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Transplanting a Poison Pill to Controlling Shareholder Regimes—Why It Is So Difficult

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Transplanting a Poison Pill to Controlling Shareholder Regimes—Why It Is So Difficult

*By Sang Yop Kang**

Abstract: Recently, the great tide of globalization has caused M&A activities to spill over into controlling shareholder regimes (economies dominated by controlling shareholders). Due to a seismic change arising from an unprecedented takeover wave, transplanting the Delaware pill has been heavily discussed in controlling shareholder regimes. This Article explores how legal and socio-economic conditions of the United States (State of Delaware) and controlling shareholder regimes are different and why transplanting the Delaware pill could create unintended results in controlling shareholder regimes. First, the legitimacy of the Delaware pill is supported by corporate governance institutions, such as a relatively functional board, a ballot box safety valve, and an efficient judiciary. Many controlling shareholder jurisdictions, however, do not have these lynchpins. As a result, the transplanted pill in controlling shareholder regimes could be absolute and M&A activities would be stifled. Second, the Delaware pill has invited a large number of friendly deals in the United States since the market has adjusted to the pill by developing a generous severance pay system. However, such a system is not legally or politically permissible in many controlling shareholder regimes. As a result, the transplanted pill would not encourage friendly M&A, but simply entrench target

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corporate insiders. Controlling shareholders may be more interested in a control premium than severance pay. The transplanted pill could enhance a controlling shareholder's negotiation leverage and, as a result, the control premium. However, when a control premium should be shared with non-dominant shareholders by law or social norm, controlling shareholders are likely to be reluctant to initiate M&A activities in the first place. On the other hand, when controlling shareholders are allowed to take a substantial fraction of control premium, it cuts directly against a core rationale of adopting the pill, i.e., protecting weak non-dominant shareholders.

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I. INTRODUCTION

The 1980s were characterized as the most vibrant decade of hostile mergers and acquisitions (M&A) in the United States.¹ Most U.S. corporations feared being the target of an uninvited acquirer, and heated public debates focused on whether the dynamic hostile takeover wave was beneficial to the economy. In 1985, the Delaware judiciary validated the

¹ Professor Merritt B. Fox describes M&A as a mechanism for correcting the managerial agency problem:

Managers face a number of pressures of varying intensity that help align their interests with those of shareholders: the threat of legal action for violation of fiduciary duties, the threat of hostile takeover, the managerial labor market, the evolutionary growth or decline of the firm as the result of succeeding or failing in product competition, peer review, the discipline of the outside directors, and the threat of removal by dissatisfied shareholders.

Merritt B. Fox, *Insider Trading Deterrence versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2098 (1994).

legality of the poison pill—the strongest anti-takeover device ever invented—in *Moran v. Household International, Inc.*² Since most U.S. corporations are incorporated in Delaware, and thus fall under Delaware law,³ the advent of a poison pill virtually crowded out the mechanism of the hostile takeover.⁴ To make things worse for critics of the pill, around the early 1990s the pill in Delaware finally developed into the “just say no” pill, which allowed a board to flatly refuse a bid that was highly attractive and non-coercive to shareholders.⁵ While one would expect M&A activities to have sharply declined in the United States, they did not. In fact, the M&A wave grew stronger with the evolution of executive compensation in the 1990s.⁶ At this time, managers started to accept (or acquiesce to) the change in control, since they realized that they could benefit from equity-based compensation (e.g., stock options) under a high-premium bid and depart from corporations with generous severance packages.⁷ The practice of granting more lucrative executive compensation packages saved the corporate control market from the pill by transforming the nature of M&A from “hostile” to “friendly.”⁸

Until recently, M&A had been generally deemed a creature of Anglo-American business culture, and the market for corporate control was

² 500 A.2d 1346 (Del. 1985) (upholding the legality of a poison pill).

³ New Jersey was the nation’s incorporation center before 1913. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 730 (2002).

⁴ “Takeover bids are no longer a major device for eliminating under-performing management because management has devised effective defensive tactics that make purchase-type takeovers impractical. The principal defensive weapon today is a ‘poison pill’ (euphemistically called ‘shareholder rights plans’).” Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 358 (2000). If a target corporation has a poison pill, an outside bidder is not able to acquire, for example, more than 20% of shares of the target. See *infra* notes 39–40 and accompanying text.

⁵ For an example of the “just say no” pill, see *Paramount Commc’n v. Time, Inc.*, 571 A.2d 1140 (Del. 1989). It is noteworthy, however, that the “just say no” pill is not an absolute takeover defense device, since it is possible that an outside bidder can use a proxy fight in order to overcome the pill. If the bidder wins a proxy fight in a target corporation, she can replace the target’s board and the new board elected by the bidder can redeem the pill.

⁶ Executive compensation plans in the United States have relied on stocks and stock options as the primary source of compensation since the 1990s. For a general explanation of CEO payment in the United States, see Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done about It?*, 58 DUKE L.J. 1013 (2009).

⁷ See generally 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 (2002).

⁸ For example, managers of a target corporation in the United States can enjoy a generous severance package when the target corporation is merged into an acquiring corporation. As a result, managers of the target corporation become less reluctant to accept an M&A deal. See *infra* Part VI. A.

virtually nonexistent outside the United States and the United Kingdom.⁹ This M&A paradigm started to change rapidly around the beginning of the new millennium. Since then, economies outside the United States and United Kingdom have observed hostile bids and takeovers (although relatively few).¹⁰ In fact, the great tide of globalization made M&A activities spill over internationally, as global entities considered cross-national acquisitions as feasible options.

