NATIONAL MARKETS AND NEW DEFENSES: THE CASE FOR AN EAST ASIAN OPT-IN TAKEOVER LAW

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I. INTRODUCTION

The arrival of Anglo-Saxon source capital to East Asia has brought with it the debate over corporate takeover defenses and the appropriate allocation of power among shareholders and directors of public companies. Takeover defenses such as poison pills, staggered boards and judicial permission to "just say no" to an unsolicited takeover

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bid all are the focus of intense discussion among companies that, due to prior state or family control, had previously been immune to takeover attempts. Complicating the debate is the history of cross- and circular-shareholdings, which has worked in East Asia to concentrate control of a vast proportion of national resources in a few corporate conglomerates. Additionally complicating and coloring the policy debate is the impact of foreign investors in national champion companies, and the often-divergent interests and expectations among financial investors, shareholder activists, local employees and other stakeholders.

The case for empowering companies to improve their takeover defenses is justifiable in circumstances where the heightened defenses empower shareholders to remove an entrenched management team, and ultimately to determine whether to accept a bidder's offer. However, absent institutional constraints such as legal rules, large shareholders, and shareholder approval rights to balance the board's power to fend off takeover attempts, the protections may operate to further concentrate power in entrenched boards, causing great social and economic cost due to misallocation of capital and staleness in corporate governance.

This paper analyzes the case for enhanced takeover defenses for East Asian companies in the modern context of global investors, open capital markets and disproportionate control structures. It surveys the current state of two families of takeover policy: (i) the American and Japanese experience with poison pills and staggered boards, and (ii) the UK's "board passivity" approach and its inclusion in the European Union's Directive on Takeover Bids. Given the incentives of controlling shareholders to seek greater takeover protection and the problems inherent in controlling minority corporate structures, a potentially attractive solution is proposed for the particular context of East Asian markets: an opt-in takeover law regime offering enhanced anti-takeover protections to companies that meet qualifying criteria. Eligibility would be contingent upon an effective one-share, one-vote control structure, and adequate disclosure practices. The opt-in takeover law would allow boards to reject an unsolicited bid, but deprive them of the ability to use a staggered board to block a bid where the bidder wins a proxy contest.

The opt-in regime strives to achieve that elusive balance between the protection of deserving managers and the preservation of the shareholder franchise. It would do no new harm to shareholders or capital markets for those companies that choose not to opt in, but markets may judge companies that opt out harshly, and company managers likely would be attracted to the benefits of the defensive measures. Most importantly, the opt-in regime aims to bypass the difficulties confronting Delaware courts in the U.S. and the European Commissioners in their

Thirteenth Directive on Takeover Bids as they wrestle with takeover defenses, incumbent-protected companies, and cross-border reciprocity issues accompanying global investors and open markets.

Additionally, the opt-in regime could streamline the political debate over defensive measures, and eliminate the need for tradeoffs that otherwise would be made with a uniform national law. By setting up clear, transparent rules to govern the market for corporate control, players in capital markets will have a better road map to the costs and conditions of hostile acquisitions. Under the right circumstances, companies could enjoy increased protection, minimizing the concern that they will be raided and forced to sacrifice their long-term best interest for a corporate raider's short-term gain.

This paper is organized as follows: Part I presents the companies' interests in strong takeover defenses, and introduces policy concerns facing a healthy market for corporate control. Part II analyzes the various families of takeover policy, and assesses their utility based upon the experiences of their home markets: the poison pill and judicially-imposed limits in the U.S. (as well as the new Japanese poison pill), the U.K.'s "board passivity" rule and Takeover Panel, and the European Union's "break-through" rule in the Thirteenth Directive on Takeover Bids. Part III proposes, under certain conditions, the opt-in regime for adopting enhanced defensive measures in East Asia. Part IV concludes and identifies additional research for takeover policy in the East Asian context.

II. THE SOCIAL VALUE OF TAKEOVERS AND THE NEW DEMAND FOR DEFENSES

Anti-takeover defenses suddenly are in high demand for East Asian companies, perhaps most urgently in South Korea.[1] The further opening of capital markets in East Asian economies in the early twenty first century has come with the possibility of hostile takeovers to these lands of formerly friendly shareholders. The market for corporate control now includes foreign investment funds and foreign companies, as well as domestic players. The regional perception is that foreign "barbarians"

[1] *See* Moon So-young & Jung Ha-won, *Business Wants Poison Pills: Defenses Called Lacking Against Hostile Takeovers*, THE JOONG ANG DAILY, Apr. 3, 2006, at A1; Greg Ip & Neil King, Jr., *Engine of Globalization Runs into Big Roadblocks: Multinationals Spur a Political Backlash; China, Korea Angst*, WALL ST. J. (Asia), Mar. 13, 2006, at C1; Koh Byung-joon, *S. Korea, Prime Target of Foreign Hostile Takeovers*, YONHAP NEWS, Mar. 7, 2006. The article quotes Lee Kyung-sang of the Korean Chamber of Commerce & Industry: "South Korea is a heaven for hostile takeovers . . . It seems as if South Korean firms are fighting with a wooden shield against foreign funds with iron swords." The article continues, "Local firms' vulnerability stems from the lack of 'shark repellents,' or measures that they can take to ward off unsolicited suitors."

pose a particularly risky problem for domestic companies and capital markets: "'vulture' and other strategic funds seek[] to generate high financial returns by taking large stakes in distressed or undervalued firms."[2]

A reasonable basis for this concern exists on the part of regulators as well as incumbent managers – though foreign capital providers are subject to the same laws and financial regulations as domestic players, foreign-based investors may not be subject to the same social constraints, norms or networks as domestic firms. Shareholder activists applaud the "outsider" status of foreign investors for their potential to challenge entrenched managers and push for the efficient allocation of capital and assets at the companies in which they invest – a perspective reflecting the Finance View in takeover policy, and at least a weak endorsement of a Western-style trust in the "efficient capital market" hypothesis.[3] Domestic policymakers, company managers and community representatives including labor unions suspect that the financial motivations of foreign investors may give rise to an inordinately primary concern with short-term returns on investments at the expense of other stakeholders' interests in the corporate enterprise. The Institutional View for takeover policy is a more appropriate fit for non-shareholder constituencies[4] and supports the current push to enhance anti-takeover protections, especially among national champion companies.

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[2] Curtis J. Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 COLUM. L. REV. 2171, 2181 (2005).

[3] William T. Allen, former Chancellor of Delaware's Court of Chancery, and Judge Leo Strine, Jr. use the terms "Finance View" and "Institutional View" to describe the two opposing perspectives on takeover policy in the U.S. and Delaware courts. The Finance View gives the authority to decide whether to accept an unsolicited buyout offer for a company to the shareholders. *See* William T. Allen & Leo E. Strine, Jr., *When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton's Vision of the Corporate Law*, 60 BUS. LAW. 1383 (2005). Consistent with the Finance View, modern advocates of a direct or stronger role for shareholders in corporate control contests are predicated on the power of shareholders to replace the board as a central tenet of the public corporation, requiring strict legal rules and exposure of the board to a real risk of replacement by dissatisfied shareholders to set up proper incentives for an effective board. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. (forthcoming May 2007), *available at* http://ssrn.com/abstract=829804 (last visited May 9, 2007).

