papers of Professor Gilson and Chancellor Chandler. Both authors project implications for Japan on

---

* Professor of Law, University of Tokyo. These comments are based on my oral presentation at the symposium "Hostile M&A and the Poison Pill in Japan: Prospects and Policy" held in Tokyo with sponsorship of Columbia Law School on June 13, 2003. I thank Professor Gilson, Chancellor Chandler and Professor Milhaupt for their interesting comments at the symposium, and Professor Mark Ramseyer for his invaluable comment on an earlier draft.

[1] Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21.

[2] William B. Chandler III, *Hostile M&A and the Poison Pill in Japan: A Judicial Perspective*, 2004 COLUM. BUS. L. REV. 45.

the basis of U.S. experience in Delaware and academic theories. Although I agree with much of what they have to say, my comments will contest a few key points.

II. COMPARING THE UNITED STATES AND JAPAN

With regard to takeover defenses, the United States is rich in both experience and academic literature. By contrast, Japan is poor. While the courts have shaped Delaware law in this area over the past twenty years, Japanese law is not clear despite the existence of several statutory provisions of the Japanese Commercial Code (which codifies corporate law in Japan).[3]

Although the United States is rich in experience and academic literature, evidence is poor. Moreover, there is so much debate among commentators that opinions are quite divided among reasonable people. As a result, this area has produced (and still today produces) one of the most difficult issues in U.S. corporate law. First, while empirical studies generally show that hostile takeovers are good for the economy in the sense that they generally enhance the value of the target firms,[4] it is unclear from past empirical studies whether defenses adopted by target boards, in particular poison pills, are good or bad for target firms (and thus for the economy).[5] Second, normative arguments in academic

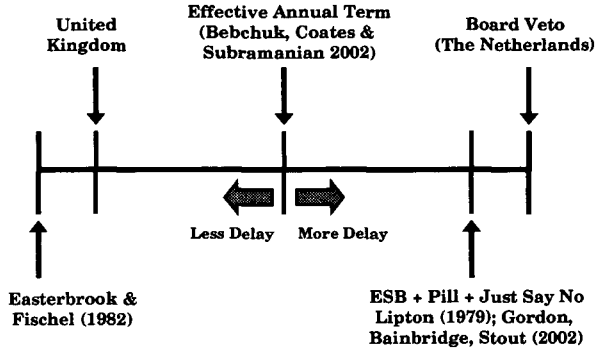
[3] Note that Japan diverges from the U.S. in that securities regulation comprises a mandatory bid rule. *See* Shoken torihikiho [Securities and Exchange], Law No. 25 of 1948, art. 27-2(1) (Japan) (purchase of more than one-third of voting shares). Even in the U.S., some states had this rule. *See, e.g.*, Pennsylvania Business Corporation Law of 1933, § 910, *repealed by* PA. STAT. ANN. tit. 15, § 2541 (2003); ME. REV. STAT. ANN. tit. 13-A, § 910, *repealed by* ME. REV. STAT. ANN. tit. 13-C, § 1110 (2003). This rule is not discussed here.

[4] *See, e.g.*, Greg Jarrell & Annette Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, 18 FIN. MGMT. 12 (1989); J. Harold Mulherin & Audra L. Boone, *Comparing Acquisitions and Divestitures*, 6 J. CORP. FIN. 117 (2000).

[5] *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000); Marcel

literature about what measures should be legally permitted or prohibited as takeover defenses, and to what degree, are hopelessly split in the United States, and no one can even discern the dominant view.[6]

TABLE 1: Continuum of Views on Takeover Defenses



ESB: effective staggered board
source: Bebchuk et al. (2002)

Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Mediation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887 (2002) [hereinafter *Symposium*]. *But see* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002) [hereinafter *Further Findings*] ("[T]akeover proponents no longer claim that defenses increase shareholder value for hostile bid targets from an ex ante perspective.").

[6] *See Symposium*, *supra* note 5. *See also Further Findings*, *supra* note 5. In Japan, the 2003 amendments to the Commercial Code introduced a new governance structure: eligible large-scale companies may have a board of directors with three committees (audit committee, compensation committee and nominating committee), and a majority of members in each committee must be independent directors. For such companies, the terms of directors and officers are one year, so that this type of company fits the proposal in *Further Findings*.

In Delaware, however, the standard of judicial review for takeover defenses (including the poison pill) has already been established. Delaware courts today apply the "enhanced business judgment rule" and require "proportionality" in reviewing takeover defenses.[7] Thus, the takeover defenses upheld by the courts in Delaware fall within a certain range, and the law is predictable as to whether a particular defensive measure (including poison pill attempts) to be taken would be upheld or denied by Delaware courts.