M&A—in particular, the hostile takeover—raises complicated issues in any jurisdiction, both economically and socially.¹¹ Commentators are sharply divided over whether hostile takeovers are beneficial for investors and capital market efficiency.¹² Moreover, even if a merger or acquisition produces additional wealth for an entire group of investors in the capital market, it might also generate many difficult socio-political questions for a local government. For example, an M&A pursuing cost-reduction and synergy is often followed by a massive layoff that can create social unrest. If such loss from the employee side is taken into account, value-maximizing acquisition for shareholders is not necessarily beneficial to society as a whole, even in Kaldor-Hicks terms.¹³ Additionally, when a prospective acquirer is a foreign entity, public sentiment could suddenly turn to politically flammable nationalism, which can make a cross-border acquisition especially difficult. From a local business perspective, a seismic change arising from an unprecedented takeover wave (although

⁹ Dynastic succession within dominant family shareholders has been deemed to be a business norm in many controlling shareholder economies. This explanation could be one of the reasons why there have been fewer sales of control, particularly in large corporations.

¹⁰ For example, Mannesmann in Germany, Fuji TV and Bulldog Sauce in Japan, and SK Corporation and Hyundai Elevator in Korea were all involved in hostile takeover wars. *See infra* notes 115–117 and accompanying text.

¹¹ For example, in Japan there is a “social distaste for hostile takeovers.” Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2083 (2001). Other countries of the controlling shareholder regime have exhibited similar hostility towards hostile takeovers. For example, during a TV interview, French President Mitterrand warned his audience “against takeover mania, against gangsterism, and the rule of the strongest.” Helen Callaghan, *Insiders, Outsiders and Politics of Corporate Governance: How Ownership Structure Shapes Party Position in Britain, Germany and France*, 42 COMP. POL. STUD. 733, 753 (2009).

¹² Some argue that a hostile takeover is the best disciplinary device to enhance shareholder value by diminishing the chronic problem of managerial agency cost. In contrast, others argue that M&A does not create sufficient benefits, pointing out that the *net* value-added to *all* shareholders (not only those of a target, but also those of an acquirer) is almost nothing. *See, e.g.*, WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 457–58 (4th ed. 2012).

¹³ “A move is said to be Kaldor-Hicks efficient if, *in principle*, the party who gains can compensate the party that loses and still be better off from the move.” RICHARD A. IPPOLITO, ECONOMICS FOR LAWYERS 72 (2005).

weak so far) is an apparent threat to the *Ancien Régime*.¹⁴ Accordingly, the poison pill is a frequently suggested solution since it has proven to be the most effective defense device in U.S. takeover history.¹⁵ In addition, the movement to enact laws, either by statute or case law, permitting the poison pill is supported by a slogan of the “global standard”¹⁶: “If the United States allows the pill, then why don’t we?”¹⁷

To be sure, transplanting is more complicated than mere copying. Thus, it is important to analyze in advance whether the poison pill would be harmonious with an importing jurisdiction’s socio-political, economic, and judicial systems, which are often markedly different from those of the United States. Since few articles, if any, have explored these issues comprehensively, this Article will shed light on takeover corporate governance scholarship by analyzing interactions between law, economics, and culture.

Most of all, the ownership structure matters when considering the consequences of implementing the pill. In the “dispersed shareholders regime,” ownership and control are separated—while shareholding is widely dispersed, control belongs to management.¹⁸ The dispersed shareholders regime is, however, a localized phenomenon in the Anglo-American economies.¹⁹ In most jurisdictions, the corporate norm is principally built on the “controlling shareholder regime,”²⁰ where typically a controlling shareholder with a large fraction of voting rights runs the business. When a controlling shareholder uses voting leverage (e.g., stock pyramiding), allowing the Delaware “just say no” pill may lead to over-deterrence of takeovers.²¹ This is because the voting leverage itself is a

¹⁴ *Ancien Régime* is originally meant to be the old political system in France prior to the French Revolution. In this Article, *Ancien Régime* refers to an old corporate governance regime in controlling shareholder jurisdictions that have not frequently observed M&A.

¹⁵ See, e.g., Hamilton, *supra* note 4.

¹⁶ A poison pill might not be a globally recognized takeover defense measure. Nonetheless, local business people could argue that adopting a very American takeover defense measure—a poison pill—in their legal system is consistent with the global standard, since the United States is the largest and most influential economy in the world.

¹⁷ Recently, this type of argument has prevailed in Japan and Korea, where many business-people are concerned about the threat of hostile takeovers from foreign business entities.

¹⁸ See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

¹⁹ John C. Coffee Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 641 (1999).

²⁰ In most countries, dominant shareholders—“usually the State or families”—control large corporations. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 474 (1999).