[4] The Institutional View gives authority for the ultimate decision in response to a buyout offer to the board of directors, presumed to act on shareholders' behalf and trusted to make correct long-term decisions, or at least negotiate the best price and terms for the company's benefit in the event of a buyout. While shareholder empowerment advocates reject the Institutional View as inefficient and conflict-ridden due to the board members' self-interest in keeping their own jobs, the Institutional View looks to the board of directors to decide whether a company is for sale. *See* Allen and Strine, *supra* note 3. This Institutional View emphasizes management consistency and job security as preconditions for long-term company success. *See* Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1749 (2006). ("Active investor involvement in corporate decision making seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the

Contributing to suspicion of foreign capital among domestic constituencies is a presumption, often correct, that foreign investors have experience with "hostile" corporate control maneuvers. Recent experience in Korea confirms that foreign investment funds are willing and able to bring litigation and shareholder proposals to challenge management teams that reject shareholders' agendas for company change.[5] In recent hostile contests for UFJ and Nippon Broadcasting in Japan, "the market players . . . used previously unheard-of tactics to achieve their objectives," including a proxy fight, a "bear hug," and an unsolicited bid, in addition to "the strategic use of litigation."[6]

Asian-based companies and funds investing globally meet a vast array of protective measures abroad, from poison pills and staggered boards, a combination of which is an almost complete defense against takeover[7], to dual-class voting stock, foreign investment review panels and the familiar structures of pyramids and cross-listings that board members use to secure control at home in East Asia.[8] It is no surprise,

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centralization of essentially nonreviewable decision making authority in the board of directors. The chief economic virtue of the public corporation is . . . that it provides a hierarchical decision making structure well-suited to the problem of operating a large business enterprise[.]") Another description of this view, at least to the extent that it affects takeover decisions in favor of director primacy, is the "team production" theory, which advocates control of a corporation at the board, serving as "mediating hierarchs" and balancing the interests of all the firm's constituents in an atmosphere somewhat insulated from shareholder control. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA L. REV. 247 (1999). Strong defensive measures such as poison pills, and the power or discretion to decide on their use, should lie with the board of directors and not shareholders, according to the Institutional View. *See* Martin Lipton, *Twenty-Five Years after* Takeover Bids in the Target's Boardroom*: Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369 (2005); *see also* Allen & Strine, *supra* note 3.

[5] In 2006, Carl Icahn, together with Warren Lichtenstein's Steel Fund II, invested in the KT&G Corporation's publicly traded shares. They soon delivered an unsolicited buyout offer for control of the company, which was promptly rejected by the board. This was followed by a proxy contest in which their nominee, Mr. Lichtenstein, won one of twelve board seats at KT&G. The buyout offer was delivered in a February 23, 2006 letter from Warren Lichtenstein, Steel Partners II, L.P., to Mr. Young-Kyoon Kwak, Representative Director, KT&G Corporation. *See Investor Group Submits Proposal to Acquire KT&G Corp.*, PRNEWSWIRE, Feb. 23, 2006, at http://www.prnewswire.co.uk/cgi/news/release?id=164708 (last visited May 9, 2007).

[6] Milhaupt, *supra* note 2, at 2181. Famous internet entrepreneur Takafumi Horie launched the takeover contest, and is now being tried in a novel case after having been jailed and noisily discredited by Japanese regulators over alleged market manipulation and accounting fraud. *See Japan After Livedoor: From Hero to Zero*, ECONOMIST, Feb. 2, 2006. Japan, however, has adopted the most American of capitalist defenses: the poison pill. See Section IV, *infra*.

[7] *See* Lucian A. Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

[8] A decade of international attention to comparative corporate governance following the financial crisis of the late 1990s has yielded a relatively consistent analysis of the complex control structures implemented over the prior two and three decades of economic growth in these markets. *See* Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *Who Controls East Asian Corporations?* (World Bank Pol'y Research, Working Paper Report No. WPS 2054, 1999), *available at* http://www-

then, that East Asian firms are demanding enhanced takeover defenses as their national capital markets have opened pursuant to domestic development policies and free trade commitments.[9] In an era of general cross-fertilization in corporate governance systems and global competition among various sources of capital for the best returns on investments, it is rational that domestic companies expect to have access to global state-of-the-art anti-takeover defenses – and shields at least as powerful as those enjoyed by their counterparts abroad.

For reasons rooted in history and culture, changes in control of the most prominent East Asian companies generally have not occurred through mergers and acquisitions using hostile takeover techniques of the

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wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2000/02/24/000094946_9903191 1113874/Rendered/PDF/multi_page.pdf (last visited May 9, 2007). A study published in the late 1990s documented the ownership structure of the ten largest non-financial corporations for a cross-section of forty nine countries, including nine in East Asia, and determined the control structures of the largest twenty publicly traded companies in twenty seven of the world's richest countries, including Hong Kong, Japan, Korea and Singapore, tracing control to the ultimate owners. The study distinguished among five types of owners, finding ownership in the majority of Japanese and Korean companies to be widely dispersed, companies in Hong Kong to be controlled by families, and Singaporean companies about half controlled by the state. Rafael LaPorta, Florencio Lopez-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998). The same study further examined the means through which control is enhanced in controlled companies. The study identifies the use of pyramiding and management appointments, frequent cross-ownership and dual class voting structures as patterns to increase control generally; the LaPorta team additionally identified East Asian companies as subject to control with significantly less than a majority of shares outstanding: the single controlling owner can achieve that control in more than eighty percent of companies by holding twenty percent or more shares. *See also* Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

Following this research into the concentration of corporate control worldwide by the LaPorta team in 1998 and 1999, the Claessens team looked at the degree to which ownership is concentrated in East Asia on a systematic, cross-country basis and found large family control in more than half of East Asian corporations. *See* Claessens et al., *supra* note 8. For this study, "East Asia" included Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. The study noted, "In many countries, control is enhanced through pyramid structures, and sometime deviations from one-share-one-vote rules, and voting rights consequently exceed formal cash-flow rights." *Id.* at Summary of Findings. "Separation of management from ownership control is rare, and management of two-third of firms which are not widely-held is related to the family of the controlling shareholder." *Id.* at 3.

[9] *See* Wonhyuk Lim & Joon-Ho Hahm, *Turning a Crisis into an Opportunity: The Political Economy of Korea's Financial Sector Reform*, *in* FROM CRISIS TO OPPORTUNITY: FINANCIAL GLOBALIZATION & EAST ASIAN CAPITALISM 83-119 (Jongryn Mo & Daniel I. Okomoto eds., 2006), *available at* http://www.brookings.edu/dybdocroot/views/articles/fellows/lim20060324.pdf. For a chronicling of the success of Asian export economies and the accompanying encouragement of foreign direct investment, see Stanley Fischer, A Development Strategy for Asian Economies: Korean Perspective (May 15, 2004) (paper presented at the Korean Seminar of the Thirty Seventh Annual Meeting of the Asian Development Bank), *available at* http://www.iie.com/fischer/pdf/fischer051504.pdf.

Anglo-American variety.[10] Indeed, from the notorious attempts by American "corporate raider" T. Boone Pickens to win a board seat in Japan in the 1980s until the very recent emergence of a small handful of hostile takeovers in Japan, the conventional wisdom was that "there is no market for corporate control in Japan, and there is not likely to be one."[11] In Asia more broadly, the strong preference for stability and non-confrontational, patient capital characteristic of main bank and state-directed systems of corporate finance are giving way to an active market for mergers and acquisitions, according to Hong Kong-based practitioners of the trade.[12] The correct takeover policy regarding the legalization of defensive techniques depends on the extent to which the hostile, unsolicited takeover is regarded as a social benefit.

The primary social benefit of hostile transactions is assumed to be the "governance value," or improvement in managers' behavior in response to a realistic possibility of losing control and its private benefits in a takeover. The social and market effects of hostile transactions have been much studied and debated over the past three decades, and the basic logic is that takeovers occur where firms are poorly managed and their assets are more valuable in the care of other fiduciaries.[13]

Empirical studies generally support the theory that hostile takeovers are good for the economy in terms of increasing the value of the target firms. Robert Bruner's survey of shareholder returns studies for acquisitions from the 1980s through 2004 shows that, regardless of the "mood" or hostility of the transaction, "target firm shareholders enjoy returns that are significantly and materially positive," whereas "buyers basically break even (i.e., acquisitions tend to offer zero net present values, or, equivalently, investors earn their required return)." [14] Combining the returns for buyers and sellers, "almost all of the studies report positive combined returns" with approximately sixty percent of the

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[10] *See generally* FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY (1996); *see also* Bernard S. Black, *Is This the First International Merger Wave?*, M&A LAW., July-Aug. 2000, at 20-26.