By contrast, in Japan, no one can tell what the law is with respect to takeover defenses. First, in the past, hostile takeovers occurred only very rarely in Japan. Reasons for this include the well known existence of stable shareholders for most large public firms in Japan, which has made hostile bids costly. Those stable shareholders own shares not only in the capacity of shareholders, but also for other purposes; typically in order to do business with the firm. For instance, insurance companies hold shares of industrial firms in order to create business relationships that will ensure that they can sell insurance to them. Those stable shareholders do not sell their shares even if bidders (in tender offer processes or otherwise) offer higher prices than the market price for the purchase of shares held by those stable shareholders, because they want to maintain their relationships with the industrial firms in order to continue to sell insurance to them.[8] Nevertheless, this stable shareholding has been gradually fading in recent years, mainly because the poor performance of the Japanese stock market in the past ten years made shareholding relatively costly.[9] Both banks and insurance companies, two champions as stable shareholders,

---

[7] Chandler, *supra* note 2.

[8] In theory, this does not mean that stable shareholders would not have traded if a bidder had offered to pay them a high premium (such as 50-100% above market) for their stock.

[9] In theory what matters is future projections and not past performance. Thus, when they sell shares, stable shareholders must have a vision of poor future performance of the shares they hold.

have been selling shares they held in the past.[10] This implies that hostile takeovers will take place in Japan in the future.

Second, while there is a rich literature in Japan explaining the U.S. situation, the literature is quite poor about the Japanese situation. This is understandable because hostile takeovers themselves have been rare in Japan. However, since stable shareholding is fading and the Commercial Code offers possibilities of takeover defenses, practitioners have begun to write about possible takeover defenses in recent years.[11]

The Commercial Code was amended in 2001, 2002 and 2003. Those amendments cover a wide range of matters, but it should be noted that the amendments were not intended to take any position regarding hostile takeovers or defensive measures adopted by target boards. The amendments, however, did open the door for various defensive measures for target boards.[12] For instance, at the post-bid stage, target firms may repurchase their own shares. There is no limitation on the amount of shares the firm may repurchase if the firm has enough profits on its balance sheet and if other conditions for creditor protection, as specified in the Code, are met. Additional amendments to the Code in 2003 permit repurchase to be made by a board decision if provided for in the firm's charter.[13] At the pre-bid stage, firms may try various measures. First, firms may issue stock options to their friendly shareholders as poison pills. Such stock options may be issued by board decisions without

---

[10] *See, e.g.*, Fumio Kuroki, The Relationship of Companies and Banks as Cross-Shareholdings Unwind—Fiscal 2002 Cross-Shareholding Survey (NLI Research Institute, 2003), *available at* http://www.nli-research.co.jp/eng/research_ind.html). Also, there is regulatory pressure for banks to sell shares they own. *See* Act for Restricting Bank Shareholdings, Law No. 131 of 2001 (basically restricting each bank's total shareholdings to its regulatory capital).

[11] *See, e.g.*, Kazuhiro Takei, *Corporate Law Amendments and Strategy for Firm Defense*, JURIST No. 1250 (2003) (in Japanese); Satoshi Kawai, *Poison Pill in Japan*, 2004 COLUM. BUS. L. REV. 11.

[12] *See* Kawai, *supra* note 11.

[13] SHŌHŌ, art. 211-3(1)(ii) (Japan).

shareholder approval.[14] Second, firms may issue, for free to existing shareholders, a special class of shares that have veto rights for elections of directors (plus a redemption feature, if necessary). This kind of share issuance is referred to as a stock split under the current Code,[15] although to call it so is quite misleading. Charter authorization is required for issuance of this special class of shares.[16]

III. RESPONSES TO PROFESSOR GILSON AND CHANCELLOR CHANDLER

Professor Gilson offers quite interesting observations about Japan. He says:

> (1) This central role for courts, operating without legislative guidance (because the Commercial Code amendments that allow a pill are technical not substantive), is particularly interesting in a legal system whose roots are in the civil, not common law. (2) Perhaps the abuse of rights doctrine, invoked so broadly by the courts to protect expectations of lifetime employment from a statute that as a technical matter dictates employment at will, can be invoked to develop case law that constrains use of the poison pill to block needed economic change. (3) Recent cases striking down white knight share allocations are an encouraging sign, but motive analysis will not prove sufficient.[17]

I must submit that the distinction between common law and civil law is not helpful in analyzing this area. It is well known that U.K. law is quite different from, and indeed quite opposite of, Delaware law. U.K. law generally does not

---

[14] SHŌHŌ, art. 280-20 (Japan).

[15] SHŌHŌ, art. 218 (Japan).

[16] SHŌHŌ, art. 222 (Japan). For other (more sophisticated) defensive measures, see Kawai, *supra* note 11.