²¹ In other words, the imported “just say no” pill in a controlling shareholder jurisdiction could become a much stronger pill than Delaware’s “just say no” pill.

built-in and strong anti-takeover device. In addition, many countries outside the United States do not have the infrastructure that legitimizes the pill. For example, a typical corporation in these countries lacks the tradition of having a functional (or relatively independent) board, which is designed to keep corporate decision-makers from abusing their power. Absent such a board, a pill's legality is greatly weakened. Moreover, unlike the efficient Delaware courts, most judiciary systems in those countries are neither equipped with the expertise required to deal with cutting-edge takeover issues nor fast enough to reduce the uncertainty associated with time-delay.²²

In addition, it cannot be overemphasized that under Delaware jurisprudence, a pill is not "absolute" and therefore not unassailable. Delaware courts rely on the proposition that shareholders ultimately have the power to replace an incumbent board with a new one in order to redeem a pill,²³ if they are dissatisfied with an incumbent's M&A defense and/or continuing business model. From this perspective, a poison pill is legally upheld *only when* the shareholder franchise is not impeded and distorted by corporate insiders.²⁴ However, many countries are unlikely to have such a "ballot box safety valve."²⁵ In particular, when the poison pill is adopted in a jurisdiction that allows a voting leverage that artificially inflates a controlling shareholder's voting power, the true will of shareholders reflecting their weighted cash-flow rights can be replaced in favor of a controlling shareholder with small cash-flow rights. Put simply, transplanting *only* the poison pill without importing complementary Delaware corporate governance systems, such as an independent board, an efficient judicial system, and safety valves, is akin to wearing a suit jacket with pajama pants.

Although the pill made hostile takeovers virtually impractical, U.S. market participants in the 1990s adapted quickly to a pill-dominated, M&A climate by restructuring executive compensation²⁶ and by accepting a high-

²² Lacking such an important legal infrastructure would seriously discourage a prospective acquirer from submitting an uninvited bid in the first place. In addition, uncertainty associated with time-delay would make a pill more powerful than an original Delaware pill.

²³ See generally *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). "The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests." *Id.* at 659.

²⁴ *Id.* at 661 (requiring management to demonstrate "compelling justification" for its defensive maneuver if the primary purpose of taking such a defensive device interferes with the shareholder franchise).

²⁵ For the explanation of a "ballot box safety valve," 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, 907-09 (2002).

²⁶ U.S. executive compensation is relatively high when compared to other countries. For

premium bid—thus aligning the interests of managers and shareholders. Similar market accommodation could be expected to take place in some pill-importing jurisdictions. In countries where social democracy and egalitarianism is popular, however, it would be extremely difficult, if not impossible, to adopt the American-style corporate compensation system that tolerates, or even encourages, vast income disparity.

In a controlling shareholder regime, in general it is not a Chief Executive Officer (CEO), but a dominant shareholder who ultimately decides significant business strategies including a defensive measure. In such cases, executive compensation might not be the main variable in a complicated equation with respect to a pill and M&A because the driving force that encourages a dominant shareholder to sell control is the control premium that she is offered rather than a severance package available to management.²⁷ As long as control is sold for the “appropriate” price, a pill would not preclude a friendly deal.

However, there are potential obstacles to the sale of control based on a mutual agreement. First, the reserve price of controlling shareholders may be higher than the offering price of prospective buyers such that deals are less likely to take place.²⁸ Another impediment arises when the control premium must be equally shared among shareholders. Under such an “equal treatment rule,” a controlling shareholder loses a great deal of incentive to sell control to a prospective acquirer. Even if equal treatment were not legally required, control sales will be rare in a country with an egalitarian culture for precisely the same reason discussed regarding executive compensation. Without accommodating devices, such as attractive executive compensation plans and the sale of control markets, if the pill is imported, M&A activities (voluntary friendly deals as well as hostile takeovers) would be seriously weakened. As a result, available outlets for a failing company would be generally limited to bankruptcy, involuntary friendly deals (such as fire sales), and bailouts, which would adversely affect the economy.²⁹

This Article proceeds as follows. Part II sketches the evolution of the

a critical view on the U.S. executive compensation practice, see Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647 (2005).

²⁷ A dominant shareholder could also be paid both the control premium and a severance package when she holds an executive position in a corporation.

²⁸ It might be, among other reasons, because a founding controlling shareholder deems a corporation as her alter ego, and thus attaches more psychic value with the corporation than any third party.

²⁹ Although an imported poison pill would cause many problems, without the pill a corporation in a controlling shareholder jurisdiction has less deterrence compared to its U.S. peers. In order to maintain a similar level of deterrence power by a target corporation, additional defense measures—which are less powerful than Delaware’s “just say no” pill—might be necessary to the legal system in this jurisdiction.

poison pill and how Delaware takeover doctrines have been developed in relation to the pill. Part III explores how the U.S. market for corporate control has survived the “just say no” pill. Part IV describes M&A in the controlling shareholder regime, which most countries outside the two Anglo-American economies adopt. Part V analyzes the Delaware pill’s potential incompatibility with the underlying socio-economic and legal infrastructure in an importing jurisdiction. Part VI explains why, in some countries, a pill might stifle not only hostile takeovers, but also voluntary and friendly deals. One reason is that executive compensation and the sale of control are not conveniently available in those countries. Finally, Part VII provides concluding remarks.

II. EVOLUTION OF THE POISON PILL AND DELAWARE DOCTRINES

Despite federalization in areas such as disclosure rules³⁰ and some areas of corporate governance in the United States, corporations are nonetheless “creatures of state law.”³¹ Because a majority of U.S. public companies are incorporated in the State of Delaware, Delaware statutory and common law governs significant aspects of the takeover landscape in the United States. Therefore, reviewing Delaware doctrines in relation to the poison pill can be valuable for a controlling shareholder jurisdiction considering adopting an American poison pill.