[11] *See* Milhaupt, *supra* note 3, at 2172 (quoting NEIL FLIGSTEIN, THE ARCHITECTURE OF MARKETS: AN ECONOMIC SOCIOLOGY OF TWENTY FIRST CENTURY CAPITALIST SOCIETIES 187 (2001)).

[12] For a catalogue of indicators leading one major law firm in the region to conclude that mergers and acquisitions are an emerging phenomenon in East Asia, see FRESHFIELDS BRUCKHAUS DERINGER, GUIDE TO MERGERS & ACQUISITIONS IN ASIA 4 (3d ed. 2004), *available at* http://www.freshfields.com/places/asia/publications/pdfs/2248.pdf.

[13] "Central to the governance role of takeovers is a belief that takeovers seek to correct for inadequate company performance and occur primarily to reconcile the interests of shareholders and managers by improving the performance of target companies." Noel O'Sullivan & Pauline Wong, *The Governance Role of Takeovers*, *in* CORPORATE GOVERNANCE: ACCOUNTABILITY, ENTERPRISE & INTERNATIONAL COMPARISONS 155, 156 (Kevin Keasey et al. eds., 2005).

[14] ROBERT F. BRUNER, APPLIED MERGERS & ACQUISITIONS 56 (2004).

studies showing "significantly positive" changes.[15] Where hostile acquisitions were defined as tender offers, where the acquiring entities made offers directly to target shareholders without friendly board negotiations, "several studies report larger announcement returns to bidders in tender offers, as compared with friendly negotiated transactions."[16] Research further suggests that targets of hostile tender offers tend to be underperformers with relatively low share prices, so that "the better returns from tender offers may reflect bargain prices and/ or the economic benefits of replacing management and redirecting the strategy of the firm."[17]

However, there is some skepticism about the lessons to draw from the wealth of studies of hostile acquisition targets. O'Sullivan and Wong conclude that the data is ultimately inconclusive as to whether hostile acquisition candidates perform worse pre-bid than other non-target companies.[18] Looking only at targets where managers are replaced after the bid, the extensive finance literature does provide support for weaker pre-takeover firm performance.[19] Empirical confirmation is also hard to trust. While some studies that use accounting returns as indicators of business performance, and others that study market value in the form of stock prices or Tobin's Q ratio comparing market value to the book value of assets are supportive, the proposition that acquirers improve the market and social value of the acquired firm is complicated by the entanglement of other factors surrounding the takeover.

Studies of companies' stock prices when they adopt new defensive measures offer a clear indication of how the market reacts to such measures. Almost without exception, stock prices dip in the wake of news that firms have chosen to adopt anti-takeover measures.[20] Bebchuk and Cohen find that staggered boards, while concededly quite effective in meeting their purpose of insulating sitting board members, are associated with "an economically meaningful reduction in firm value (as measured

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[15] *Id.* at 57.

[16] *Id.*

[17] *Id.*

[18] O'Sullivan & Wong, *supra* note 13.

[19] *See* Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671 (1991); *see also* Omesh Kini, William Kracaw & Shehzad Mian, *The Nature of Discipline by Corporate Takeovers*, 59 J. FIN. 1511 (2004).

[20] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 196 (1991).

by Tobin's Q) . . . [and] that staggered boards bring about, and not merely reflect, a reduced firm value."[21]

If an active market for corporate control is a public good, then what is the best way to facilitate the market's development – and to what extent is protection from hostile foreign capital warranted? Based on the recognition of the "governance value" of an active market for corporate control, Western markets tolerate – and in some quarters, wholeheartedly endorse – shareholder battles for control of corporate assets. In markets with active control contests, corporate and securities laws have evolved in response to innovative financial engineering and corporate maneuvering initiated by companies, lawyers and investment banks. The evolutionary history now offers a rich vein for study by policymakers and players in developing capital markets, both in terms of takeover methods and defensive measures that companies may employ, and in terms of the array of legal instruments including statutes, rules, policies, and judicially created standards available to policymakers and regulators. The experience runs from Wachtell Lipton's invention of the poison pill in 1982, through the European Union's years of debate on the prudence of "breaking through" long-held corporate control mechanisms, coming full-circle with Japan's Takeover Guidelines of 2005. While the growth of international mergers and acquisitions will doubtless lead to the development of new adaptive responses in new environments, the policy considerations are rather uniform in any legal setting: Who should determine whether a company is for sale? Which corporate group gets to decide whether a premium offer is not in the company's best interest – the board, a controlling shareholder, or a majority of shareholders? And under what conditions should defensive measures be available to incumbent managers?

Sale of the business presents the threat of an endgame in which the controller must discount all future private benefits of control to be convinced to sell now. The form of a buyout offer must somehow compensate the controller for giving up the private benefits of the controlling-minority-shareholder (CMS) position.[22] A simple premium to the current market price per share will be distributed proportionally among all shareholders, and is unlikely to adequately and independently

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[21] Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 409 (2005), *available at* http://www.law.harvard.edu/faculty/bebchuk/pdfs/Bebchuk-Cohen_Costs-of-Entrenched-Boards.pdf.

[22] *See* Lucian A. Bebchuk, Reinier H. Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 445 (Randall K. Morck ed., 2000).

compensate the controller. For this reason, the CMS structure is naturally resistant to transfers of control.

Research on the effects of CMS structures broadly suggests that "such concentrated ownership coincides with a lack of investor protection,"[23] and that "a great number of firms around the world have managers who possess control rights that exceed their cash flow rights in the firm."[24] Thus, the controlling managers generally are able to exercise effective control "while they bear relatively less of the cash flow consequences of exercising their control."[25] The extent to which managerial agency problems affect firm value depends, *inter alia,* on the extent to which the management group is insulated from outside shareholder demands, in which case managers might choose to extract corporate resources; this consumption of private benefits by board members leads to a reduced firm value.[26] When Lins assessed the performance of companies in emerging market economies where managers' control rights exceed their proportional ownership, he found that company valuations are "significantly lower in countries with low shareholder protection."[27] With respect to East Asian companies, a value discount of approximately seven percent in diversified firms with group affiliations was attributable to resource misallocation and the greater ease of expropriation by controlling shareholders from minority shareholders.[28]

To a shareholder, the cost of insider expropriation increases with the percentage of the company owned. Thus, controlling shareholders who nevertheless have a small financial interest in the company have a strong incentive to expropriate corporate assets when such opportunities present themselves.[29] Korea's Fair Trade Commission has taken a special interest in the size of the wedge in the *chaebol*, finding "wide and growing disparities between ownership and control of the ten largest [corporate groups since the Asian financial crisis. Since then] the

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[23] Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159, 160 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214909.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.* at 184.

[28] Cai Xiang, Ownership, Control and Acquirers' Returns: Preliminary Evidence from East Asian Companies (Nov. 25, 2004) (Cornell L. Stud. Res. Paper No. 04-038), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625684.

[29] Chandrasekhar Krishnamurti, Aleksandar Sevic & Zeljko Sevic, Legal Environment, Firm-level Corporate Governance and Expropriation of Minority Shareholders in Asia (June 23, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=407847.

percentage of shares directly owned by controlling families has fallen to less than four percent, but they have maintained control through systems of cross-shareholdings."[30] As for the market impact of the wedge, "the higher the disparity between ownership and control, the higher the discount on the shares."[31]

The Claessens team found a high degree of expropriation in Indonesia, the Philippines and Thailand, but did not find empirical support for expropriation in Malaysia, Singapore or Taiwan.[32] The Krishnamurti team inquired whether firms' controlling minority shareholders in these markets "compensate by adopting voluntarily high standards of corporate governance."[33] They did not find such voluntary adoption in low corporate governance scoring nations, but did find that in Hong Kong and Singapore, such firms "signal their intention to not expropriate minority shareholders' wealth by voluntarily adopting measures to strengthen their discipline and responsibility scores."[34] This willingness of high-control or CMS firms voluntarily to adopt measures indicating their willingness to "bond" or enhance their firm value by foregoing private benefits is encouraging: it gives one hope that, if an opt-in regime for a shareholder-friendly takeover policy is made available, a critical mass of companies will promptly sign up to the regime.