[17] This is extracted from the original presentation at the symposium referred to in *supra* note 1. *But see* Gilson, *supra* note 1, at 43.

permit takeover defenses by target boards.[18] Additionally, within civil law jurisdictions, German law is different from French law,[19] and most notably, Dutch law is known as generous in permitting defenses by target boards quite broadly (permitting the so-called "just say no" rule).[20]

It might not be realistic to think that Japanese courts will apply the "abuse of rights" doctrine suggested by Gilson in the future in order to police takeover defenses. The abuse of rights doctrine has often been employed by Japanese courts in certain areas, particularly in labor law, where courts have nullified termination of employment contracts by employers that were deemed not to have legitimate cause for termination.[21] However, although the specific doctrine Japanese courts will choose to apply in the future is actually not important, Gilson is right in that courts must use some type of doctrine in controlling takeover defenses in Japan. My prediction is that Japanese courts will enjoin the issuance of certain poison pills, namely the issuance of a new class of stock or stock options, if they think such pills are bad. They could do so pursuant to the Commercial Code's explicit provision in articles 280-10 and 280-39(4), which provide that a "significantly unfair" issuance may be set aside.[22] Finally, I agree with Professor Gilson in that the "primary purpose" doctrine that has been applied to certain cases in Japan for enjoining the unfair issuance of stock might not be helpful in reviewing takeover defenses.[23] Factors in deciding whether a defensive measure in question

---

[18] *See* Paul Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States, in* EUROPEAN TAKEOVERS: LAW AND PRACTICE 195 (Hopt and Wymeersch eds., 1992).

[19] *See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW ch.7 (forthcoming 2004) (on file with the author).

[20] Jan R. Schaafsma, *Hostile Takeover Bids and Defenses: The Netherlands, in* EUROPEAN TAKEOVERS, *supra* note 18, at 217.

[21] *See* KAZUO SUGENO, LABOR LAW ch. iii-4 (6th ed. 2003) (in Japanese).

[22] SHŌHŌ, arts. 280-10, 280-394 (Japan).

[23] Interestingly, in Delaware, the "business purpose" doctrine was once adopted but later abandoned. *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

is good or bad for a firm (and the economy) should be identified, and the "primary purpose" of the stock issuance is too narrow for the court to view in such a determination. In any event, what doctrine should be used is unimportant. Future court development in this area remains to be seen in Japan.

Professor Gilson also reminds us of the importance of who plays the policing role in the United States. He notes:

> (1) Three different institutions have the capacity to police the use of the poison pill: independent directors, shareholders, and courts. (2) A critical feature of the U.S. poison pill infrastructure is that all three institutions operate as important checks on the misuse of defensive tactics generally and the poison pill in particular.[24]

Here, it is interesting that in the United Kingdom only shareholders play the policing role.[25] What about Japan? Who should be the ultimate decision-maker on whether a defensive measure at issue is good or bad? It is too early to make predictions, but as Gilson suggests, I am inclined to think that the court will be the most important player in Japan, rather than a combination of shareholders, independent directors and the court functioning together, as in the United States.

TABLE 2

- Who should be the ultimate decision-maker?

UK	US	Japan
shareholders	independent directors courts shareholders	?

[24] This is extracted from the original presentation at the symposium referred to in *supra* note 1. *See also* Gilson, *supra* note 1.

[25] *See* Davies, *supra* note 18.

Chancellor Chandler addresses several interesting points, and to me, two general issues are of particular importance. The first issue is whether shareholder value or firm value should determine the merits of any given defensive measure. The second question is whether rules or standards are better suited for policing takeover defenses.[26]

The answer to the first question should be the same in Japan as in the United States. In theory, maximizing firm value should be the goal of the law, and when the firm is not insolvent, firm value is identical to shareholder value. In practice, shareholder value is easier to obtain, and thus a good proxy for firm value.[27]

The question of "rules versus standards" is complex.[28] The answer to this question is contingent on many factors, including law enforcement infrastructure (for instance, whether the class action system is recognized).[29] While this is hardly the place for detailed discussion on this question, demand for legal certainty might support clear rules in Japan (and even in the United States).[30] Ultimately, however, law might not matter much.[31]

IV. CONCLUSION

In Japan, hostile takeovers may become popular. If stable shareholding disappears, the takeover might become a quick and relatively inexpensive means for acquisition. Correspondingly, defensive measures by target boards may become widely deployed. If such measures were to be

---

[26] Chandler, *supra* note 2.

[27] *See* Kraakman et al., *supra* note 19, ch. 1.

[28] *See generally* Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992). *See also* Kraakman et al., *supra* note 19, ch. 2.

[29] The class action system is not recognized in Japan.

[30] Professor Gilson seems to be in favor of clear rules. *See, e.g.*, Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001). *See also* Gilson, *supra* note 1.

[31] *See* Table 1 *supra*; *see also* Kraakman et al., *supra* note 19.

challenged before the court, the court would face a very difficult question without clear guidance from explicit Commercial Code provisions. In such an event, it is possible that bright-line rules would be introduced through legislation.

Ultimately, however, the law might not matter much. As U.S. experience shows, there will be a range within which defensive measures are legally permitted, so the value of a particular defensive measure can only be tested in the marketplace. Although the role of law should not be undervalued, it should not be overemphasized either.