A. The Poison Pill in General: Its Nature and Impacts

Traditionally, the main tool for hostile takeovers is a proxy contest,³² in which an insurgent attempts to obtain control of a target company using the support of colleague shareholders in a directors election. The proxy contest, however, is not an effective method for a would-be acquirer. The proxy machinery is procedurally advantageous for incumbents, so gaining the endorsement of the majority of shareholders is a difficult task for an insurgent. In addition, while a hostile bidder shares the benefits from replacing a less capable management, it is common that she alone bears the

³⁰ For more explanation on mandatory disclosure and its related discussion, see Merritt B. Fox, *Retaining Mandatory Securities Disclosure*, 85 VA. L. REV. 1335 (1999).

³¹ This expression is often used in the context of U.S. corporate governance. See, e.g., *Santa Fe Indus., Inc. v. Green et al.*, 430 U.S. 462, 479 (1977) (“Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”) (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

³² Jack B. Jacobs, *Implementing Japan’s New Anti-Takeover Defense Guidelines—Part I: Some Lessons from Delaware’s Experience in Crafting Fair Takeover Rules*, 2 N.Y.U. J. L. & BUS. 323, 328 (2006).

entire cost of the proxy fight and future managerial efforts.³³

Understanding the disadvantages associated with a proxy contest, hostile bidders mainly used tender offers from the 1960s. Reliance on tender offers was further strengthened by financial innovations, such as a developed junk bond market, in which even a bidder with limited financial resources could raise capital to purchase a large fraction of a target's stocks. In this respect, the takeover arena was changed from an "election" to a "market," wherein a would-be acquirer could bypass a target corporation's board by dealing directly with individual shareholders.³⁴

With the advent of the "poison pill" in the 1980s—the colloquial name for various "shareholder rights plans"—tender offers made without other acquisition maneuvers became powerless.³⁵ A poison pill can be adopted by a board's resolution without shareholders' approval.³⁶ With a pill, target shareholders other than the potential acquirer are entitled to purchase additional securities of a company³⁷ at a bargain price.³⁸ The rights become exercisable when a specified triggering event takes place,³⁹ such as the acquisition of 20% of the target's stock by a third party. Since the potential exercise of the pill would massively dilute the value of the target stock a bidder proposes to acquire, she is discouraged from making a bid in the first place.⁴⁰ Thus, if a bidder were still interested in the acquisition of a target,

³³ For a general explanation of an insurgent's difficulties in a proxy contest, see Lucian A. Bebchuk, *The Myth of Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

³⁴ Discussions with Jeffrey N. Gordon, Professor, Columbia Law School, in N.Y.C., N.Y. (discussing corporate law during author's J.S.D. studies at Columbia Law School, 2010–2011).

³⁵ The official name for a poison pill is the "shareholder rights plan." STEPHEN M. BAINBRIDGE, *CORPORATE LAW* 379 (2d ed. 2008); see also CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS* 779–80 (5th ed. 2006) (noting that poison pills "make takeovers more difficult, time consuming, and expensive for an acquirer unless the acquirer negotiates with the target's board of directors" and that "a tender offer against a poison pill can be prohibitively expensive.").

³⁶ BAINBRIDGE, *supra* note 35, at 379; RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 747 (2d ed. 1995) ("A central characteristic of a poison pill plan is that shareholder approval is not required for adoption.").

³⁷ Depending on the types of securities involved, a poison pill can be classified either as the flip-over feature (in which securities are a bidding company's shares) or as the flip-in provision (in which securities are a target company's shares). O'KELLEY & THOMPSON, *supra* note 35, at 779–80.

³⁸ JEFFREY D. BAUMAN, *CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS* 1086 (7th ed. 2009) (noting that target shareholders can purchase securities "at a significant discount from prevailing market price"); MELVIN A. EISENBERG, *CORPORATIONS AND OTHER ORGANIZATIONS: CASES AND MATERIALS* 1118 (9th ed. 2005) (noting that target shareholders can purchase securities "at a deep discount.").

³⁹ See BAUMAN, *supra* note 38.

⁴⁰ See EISENBERG, *supra* note 38, at 1118; see also Bebchuk, Coates IV & Subramanian,

she would be compelled to negotiate with the target's board on the terms of a bid.⁴¹ If consent is not reached in that negotiation, the only way for the bidder to take control of the target is to wage a proxy contest with the incumbent management.⁴² In this sense, the advent of a pill changed the arena of a takeover from a "market" to an "election."⁴³

In terms of impacts on corporate governance brought by the poison pill, there are two contrasting views. One view is that a pill can be used to protect shareholders. As *Unocal Corp. v. Mesa Petroleum Co.*⁴⁴ implies, dispersed shareholders are afraid of ending up with worse payoffs if they reject an initial tender offer.⁴⁵ Unorganized shareholders are stampeded by a hostile bidder to accept even a lowball bid.⁴⁶ With a pill, this coercion could be prevented to a large extent because the pill requires a prospective bidder to negotiate with the target board that acts as a centralized agent on behalf of the shareholders.⁴⁷ In addition, the premium from a takeover can be enhanced for the shareholders' benefit.