The empirical findings of the valuation consequences and social costs of CMS structures point to important consequences for takeover policy in those markets where CMS structures are common: the extent to which shareholders are made worse off by offering enhanced legal options for anti-takeover defenses can be expected to cause a further decrease in firm value. Without resolving the ability of insiders to extract harmful private benefits, the new availability of defensive measures would have a compounded value-reducing effect on the market value of protected companies.

[30] Fischer, *supra* note 9, at 42.

[31] *Id.*

[32] Claessens et al., *supra* note 8.

[33] Krishnamurti et al., *supra* note 29, at 4.

[34] *Id.* at 20.

III. PRECEDENT: ANTI-TAKEOVER DEFENSE FROM ELSEWHERE

The history of hostile takeover methods and their corresponding defensive weapons developed like an arms race.[35] Only the weapons most sought after are described here. This section evaluates the background and current state of the defense and takeover policy debate in the jurisdictions in which these tools originated.

The best takeover defense requires no special legal permission, maximizes social benefit and is highly effective: a high share price. Another uncontroversial takeover defense is for the controller to own the majority of outstanding shares. Other means of protecting the company are non-market-oriented defenses based on instruments of contract, corporate statute, or political process. These non-market instruments raise the omnipresent specter of abuse by managers seeking to protect their positions at the expense of shareholders, and therefore are justifiably scrutinized for their potential to result in net social harm. The legal tactics and political procedures effectively trump the market-oriented safeguards in a contest for corporate control – or prevent any contest from occurring at all – and are suspect for that reason alone. Assuming that assets are put to their highest social use when in the hands of the party willing to bid the highest price for them, a mechanism that removes price from the determinant of the winner in a bid for corporate assets must be based on some other overriding social benefit.

In the case of defensive measures that allow the company to "just say no" to a premium bid, the justifying benefit is the preservation of the corporation in its current form, including its management team, capital structure, employees and operations. In some estimations, the premium is not persuasive because the market price for a company's shares is not trustworthy – i.e., it does not capture long-run value or the price of good will – but gives rise to a conflict of interest between "investors who plan to sell their shares in the near future (who care only about today's market price) and investors who plan to hold their shares (who care about long-run economic performance)."[36] Efficiently priced capital markets would alleviate this conflict and likely represent the best hope for a properly functioning, beneficial market for corporate control. Defensive maneuvers cannot be justified as a means to shield company managers and boards from the market impact of their performance.

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[35] For an overview of this history and its lively nomenclature, *see* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS (2d ed. 1995).

[36] Lynn Stout, *Takeovers in the Ivory Tower: How Academics are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435 (2005).

A. *The United States: Pills, Polls, Professors, Delaware and the Mythic Shareholder*

Takeover laws or regulations, including those in company and securities laws or stock exchange listing rules, generally regulate the process of hostile acquisitions in the interest of fairness to all shareholders, with the effect of eliminating a large swath of inadequate or coercive bids via mandatory bid rules and tender offer regulations. Contractual provisions between the target company and its executives, labor unions, suppliers, customers and others can effectively booby-trap a company with change-of-control provisions that are expensive or destructive to firm value if triggered. Indeed, the golden parachute is so common for executives at American companies that it effectively has removed the fear of – or at least any material incentive to decline – takeover bids at many U.S. companies. [37] This was intentional. Executives' incentives are thought to be more closely aligned with their shareholders' if they stand to gain from a change of control alongside shareholders; the risk of managers' losing their salary is offset by the typical termination payments within a year or so following a change in control that are usually three times pre-termination compensation. Other techniques to deter takeovers were of brief importance in the U.S. experience and still arise from time to time, including such exotica as shark repellents, greenmail, white knights and the Pac-man defense.[38] However, a cocktail with two ingredients turned out to offer the full remedy for most American companies: the staggered board and the poison pill.

B. *Staggered Boards*

The corporate form lends itself to a variety of structures that make transfer of control of the board expensive, difficult or impossible. The class of measures meant to deter a hostile takeover attempt *ex ante* includes a set of rules for the board of directors that renders impossible their quick replacement at a single annual meeting or at a meeting specially called by a new majority shareholder. A staggered board, with a number of classes of directors usually limited by law to three – meaning that one-third are up for re-election each year, and it will take at least two

[37] Marcel 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, 884 (2002).

[38] *Id.* at 875.

years for a hostile acquirer to achieve majority control of the board – is the primary structure for achieving this. Additionally, for the staggered board to be an effective defense, the structure usually includes the following:

- a prohibition of removal of directors without cause;
- the reservation to the board of sole authority to decide the number of directors the board will have;
- the power to fill any vacancies due to resignations or increase in the number of directors; and
- limits on the circumstances in which special meetings can be called by shareholders.[39]

Fifty nine percent of publicly traded U.S. companies had staggered boards in 1998.[40]

Nominally, the staggered board structure alone merely delays the transfer of control. In operation, however, staggered boards do more than merely delay a takeover – rather, they "make it extremely difficult for a hostile bidder to gain control over the incumbents' objections."[41] Further, staggered boards are such effective defenses that they reduce returns to target company shareholders.[42] The Bebchuk team concluded that the temptation for board members to act in their own self interest was not eliminated by the presence of independent directors on the board.[43] Moreover, they found that staggered boards do not benefit shareholders by negotiating more favorable premiums in circumstances of hostile bids,[44] giving the lie to conventional wisdom often offered in support of defensive tactics generally.

Finally, Bebchuk dispels the myth of the essential ability of shareholders to oust directors by whom they are poorly served.[45] This is a serious problem for the takeover regime as developed in the American system, because the Delaware courts' permission of defensive measures to block hostile bids has been predicated on the assumption that

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[39] *See* Gilson & Black, *supra* note 35, at 736-37.

[40] Lucian A. 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. 887, 889 (2002).

[41] Bebchuk et al., *supra* note 7, at 890.

[42] *Id.*

[43] Bebchuk et al., *supra* note 40, at 898

[44] *Id.* at 891.

[45] Bebchuk, *supra* note 3.

shareholders have the power to replace an entrenched board that refuses to sell to the company's and shareholders' detriment.[46]

C. *Poison Pills*

The ultimate weapon is the Shareholder Rights Plan, also known as the poison pill, limited only by fiduciary law and, recently, shareholder revolt. Created by New York corporate lawyer Martin Lipton of Wachtell, Lipton, Rosen & Katz in 1982 amidst a wave of hostile takeovers in the U.S., the pill is a complete defense against an unwanted takeover – the nuclear deterrent in the corporate theater. Its invention and widespread adoption changed the American landscape for corporate control.

The Rights Plan creates contractual rights that attach to each share of company stock with the effect of massively diluting a would-be hostile acquirer, so that no acquisition will occur without board cooperation to redeem the pill. Legal and financial engineers have used the form innovatively, and various versions of the pill have been tested in the Delaware courts over the years with a resulting roadmap in judicial rulings that define, at least in general terms, which pill features and in which circumstances the pill may be used to defend incumbent management from an insufficient buyout offer or otherwise unfavorable terms for shareholders.[47]

The policy justification for the pill lies in the Institutional View of the corporate form, the perspective that prizes stability and protects managers from having to fend off hostile investors. This perspective discounts the incentives created by an open market for corporate control. As Lipton explains the motivation behind *Takeover Bids in the Target's Boardroom*,[48] his influential article from twenty five years ago, the primary impetus was his "concern that the business judgment rule and the board's fundamental gate-keeping role were severely threatened by calls for director passivity in the context of hostile takeover attempts."[49] He judges that "the first battle has been won"[50] for his position that the board should have the ability, via the pill and other means, "to take unilateral measures that the board considered to be in the best interests of the

[46] *Id.* at 4; *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[47] For a detailed discussion of the Delaware case law and the experience of American companies under the pill, see Lipton, *supra* note 4, and the accompanying reviews from the American Bar Association's "Symposium on *Takeover Bids in the Boardroom*: 25 Years Later." 60 BUS. LAW. 1383-1467 (2005).

[48] Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

[49] Lipton, *supra* note 4, at 1369.

[50] *Id.* at 1374.

corporation"[51] and play "an active role . . . in the context of hostile takeover bids."[52]

The victory came in the Delaware courts and some state statutes granting company boards the right to "just say no" to a buyout offer, where they can do so consistent with their fiduciary duties to shareholders.[53] Mr. Lipton now sees a second front emerging in the same battle: "some regulators, academics and special-interest shareholders"[54] are charged with "demoniz[ing] the American corporation" and "mounting a more trenchant, multi-level and multi-jurisdictional attack on the ability of the board and management to manage effectively the corporation."[55] Mr. Lipton's battle is with proponents of shareholder empowerment; his Institutional View identifies the board of directors as the gatekeeper of significant business transactions. As to takeover bids in particular, in Mr. Lipton's experience and interpretation of the corporation law's grant of broad authority to the board, the determination of whether a bid should be accepted lies ultimately with the directors rather than the shareholders. The social good of corporate continuity justified the board's ability to reject a takeover bid; long-term corporate planning would be jeopardized if the corporation was required constantly to "have a for sale sign on the lawn."[56] Under this theory, shareholders could not be trusted to understand or wait for long-term goals to be fulfilled if they were offered a quick profit in the form of a premium buyout offer. In sum, the case for directors' use of poison pills to keep the company off the market was based on the logic that "the fate of important societal institutions" should not be entrusted to "arbitrageurs, short-term investors and corporate raiders" when "duly elected boards of directors are likely to do a better and more responsible job."[57] In an effort to balance correctly the merits of the Institutional View with the benefits of the market for corporate control, Professor Gilson provides a helpful test of when pills are properly policed: (i) "defensive tactics motivated by management self-interest are never allowed," (ii) "defensive tactics motivated by an effort to secure the best price for shareholders are always allowed," and (iii) "defensive tactics motivated by a timing claim are

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[51] Lipton, *supra* note 4, at 1369.

[52] *Id.* at 1369.

[53] *Id.* at 1371-1374.

[54] *Id.* at 1370. In footnote 2, Lipton defines "special interest shareholders" as "public employee pension funds managed by politicians and labor union pension funds, whose agendas may be contrary to the interests of the company or its shareholders."

[55] *Id.* at 1369-1370.

[56] Lipton, *supra* note 48, at 112.

[57] Lipton, *supra* note 4, at 1392.

carefully evaluated to prevent claims of timing from cloaking self-interested behavior."[58]

Looking back on the era in which the poison pill was invented and refined, Professors Gilson and Kraakman observe that the 1980s American experiment with Schumpeterian capitalism in the form of junk-bond-financed corporate raiders' leveraged buyouts was short-lived and is no more, given the powerful insulation now in place at American companies.[59] This insulation is provided most importantly by the poison pill deterrent. "The argument for companies adopting and retaining a poison pill is that it protects against a bid the board determines is not in the best interests of shareholders, and it provides leverage to increase the premium from the potential acquirer and time to find alternatives."[60] Indeed, studies have found that takeover premiums are significantly higher for companies with poison pills and other takeover defenses.[61]

While the Delaware courts referee contested cases, institutional and activist shareholders have recently stepped up efforts to pressure companies to limit their use of poison pills. Shareholder activism has increased substantially on poison pill-related proposals since the large-scale corporate fraud and governance reform in the U.S. over the past five years. Their objections begin with the lack of shareholder approval for the adoption of poison pills under U.S. and Delaware law; given that there is no requirement to obtain shareholder consent, companies have rarely done so.[62]

Shareholders now are taking actions to remove the board veto where a majority of shareholders would likely approve a premium buyout offer. The actions are coming primarily in the form of shareholder proposals requesting that companies eliminate or not adopt poison pills without limiting terms such as shareholder approval, expiration dates or sunset terms, and limits to its use in the event of a qualifying offer.[63]

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[58] Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21, 31 (2004).

[59] Ronald J. Gilson & Reinier Kraakman, *Takeovers in the Boardroom: Burke versus Schumpeter* (paper presented at ABA symposium, *supra* note 47), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=732783.

[60] Victor Lewkow & Sarah ten Siethoff, *The Embattled Poison Pill*, CLEARY GOTTLIEB MERGERS & ACQUISITIONS REP. 4, 5 (Mar. 2005), *available at* http://www.cgsh.com/files/tbl_s47Details%5CFileUpload265%5C296%5CCGSH_MA_Report_-_March_2005_Rev.pdf.

[61] Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Company Performance (Dec. 7, 2004), *available at* http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf.

[62] Lewkow & Siethoff, *supra* note 60, at 5.

[63] *Id.*

Companies have received the message and responded quickly, many without waiting for the shareholder proposal to embarrass them.[64] Some companies have added a TIDE provision (Three-year Independent Director Evaluation) requiring independent directors to review and decide whether to terminate the pill every three years; others added a provision requiring either the board or shareholders to review and renew or cancel the pill after a few years; some specified qualified offer criteria in which case the pill does not apply.[65] Other companies, including General Electric, have adopted commitments to their shareholders regarding possible future adoption of a poison pill: its adoption would be submitted to shareholders for prior approval, or for ratification within twelve months.[66]

These proposals came very quickly on the heels of the independent director requirements and board committee procedures enacted under the Sarbanes-Oxley Act of 2002 in the post-Enron and Worldcom fever of corporate governance. They reflect the capital markets' reaction to the fraud and loss of confidence in boards' abilities to effectively protect shareholder interests. How these requirements for shareholder approval may play out when tested remains to be seen.[67]

In its U.S. history to date, the poison pill has not required shareholder approval for adoption, though pressure from institutional shareholders now indicates that they are developing adaptive responses to a situation of insider over-protection, and may succeed in pressuring boards to remove pills or reduce their entrenchment potential. Interestingly, in relation to how the pill might be used in a market characterized by CMS companies, empirical research in the U.S. tested a hypothesis that managers with a smaller ownership stake in their firms would gain less from a premium takeover than managers who had a greater ownership stake (because they would receive less of the premium), and thus would be more likely to cause their companies to adopt defensive measures like poison pills.[68] The data was supportive: managerial ownership in firms that adopted poison pill plans was less

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[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] The initial Delaware decision may come in the litigation surrounding NewsCorp's reincorporation to Delaware from Australia, and its refusal to remove a poison pill as promised in a non-binding commitment to shareholders (if such an oxymoron can exist in law). *See* UniSuper Ltd. v. News Corp., 2005 WL 3529317 (West) (Del. Ch. Ct. Dec. 20, 2005).

[68] Paul H. Malatesta & Ralph A. Walkling, *Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure*, 20 J. FIN. ECON. 347 (1988).

than half that of other companies in the same industries.[69] Gilson and Black interpreted this finding to indicate that "the lower the managerial ownership, the more difficult shareholder approval will be to secure, and the more likely managers will select a tactic that does not require approval."[70] However, the market environment and the need for general shareholder support have changed significantly from the 1980s to the early twenty first century. The age of protected executive management at large American firms certainly is threatened by calls for a more direct democracy for shareholders.[71] At least one other jurisdiction has carefully studied the American experience with poison pills and chosen to adopt the pill, but in a next-generation formulation: Japan.