On the other hand, the pill could worsen the managerial agency problem.⁴⁸ With the pill, a hostile bidder may find it difficult—if not impossible—to prevail in a takeover battle, even if she is welcomed by

supra note 25, at 904 ("[T]he resulting dilution . . . may make the acquisition of the target through market purchases too expensive to pursue."); William B. Chandler III, *Hostile M&A and the Poison Pill in Japan: A Judicial Perspective*, 2004 COLUM. BUS. L. REV. 45, 49 (2004) (noting that a triggered poison pill would result in "a massive dilution of an acquiring entity's stock position, thus making it prohibitively more expensive to complete the acquisition."). However, "[a]ll rights plans have a provision that enables the board to 'redeem' the rights even after they are triggered, for a very nominal sum (say, one penny per share)." Jacobs, *supra* note 32, at 338.

⁴¹ See Hamilton, *supra* note 4, at 358 ("[Due to the poison pill], in the United States today, takeover bids are usually negotiated acquisitions rather than truly external bids.").

⁴² Gordon, *supra* note 34.

⁴³ *Id.*

⁴⁴ 493 A.2d 946 (Del. 1985).

⁴⁵ See *id.* at 956 ("It is now well recognized that such [two-tiered coercive] offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.").

⁴⁶ *Id.*

⁴⁷ "[Shareholders' rights] plans are an example of lawyers using general powers in a new way to make takeovers more difficult, time consuming, and expensive for an acquirer unless the acquirer negotiates with the target's board of directors." O'KELLEY & THOMPSON, *supra* note 35, at 779.

⁴⁸ In a corporation, managers have decision-making power. The managerial agency problem arises from the fact that managers, who are agents of shareholders, can use this power for their own interests and at the expense of shareholders. For a general explanation of agency problems, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

most shareholders of a target corporation.⁴⁹ Even worse, in a corporation without a poison pill, it takes only a few hours for a board to adopt a pill because shareholder approval is not necessary—all that is required is a board meeting and subsequent board approval.⁵⁰ Put differently, every corporation *inherently* has a shareholder rights plan—although not at the time of a hostile bid—in the form of a “shadow” pill.⁵¹ As Professor Grundfest articulates, the hostile takeover wars are now over, and management has won.⁵² Although disgruntled shareholders and the prospective acquirer have an opportunity to replace the board through a proxy fight, it is an uphill battle since a proxy fight is both cost-inefficient and time-consuming. As such, the poison pill works as a near-impermeable armor that insulates incumbent management from the threat of hostile takeovers.

B. *Unocal*'s Proportionality Test: Intermediate Standard and Harbinger of the Pill

By the mid-1980s, when the wave of hostile takeovers reached its peak, Delaware courts had a doctrinal dilemma in takeover cases. Under the business judgment presumption,⁵³ a court was not permitted to second-guess the legality of a board's decision unless a plaintiff rebutted the presumption.⁵⁴ This highly deferential standard in favor of the board⁵⁵ could have over-protected directors who were inherently involved in the

⁴⁹ Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 858 (1993).

⁵⁰ See John Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 286–87 (2000).

⁵¹ *Id.* at 288 (“Another way of putting the point is that once the Delaware Supreme Court made it clear in *Moran v. Household International* that pills were legitimate, all Delaware firms . . . have had a shadow pill in place, witting or not.”).

⁵² Grundfest, *supra* note 49, at 858 (“The takeover wars are over. Management won. Although hostile tender offers remain technically possible, the legal and financial barriers in their path are far higher today than they were a few short years ago. As a result, it will be difficult for hostile bidders to prevail in takeover battles, even if shareholders support the insurgents' efforts. Future acquisitions will therefore more frequently involve consensual transactions.”).

⁵³ The business judgment rule is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

⁵⁴ For more explanation on the business judgment rule, see S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

⁵⁵ “[T]he business judgment rule means that courts will not decide (or allow a jury to decide) whether the decisions of corporate boards are either substantively reasonable by the ‘reasonable prudent person’ test or sufficiently well informed by the same test.” ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 12, at 228.

“omnipresent specter”⁵⁶ of the agency problem, particularly in M&A cases where managers and directors would lose their jobs.⁵⁷ In contrast, under the entire fairness review,⁵⁸ directors and managers had to prove that the transaction was entirely fair to the corporation in terms of both the process and the price.⁵⁹ Under this stringent doctrine, the board could not have implemented defensive devices against potentially coercive two-tiered offers for fear that the defense would be invalidated.⁶⁰ Without any defensive device, shareholders would be worse off.