D. *From Japan: Experimental Transplant Procedure*

A fascinating and as yet little understood phenomenon is occurring with increasingly connected financial and legal markets: transplants of financial and legal technology from one jurisdiction to another. Commentators are careful to point out that a transplanted technique's fate is unpredictable in new environments, and the technique itself is likely to change significantly by being introduced into the new setting.[72] With these warnings and disclaimers provided, it remains possible that Japanese and other East Asian markets may incorporate these techniques into their own structures of corporate governance, while learning from the mistakes made on the other side of the world in decades past. Certainly, the unique legal infrastructure and institutions of capital markets in a particular adopting nation may alter the performance of the new "technology," and the infrastructure may need updating to

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[69] *Id.*

[70] Gilson & Black, *supra* note 35, at 748.

[71] Evidence of significant shareholder empowerment in a more direct democracy, itself reflecting suspicion of board motives and insider control, includes the Securities and Exchange Commission's new and comprehensive disclosure rules for executive compensation, the debate over shareholder access to the company's proxy ballot, majority approval requirements to elect directors, institutional shareholders' proposals to withhold the required approvals from directors who refuse to limit or remove poison pills, and even proposals from shareholder democracy advocates such as Professor Bebchuk to un-stagger boards or subject the full board periodically to a shareholder confidence vote. *See* Bebchuk, *supra* note 3.

[72] "Despite the importance of transplants to legal development around the world, scholarly understanding of this ubiquitous form of legal development is still fairly rudimentary. . . . For example, there is little agreement among scholars on transplant feasibility and the conditions for successful transplants, or even how to define 'success.' Moreover, there is little analysis of how the success or failure of legal transplants relates to the achievement of larger goals, such as economic development." Hideki Kanda & Curtis J. Milhaupt, *Reexamining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887, 887 (2003).

accommodate it. This concern regarding transplantation is unlikely to overwhelm policymakers who are interested in the potential benefits of new defensive measures for companies in their jurisdictions. Because many jurisdictions require enabling legislation to legalize adoption of poison pills, staggered boards or dual class shares, lawmakers can study the recent history of nations where these devices have been in place for years, and develop a coherent policy before the devices are introduced into their markets.

Regarding poison pills, a shareholder approval requirement is the first, most obvious next-generation feature that would eliminate or reduce conflicts between the principal shareholder and the agent director. East Asian nations may be informed by the U.S. experience, with institutional shareholders now designing plans to force companies by indirect means to limit their use of pills – an inefficient avenue pursued where a direct vote was not available. Nevertheless, recent Commercial Code amendments in Japan making the shareholder rights plan technically feasible for Japanese firms in most cases do not require shareholder approval.[73] The Japanese Commercial Code's poison pill may represent a missed opportunity to begin with a better, shareholder-legitimized pill, and likely reflects a certain degree of regulatory capture.

In response to takeover activity in Japan's newly-energized market for corporate control, "[v]irtually every major actor in the Japanese political economy has mobilized to respond to the new development."[74] The Ministry of Economy, Trade and Industry (METI) and the Ministry of Justice (MOJ) formed the Corporate Value Study Group, a task force composed of legal experts and business representatives, tasked with crafting government guidance for hostile takeover policy. Their work culminated in the Takeover Guidelines jointly issued by the Ministries in May 2005.[75] The Study Group's policy response followed four principles: "enhancement of corporate value, global standards, no discrimination between foreign and Japanese firms, and expansion of choice."[76] Their report notes that, according to one commentator, "the establishment of defensive measures in Japan [had]

[73] *See* Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT'L L. 169 (2004).

[74] Milhaupt, *supra* note 2 at 2172.

[75] Keizai Sangyosho & Homusho [Ministry of Economy, Trade and Industry (METI) & Ministry of Justice], Kigyo Kachi, Kabunushi Kyodo no Rieki no Kakuho Mata wa Kojo no Tame no Baishu Boeisaku ni Kansuru Shishin [Takeover Defense Guidelines for Protecting and Enhancing Corporate Value and the Common Interests of Shareholders] (May 2005), *available at* http://www.meti.go.jp/press/20050527005/3-shishinn-honntai-set.pdf.

[76] Milhaupt, *supra* note 2 at 2195.

been hampered by uncertainty over their legal effect, a paucity of precedents and experience, and a lack of consensus on what constitute[d] reasonable defensive measures" but concludes that "if adjusted for Japanese circumstances, most defensive measures recognized in the U.S. and Europe [could] also be implemented in Japan."[77] The Study Group then draws heavily on Delaware jurisprudence to lay out the reasonableness and proportionality requirements that define the Delaware doctrine, though Milhaupt finds that "they place more emphasis on shareholder approval of defensive measures as a means of ensuring fairness than does Delaware doctrine."[78]

In a parallel Company Law update effective May 1, 2006, Japanese companies are required to disclose in their annual business reports specific defensive measures contemplated under certain circumstances. The reports must set out a basic policy regarding control of the company, the details of defensive measures adopted and an assessment of the Boards of Directors that the defensive measures are "in line with the basic policy, do not impair the common interests of shareholders and are not for the purpose of protecting the company's directors', corporate auditors' and corporate executives officers' positions." [79] The Tokyo Stock Exchange also now requires listed companies to timely disclose information when they issue new shares or rights as a takeover defense, and enjoys the right to de-list a company if it feels that adoption of defensive measures was inappropriate.[80] As of spring 2006, Japanese lawyers reported that "more and more Japanese companies are choosing to adopt defensive measures against potential hostile takeovers," the most widely used being the "pre-warning defensive scheme" in which the "company makes public its proposed procedures and management's possible countermeasures to be employed in the event of a potential hostile takeover."[81]

The Japanese solution represents a transplant experiment in law, and an informed one, given that twenty-five years of U.S. history is collapsed into the Takeover Guidelines and transparency concerns are addressed in the disclosure scheme. It remains to be seen whether the

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[77] *Id.* at 2197 (quoting Kigyo Kachi Kenkyu Kai [Corporate Value Study Group], Tekitaiteki Baishu Boeisaku (Kigyo Kachi Boeisaku) no Seibi [Preparing Defensive Measures toward Hostile Takeovers (Measures to Defend Corporate Value)] 19 (Mar. 2005), available at http://www.meti.go.jp/committee/materials/downloadfiles/g50307a11j.pdf).

[78] *Id.*

[79] Nagashima Ohno & Tsunematsu, *Japan: Takeover Defences*, INT'L FIN'L L. REV., Apr. 2006, *available at* http://www.iflr.com/?Page=10&PUBID=33&ISS=21613&SID=623513&TYPE=20.

[80] *Id.*

[81] *Id.*

market for corporate control will benefit from the new technology. Professor Gilson raises concerns that the institutional infrastructure that made the pill less harmful in the U.S. does not exist in Japan and "[t]hus, the poison pill has the potential to be greatly more pernicious in Japan than it has been in the United States."[82] Predictions that the poison pill would ruin the market for efficient takeovers were not realized in the U.S. due to the role the Delaware courts and institutional shareholders have played in mediating the market for corporate control and in limiting pills' abuse by incumbents.[83] Without these institutions, and in a corporate market where hostile takeovers are "one of the few external mechanisms for systemic change," Gilson finds that the stakes are much higher in Japan.[84] The outcome ultimately will depend on whether something outside the pill – the legal standards for when the board may use it – operate to prevent the pill from "achieving its destructive potential."[85] The new defenses permitted and soon to be published at Japanese companies should provide helpful data in evaluating the merits of the transplant experiment as well as a second set of data points for evaluation of the poison pill generally.

The American model was not the only "global standard" available to Japan's Corporate Value Study Group for a relatively successful takeover policy. The British City Code on Takeovers and Mergers offers an alternative that centers on shareholder approval, but is less protective of management. The City Code was the model for takeover policy in Malaysia and Singapore. Its merits have been much debated and its transplant potential carefully studied in the extended tour that led, finally, to the European Union's adoption of the Thirteenth Directive on Takeover Bids. The Takeover Bid Directive, however, transplants the City Code only in form.

E. The U.K.: Isles of Passivity

The U.K.'s City Code settles the question of who will decide on an unsolicited takeover bid in the opposite direction of the American system, and gives the power to the shareholders. Boards are prohibited (under General Principle Seven, the "passivity rule") from taking any "frustrating action" – i.e., any action "which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an

[82] Gilson, *supra* note 58, at 25.

[83] *Id.*at 35-40.

[84] *Id.* at 25.

[85] *Id.* at 33.

opportunity to decide on its merits."[86] Unlike American boards that are delegated authority and discretion in erecting pre-bid and post-bid barriers to an offer (an effective veto, in some interpretations), the City Code allows pre-bid barriers only (such as shares with multiple voting rights) and no post-bid board action regarding the bid. Effectively, a takeover bid made to the company is synonymous with an offer made directly to the shareholders. The law reflects the landscape, of course – large institutional shareholders have long played a key role in British corporate governance. A Takeover Panel mediates the market for corporate control in the UK.

F. *The European Union: The Optional Rules of the Thirteenth Directive on Takeover Bids*

The thirty years leading up to the Directive's ratification on May 20, 2004 highlighted the differences in capital structures and their effects on corporate control among European nations. The purpose of the Directive on Takeover Bids (DTB) is to harmonize national law and capital market regimes to create a level playing field among European companies in the market for corporate control.[87] Specifically, the DTB set out to:

> create a uniform floor of minority shareholder protection for takeover targets; create a framework for determining which legal authority will supervise takeovers and enforce the new rules; and impose disclosure and procedural requirements on bidders, including the requirement of a mandatory bid once a bidder acquired a control block, at a threshold to be specified by member states.[88]

The most ambitious goal attempted in the harmonization process was ridding European companies of the effects of CMS structures. A

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[86] Paul Davies & Klaus Hopt, *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 157, 166 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda & Edward Rock eds., 2004).

[87] Juergen Reemers, Adrien Fournier De Launay & Hanno P. Schultze Enden, *The European Directive on Takeover Bids: A Comparison with U.S. Tender Offer Pratice*, JONES DAY PRAC. PERSPECTIVES Q. (Summer 2005), *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S2875.

[88] John C. Coates IV, Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be? 2 (July 9, 2003) (Harv. L. & Econ. Discussion Paper No. 450), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=424720.

radical legal mechanism called the "break through rule" would allow a "bidder acquiring more than a majority . . . of the target's cash flow rights to 'break through' any mechanism or structure that frustrates its control of the target."[89] The break-through rule would cancel the effects of multiple class capital structures and various voting restrictions common in Europe. "In general terms, the goal of the BTR is the same as the overall goal of the DTB – to transform control of listed EU firms into a commodity available for purchase throughout (and outside) the EU."[90] The break-through rule functions to strip shares of special voting characteristics and achieves a one-share, one-vote result; voting restrictions or multiple voting provisions would be deemed unenforceable.

The BTR would not affect stock pyramids and cross-shareholding structures for reasons of "practicality," though the EU's Takeover Bid Report of January 2002 "singles out pyramids as 'difficult to justify from a general capital markets and company law perspective.'"[91] Looking at the likely effect of the break-through rule, Bebchuk and Hart predicted in a 2002 *Financial Times* piece that firms would switch from their dual class share structure to a pyramid form of CMS to continue disproportionate control with a minority equity interest.[92] Others argued that it would be expensive and difficult to achieve the same ten-to-one voting power lost under the BTR (requiring at least a three-level pyramid or reincorporation outside the EU) and therefore be a less likely substitute,[93] while others concluded that the BTR would render less than three to four percent of EU firms vulnerable to takeover.[94] Though small in number, some of the firms that would be affected are "quite large," including "[a]t least 20 of the 500 largest firms in the EU."[95] Coates concluded that to the extent firms moved to pyramid structures or cross-holdings (including the possibility of existing firms and newly public firms choosing these CMS substitutes for the dual class shares defeated by a break-through rule) to retain control, the net effect would be a reduction in transparency and impairment of capital markets outside the

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[89] *Id.* at 3.

[90] *Id.*

[91] *Id* at 8, n.24 (quoting the Takeover Bid Report).

[92] Lucian A. Bebchuk & Oliver Hart, *A Threat to Dual Class Shares*, FIN. TIMES (London), May 31, 2002, at 13.

[93] *See generally* Jeffrey N. Gordon, An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000 (2003) (Harv. L. & Econ. Discussion Paper No. 406), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=374620.

[94] Coates, *supra* note 88, at 6.

[95] *Id.* at 11.

scope of takeover bids. The Takeover Bid Report did not feign ignorance of the problem. "Pyramid structures . . . undermine the transparency of the ownership structure of listed companies . . . [and] affect the pricing mechanism with regard to listed shares at all levels in the structure[.]"[96]

In the final DTB enacted in 2004, the political compromise included the break-through rule in the structure of the DTB, but made it merely an option for countries to opt into or out of, under DTB Article Eleven.[97] The value of the BTR optional rule lies in its precedent, in the research its introduction spawned on CMS structures in Europe, and in its application in future corporate law practice if in fact any nations opt in. Even where nations opt out of the break-through rule, companies can opt in at the firm level. Some companies may actually take the option because opting in has advantages under the DTB reciprocity rules.[98]

A second ambitious goal for the DTB was the proposed application of a UK-style "board passivity" rule across Europe. The DTB's Article Nine, modeled on the City Code principle, "outlaws post-bid defen[s]es against hostile bids by obliging the board of directors of target companies to remain neutral and not take any actions that could frustrate the bid."[99] Like Article Eleven, Article Nine in the final DTB is an option for nations and for firms if their jurisdiction opts out.[100] While the European Commission's initial approach in an Article Nine of the UK variety is charged with "aiming to create a liberal variety of capitalism, which privileges minority shareholders – such as institutional portfolio investors – over blockholders, management, and workers,"[101] the optional version finally adopted in the DTB represents a triumph for the Institutional View of the firm to the extent that opting out is prevalent and CMS structures remain common in Europe. In its optional form, it will

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[96] *Id.* at 12 (quoting Jaap Winter et al., *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids* 39 (Jan. 10, 2002), *available at* http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf).

[97] *Implementing the Takeover Directive in the EU: What Does It Mean for Member States?*, July 2006, at 2 (Freshfields Bruckhaus Deringer, Briefing Newsletter), *available at* http://www.freshfields.com/publications/pdfs/2006/TakeoverDirective.pdf. The report observed that no nations are expected to opt into the break-through rule, with the possible exception of Italy. *Id.* at 7.

[98] *Id.* at 2-3.

[99] Andre Nilsen, *The EU Takeover Directive and the Competitiveness of European Industry*, Nov. 2004, at 2 (Oxford Council on Good Governance Economy Analysis No 1), *available at* http://www.oxfordgovernance.org/fileadmin/Publications/EY001.pdf (last visited Mar. 8, 2007).

[100] Freshfields reports as of July 2006 that France, Spain, the UK, and possibly Austria and Italy are likely to opt into Article Nine, while Germany, Luxembourg, The Netherlands and possibly Belgium plan to opt out. *See Implementing the Takeover Directive in the EU*, *supra* note 97, at 7.

[101] Nilsen, *supra* note 99 at 2.

not quickly result in the one-share, one-vote ideal sought by advocates of a Finance View.