Recognizing these problems, the Delaware Supreme Court, in *Unocal*, put forward an “intermediate (or proportional) standard,” compromising the two traditional standards of review.⁶¹ Under the *Unocal* standard, the board must demonstrate that a takeover bid generated “reasonable grounds for believing that a danger to corporate policy and effectiveness existed”⁶² and that the defensive measure adopted was “reasonable in relation to the threat posed.”⁶³ After satisfying these conditions, the board’s conduct in a hostile takeover may then be evaluated under the business judgment rule.⁶⁴

It is noteworthy that *Unocal* itself had nothing to do with a poison pill.⁶⁵ In *Unocal*, the target (Unocal Corp.) implemented a self-tender as a defense tactic, excluding only Mesa Petroleum, an unwanted suitor, so that Mesa’s economic interest would be massively diluted.⁶⁶ Fearful of this economic damage, Mesa was deterred from closing in to complete a hostile takeover and ultimately brought suit.⁶⁷ The court held that Unocal’s selective self-tender satisfied the two-pronged proportionality test, and the court legitimized the board’s conduct of discriminating against an insurgent

⁵⁶ The *Unocal* court was concerned about the “omnipresent specter that a board may be acting primarily in its own interest rather than those of the corporation and its shareholders.” *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

⁵⁷ John Armour, Jack B. Jacobs & Curtis J. Milhaupt, *The Evolution of Hostile Takeover Regimes in the Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT’L L.J. 219, 244 (2011).

⁵⁸ As for the entire fairness review, see *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

⁵⁹ *Id.* at 711; see also Armour, Jacobs & Milhaupt, *supra* note 57 at 244.

⁶⁰ See Armour, Jacobs & Milhaupt, *supra* note 57, at 244 n.114.

⁶¹ *Unocal*, 493 A.2d at 955.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ See *id.* at 958; O’KELLEY & THOMPSON, *supra* note 35, at 777.

⁶⁵ See *Unocal*, 493 A.2d at 949 (“We confront an issue of first impression in Delaware—the validity of a corporation’s self-tender for its own shares which excludes from participation a stockholder making a hostile tender offer for the company’s stock.”). The issue in *Unocal* was whether a corporation’s discriminatory self-tender, rather than a poison pill, was valid.

⁶⁶ *Id.* at 950–51.

⁶⁷ *Id.*

shareholder in the takeover context. After *Unocal*, the Securities and Exchange Commission (SEC) promulgated Rule 14d-10, prohibiting selective self-tenders.⁶⁸ Nonetheless, the “general principle” articulated in *Unocal* has been unchanged: an anti-takeover device discriminating against a hostile bidder/shareholder could be allowed as long as the proportionality test is passed, unless that device is a selective self-tender. In this manner, *Unocal* paved the way for approving the legality of a poison pill, which is dependent upon discriminatory treatment among shareholders.⁶⁹

C. The Evolution of the Poison Pill to the “Just Say No” Defense

In the same year *Unocal* was decided, the Delaware Supreme Court, in *Moran*, upheld the legality of a (flip-over) poison pill.⁷⁰ The underlying reasoning was that the two-pronged proportionality test was satisfied and a (prospective) bidder could still rely on a proxy contest through which a newly-elected board could redeem the pill.⁷¹ A few years later, the Delaware Chancery Court opined in *City Capital Associates v. Interco Inc.*⁷² that a target board had to redeem a poison pill if it was used against a *non-coercive* tender offer.⁷³ Accordingly, the shareholders’ right to sell their shares was restored without the obstacle of a continued pill, unless they were coerced by a bid. A corporate raider was another beneficiary of the case, since under *Interco* she gained a substantial chance to triumph in a hostile takeover without relying on a highly burdensome proxy contest.

The *Interco* regime, however, was soon struck down by the Delaware Supreme Court in *Paramount Commc’ns v. Time Inc.*⁷⁴ Although Paramount announced an all-cash 100% non-coercive tender offer for Time

⁶⁸ See Equal Treatment of Security Holders, 17 C.F.R. § 240.14d-10 (2006); O’KELLEY & THOMPSON, *supra* note 35, at 778.

⁶⁹ Discussions with Katharina Pistor, Professor, Columbia Law School, in N.Y.C., N.Y. (discussing corporate law during author’s J.S.D. studies at Columbia Law School, 2010–2011).

⁷⁰ *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1348 (Del. 1985). As Professors O’Kelley and Thompson note, some courts in the United States have found poison pills discriminatory and illegal. O’KELLEY & THOMPSON, *supra* note 35, at 787. “However, in each case in which a court has challenged the board’s authority to enact a poison pill, the affected state’s legislature has followed with a statute authorizing the pills. Indeed, many states have enacted statutes even if there has not been an invalidating judicial decision in that jurisdiction.” *Id.*

⁷¹ See generally *Moran*, 500 A.2d 1346. In this sense, it can be said that after *Moran* the Delaware court expressed preference for the “election” over the “market” as a solution for the conflict generated in a corporate control contest.

⁷² 551 A. 2d 787 (Del. Ch. 1988). As to the *Interco* pill’s relative deterrence power, see *infra* notes 213–218 and accompanying text.

⁷³ See Bebhuk, Coates IV & Subramanian, *supra* note 25, at 905–06.

⁷⁴ 571 A.2d 1140 (Del. 1989).

at a substantial premium,⁷⁵ Time's board refused to redeem a pill, asserting that the price was inadequate. Reviewing this case, the Delaware Supreme Court stated that the "threat" examined in the *Unocal* test included shareholders' "ignorance or mistaken belief" of the strategic benefit from a target board's favored business combination (i.e., the Time-Warner merger).⁷⁶ These statements seem to be based on the notion that a target board may know more than the market does.⁷⁷ Accordingly, a "wise" board, which is assumed to be a faithful agent who cares primarily for shareholders' interest, is allowed to force "foolish" shareholders not to sell their shares to the unwanted bidder. In other words, a board can "just say no"⁷⁸ to redeem the pill even in a non-coercive and high-premium bid.