A reciprocity provision for non-EU bidders addresses the potential imbalance of defensive measures in cross-border offers. EU countries or firms opting in to Article Nine and Article Eleven would be vulnerable to takeover, but American and other firms allowed poison pills and staggered boards would not. Therefore, a European target company would be exempt from the Articles if the bidder is not bound by such restrictions.[102]

IV. AN OPT-IN PROPOSAL FOR ENHANCED TAKEOVER PROTECTIONS

The perceived threat of foreign hostile takeovers and new demand for strong takeover defenses presents an opportunity for East Asian policymakers to strike a bargain with the CMS companies whose regulation is in their care: restructure and become eligible to adopt the poison pill. The eligibility requirement would be a transparent one-share, one-vote capital structure in which control rights are proportionate to cash flow rights. In return for giving up the structural method of control, managers would enjoy the privileges of a code or statute that permits the adoption of poison pills and other defensive measures, subject to reasonable rules to protect firm value and prevent abuse or entrenchment.

Once a firm qualifies under the one-share, one-vote criteria, its use of defensive measures such as poison pills would be subject to the regular fiduciary duties that directors and executives owe their companies under standard corporate law. One option for applying corporate fiduciary duties to the new defensive measures is to adopt a statute or set of rules with fairly specific guidelines. At least two families of precedent are now available: (i) the Japanese Takeover Guidelines and the Delaware court standards of reasonableness and proportionality; and (ii) the UK and Europe's non-frustration rule. The former would empower the board to reject an unsolicited takeover bid or negotiate on behalf of shareholders if it decides to entertain the bid, all while using the poison pill as leverage in the negotiations – or as a complete deterrent if the decision is to reject the bid. The latter would require the board to redeem a poison pill in the event it receives a premium offer and pass the decision directly to shareholders. A passive board has no need of a poison pill post-bid, and must remove it if shareholders accept the bid. Other defensive measures may be permitted under the opt-in code, to deter partial or insufficient

[102] Reemers et al., *supra* note 87.

offers. A minimum qualifying bid may be set, at which point the passivity obligation is triggered.

If board discretion is chosen (i.e., the Japanese and American systems), the opt-in scheme must protect the shareholder franchise. The one-share, one-vote eligibility criteria will be meaningless if other measures are permitted under the opt-in code that entrench management in new and different ways. The pill will be available to protect the board's ability to govern the company in an atmosphere of institutional stability. It will enable the board to negotiate for the best deal under the circumstances for shareholders. It should not be coupled with a staggered board with no trumping provision, such that the company is takeover-proof and will remain so despite shareholders' wish to sell. The poison pill can be used to decline a buyout offer in a specific circumstance, consistent with fiduciary duties. However, if the bidder then wins a proxy contest and places a qualifying number of directors on the board, or receives a majority or other qualifying percentage of votes for its nominee(s), then the pill would become void and the board would be required to adopt a passive role, allowing the bidder's offer to then go to shareholders. The shareholder vote in the proxy contest would be determinative: where shareholders vote in the nominees of the rejected bidder by a qualifying percentage, the message is that the incumbent board in fact did not act in shareholders' best interest when it turned away the bidder. As Professors Black and Kraakman put it, the board could not say "never." [103]

The opt-in regime may need to contain enhanced disclosure requirements for companies opting in if the background rules are insufficient to adequately inform shareholders about firm value, including a full description and access to the legal documents containing all takeover defenses. Consistent with protecting the shareholder franchise in the new legal scheme that allows enhanced takeover protections, shareholders must have adequate information to recognize the true value of the firm. The opt-in regime should not allow boards to hide behind a "hidden value" presumption that they are able to detect the true value of the firm, but bidders and shareholders are not, in addition to their poison pill. A definitive determination of when the board has got it wrong is available in the outcome of a proxy battle. The opt-in regime must therefore enable the bidder to launch a proxy fight and put the buyout offer to the shareholders if the proxy contest is won by the bidder in a single election.

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[103] Bernard S. Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 95 NW. U. L. REV. 521, 525 (2002).

Dual class shares would be disallowed under the eligibility requirement of one-share, one-vote, or disabled by a break-through rule.

V. CONCLUSION AND RESEARCH AGENDA

Companies with disproportionate ownership and control are afflicted with agency problems and perverse incentives for the controller to extract private benefits at the expense of the other shareholders and corporate constituents. CMS companies tend to suffer in their market valuations as a result. With the arrival of foreign-based investors in East Asian markets and their cowboy capitalist ways, companies formerly protected by friendly shareholders find that they are at risk of hostile takeovers by bidders that they cannot control or appease via the domestic social network. Exposed companies therefore look to the corporate law system to offer them protection from unsolicited buyout offers. Board passivity of the UK/ European DTB variety is not a satisfactory system for CMS controllers who cannot vote down the bid by a majority they do not own in shares.

This dilemma presents an opportunity to offer the desired protection in exchange for a better, more transparent and socially efficient capital structure at CMS companies. An opt-in legal regime (an "enhanced protection corporate law"), would offer the poison pill and perhaps other defensive measures to qualifying companies. Qualification would depend on achieving a one-share, one-vote capital structure. Effectiveness of the opt-in provisions at a particular company can be planned to occur, with regulatory pre-clearance, simultaneously with the corporate restructuring. Given the very small percentage ownership by controllers and multi-generation succession issues creating controversy for controlling families' succession plans at CMS companies, the opt-in regime offers some benefit at a time of transition for many reasons for CMS structures in East Asia. The choice of legal regime for takeovers allows the "good" or better-structured companies to receive credit in terms of market value. Companies opting in can achieve the protection they have sought in CMS structures in a more transparent system with clear rules and clear ownership. Precise, transparent rules governing the market for corporate control would provide capital markets players a better roadmap to the costs and conditions of hostile acquisitions, potentially eliminating some inefficient acquisition efforts and the accompanying drain on management resources. If companies opt in in significant numbers, the new regime may result in a net social benefit in the form of reducing the opportunity for bad-private-benefits extraction at the formerly minority-controlled companies.

Careful consideration and further research is needed to define the qualifications for the opt-in regime. The EU Takeover Bid Report correctly acknowledges the practical difficulty in defining and collapsing complex shareholdings into a structure where effective control is proportionate to cash flow rights. However, there is evidence that at least two identifiable groups are able to sort out the control consequences of the current CMS structures: the controllers and the competition (antitrust) regulators. A government agency of experts may be needed to evaluate the applications of companies for their eligibility. This agency could have a broader mandate, somewhat like the UK's Takeover Panel, acting as a specialist regulator for the new opt-in code. A regulatory gatekeeper would determine eligibility for the enhanced protection corporate law regime (pre-bid), not the outcome of any particular contest for corporate control (post-bid). The regulatory function should not operate as a veto or other politically controlled state right (such as a "golden share"). Rather, a specialist regulator would be the judge of whether a one-share, one-vote capital structure is achieved prior to adoption of a poison pill. The regulator's mission would be to guarantee investor protection and market fairness.

Additional research is needed to support the proposition that the market would recognize and value opting in companies at a premium to their current value in CMS form. And how would capital markets judge firms that opt out? The incentives for controllers must be evaluated, as they currently control the relevant firms – would the enhanced defenses adequately compensate them for the private benefits they would surrender upon the capital restructuring? There are significant costs – the effect of unwinding CMS structures could impact inter-company commercial relations and management reporting relationships. The mechanical steps to restructure under the domestic corporate and securities laws, accounting treatment and taxable gain realization all are practical concerns that require feasibility research, planning, financial commitment, shareholder support and regulatory approval in some cases. A cost-benefit analysis is clearly in order at any particular company or group if an opt-in enhanced protection corporate law were to become available in its jurisdiction.

Finally, specific rules in the opt-in regime must be tailored to the legal and financial infrastructure. The risk of transplant failure seems particularly high for anti-takeover measures, given the quite different legal and financial infrastructure in the destination markets from the native ones. The consequences of getting it wrong are rather grave in terms of lost benefit from the market for corporate control (opportunity cost) and the perverse incentives takeover protections can create (increasing agency costs). This exercise in comparative law therefore focused on identifying aspects of takeover policy that have a high likelihood of transplant success. If chosen wisely, foreign-bred anti-takeover devices may be just the right match for the offensive maneuvers employed by foreign-bred investors.