III. HOW DEALS SURVIVE UNDER "JUST SAY NO" IN THE UNITED STATES

So far, the "just say no" pill in *Time* has remained valid in Delaware takeover law.⁷⁹ This Part first sketches the pill's two safety valves,⁸⁰ and then explains how an effective staggered board⁸¹ can render a ballot box's safety valve powerless. This Part further explains a puzzling U.S. phenomenon: M&A activities have thrived despite the highly potent defensive combination of a poison pill and a staggered board.

⁷⁵ The final bid price reached \$200 per share for Time, while the stock price of Time before Paramount's initial bid was only \$126 per share. *Id.* at 1147, 1149.

⁷⁶ Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 523 (1997); see also *Time*, 571 A.2d at 1147.

⁷⁷ Under the semi-strong version of efficient market hypothesis, "the stock market price of an actively traded company's stock will reflect all relevant *publicly* available information." STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 32-33 (3d ed. 2012). Thus, it is possible that the price of a corporation's stock does not reflect inside information that the corporate insiders know but the market does not know. In this sense, it is known that under the semi-strong version, the market price of a corporation's stock could be inaccurate from the eyes of corporate insiders.

⁷⁸ While the "just say no" pill can theoretically be defeated, there is no empirical support for such a possibility. See Bebchuk, Coates IV & Subramanian, *supra* note 25, at 906 ("While Delaware jurisprudence does not say that courts will never order the redemption of a poison pill, there has not been since *Time* a single case in which redemption of a pill was ordered by a Delaware court. Thus, as a practical matter, a bidder has had to assume in planning a bid that a target could 'just say no' and retain a pill unless and until the bidder obtained majority control of the target's board.").

⁷⁹ As noted, most public corporations in the United States are incorporated in Delaware. See generally Kahan & Kamar, *supra* note 3. Thus, Delaware takeover law plays a key role in U.S. takeover law.

⁸⁰ Commentators widely use the term "safety valves," which refer to the limitations of "just say no." See generally Bebchuk, Coates IV & Subramanian, *supra* note 25.

⁸¹ As for an effective staggered board, see *id.*

A. Two Safety Valves and “Just Say No”

Under the *Time* regime, the shareholders’ only recourse in the face of a board’s “just say no” pill is to replace the existing directors.⁸² In fact, this is why the pill satisfies the proportionality test and is legitimate. Although a board can refuse an acquisition by using a pill that blocks transactions between a prospective acquirer and shareholders, ultimately shareholders can make the final and fundamental decision on the M&A via their confidence votes for an incumbent board.⁸³ This ballot box safety valve keeps the “just say no” pill in check. Thus, maintaining the shareholders’ franchise unscathed is the essential foundation for the legality of a poison pill. In this respect, *Blasius Industries, Inc. v. Atlas Corp.*⁸⁴ is important. In the specific context of a contested election for directors, a board has the burden of demonstrating a compelling justification for its defensive actions, if the primary purpose of such actions is to interfere with the effectiveness of the shareholders’ franchise.⁸⁵

Another safety valve available to shareholders for the “just say no” pill is proposed in *Revlon, Inc. v. MacAndrews & Forbes*.⁸⁶ When a board is to abandon its independence and enter into particular modes such as selling a company, breaking it up, or selling control (all of which are irreversible for shareholders), the board’s decision on the takeover defense strategy is subject to the *Revlon* standard, which is more stringent than *Unocal*.⁸⁷ Now the board’s role must change from a defender of a corporation to a neutral auctioneer charged with the duty to maximize the sale price of a corporation for the shareholders.⁸⁸ A board’s discretion as to whether to take into consideration the stakeholders such as “creditors, customers, employees, and perhaps even the community generally” (as was argued in *Unocal*)⁸⁹ no longer exists in *Revlon*, under which shareholder wealth maximization is the board’s only goal.

B. How Safety Valves Have Been Weakened

The *Revlon* duty was further developed in *Paramount Commc’ns, Inc.*

⁸² Gordon, *supra* note 76, at 523.

⁸³ For example, relying on the Court of Chancery, the Supreme Court of Delaware explains that a pill does not limit shareholders’ voting power. *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985).

⁸⁴ 564 A.2d 651 (Del. Ch. 1988).

⁸⁵ *Id.* at 661; Discussions with Curtis J. Milhaupt, Professor, Columbia Law School, in N.Y.C., N.Y. (discussing corporate law during author’s J.S.D. studies at Columbia Law School, 2010–2011).

⁸⁶ 506 A.2d 173 (Del. 1986).

⁸⁷ *See id.* at 182.

⁸⁸ *Id.*

⁸⁹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

v. QVC Network.⁹⁰ Nonetheless, Delaware courts have rarely recognized the *Revlon* duty.⁹¹ In practice, the ballot box (*Blasius*) safety valve imposes only limited constraints on management's "just say no" defense. As discussed, since the proxy contest is far more advantageous to an incumbent than a challenger, shareholder voting does not precisely reflect the will of shareholders on the control contest issue. In addition, since shareholder meetings usually take place once a year, a prospective acquirer has to adhere to a particular timeframe in order to mount a proxy fight. Therefore, a prospective acquirer may give up taking part in the corporate control contest in the first place if the timing is not favorable.⁹²

Perhaps the most powerful device to nearly incapacitate the ballot box safety valve is a staggered board⁹³ implementing a poison pill. When a board is staggered based on a charter provision, both a shareholder approval and a board resolution are necessary in order to dismantle the staggered board. Since a staggered board usually consists of three classes,⁹⁴ a hostile bidder is required to win two proxy contests in a row in order to take control of the board. Then the board, which is under control of the hostile bidder, will redeem a poison pill. Thus, an incumbent has more incentives to fight since it can successfully fend off a hostile bid by winning only one of two consecutive elections.⁹⁵ In addition, winning two consecutive elections means that it will take more than a year for a prospective acquirer to take control of a target. Since expediting a takeover process is key in terms of reducing uncertainty, this protracted timetable discourages a bidder from initiating a hostile takeover in the first place.⁹⁶ For the foregoing reasons, a staggered board—if it is not dismantled or "packed" by an

⁹⁰ 637 A.2d 34 (Del. 1994). Under *QVC*, if the control is transferred from public dispersed shareholders (i.e., the market) to a single person, entity, or group, the *Revlon*-mode is triggered and a board has to discharge its fiduciary duty to sell the company to the bidder with the highest value reasonably available. *Id.* at 43.

⁹¹ Pistor, *supra* note 69.

⁹² See Gordon, *supra* note 76.

⁹³ ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 12, at 156 ("Each year, holders of voting stock elect either the whole board, when there is a single class of directors, or some fraction of the board. For example, shareholders elect one-third of the board annually when the charter provides for a 'staggered' or 'classified' board made up of three 'classes' of directors, each serving three-year terms.").

⁹⁴ See, e.g., DEL. CODE ANN. tit. 8, § 141(d) (2010).

⁹⁵ Under a staggered board with three classes, if a hostile bidder wins the first year proxy contest, she can replace one third of the target board. After that, if the incumbent wins the second year proxy contest, the hostile bidder still maintains only one third of the target board. At this moment, the hostile bidder is likely to give up the third year proxy contest for mainly two reasons. First, the bidder is not sure whether she will win the third year proxy contest. Second, even if the bidder ultimately wins, too much time and resources would be spent in order to acquire the target, which is inefficient to the bidder.

⁹⁶ See generally Bebchuk, Coates IV & Subramanian, *supra* note 25.

insurgent within a year⁹⁷—is referred to as an effective staggered board (ESB), which makes a corporation almost invincible when it adopts a pill.⁹⁸

C. How M&A Activities Survive: Golden Parachutes and Equity-Based Compensation

A great number of U.S. corporations were exposed to the threat of hostile takeovers in the 1980s. Soon after the “just say no” defense was firmly established in Delaware jurisprudence, however, the wave of hostile takeovers ebbed. A careful board that was advised by good lawyers and investment bankers could figure out how to avoid triggering *Blasius* and *Revlon* standards under which defensive conduct would be reviewed more stringently than under the deferential *Unocal* (or the even more watered-down *Unocal/Unitrin*⁹⁹) standard. Furthermore, a target became impenetrable with the combination of an ESB and the “just say no” pill. Interestingly, however, the market for corporate control has flourished. Since the middle of the 1990s, the nature of M&A has become “friendly.”¹⁰⁰ To corporate insiders, being acquired was a disaster until the 1990s—as a result of an acquisition, corporate insiders lost jobs, high compensation and perquisites, and psychic utility¹⁰¹ from running a company. In order to avoid these losses, a target management objected to bids even though the price and terms were attractive to shareholders. The “omnipresent specter”¹⁰² of the agency problem weakened the mechanism of a hostile takeover, which was a market device to discipline corporate insiders.

However, the evolution of executive compensation changed this situation. The typical executive’s compensation is chiefly composed of a salary, a bonus, and equity-based compensation (e.g., stock options).¹⁰³ In the 1990s, stock options became one major component of the executive compensation.¹⁰⁴ The idea behind this development was to redress the

⁹⁷ *Id.* at 894.

⁹⁸ *Id.* at 899.

⁹⁹ See *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

¹⁰⁰ Kahan & Rock, *supra* note 7, at 880 (quoting Joseph H. Flom, *Merger & Acquisitions: The Decade in Review*, 54 U. MIAMI L. REV. 753, 761–72 (2000)).

¹⁰¹ While corporate insiders run corporations, they enjoy psychic utility since their position comes with social prestige, reputation, and social influence, including political power. “Psychic utility” and “non-pecuniary benefits of control” are used interchangeably in this Article. As for non-pecuniary benefits, see Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1661–73 (2006).

¹⁰² *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

¹⁰³ As for executive compensation and its problems, see generally Bebchuk & Fried, *supra* note 26.

¹⁰⁴ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–*

agency problem by aligning the interests of executives and shareholders—if management performed well and stock price went up, management as well as shareholders benefited from the increased stock price. It is well known that stock options based on such high-powered incentives were supported by tax and accounting rules. The end result was an explosive increase in a typical executive compensation package during the 1990s, when the stock market was prosperous.¹⁰⁵

During this period, a generous severance package, or “golden parachute,” was developed as well.¹⁰⁶ A typical golden parachute provided a departing executive with the average bonus of prior years as well as three times of the executive’s salary.¹⁰⁷ In addition, in the case of a change-in-control transaction, the parachute also included the accelerated vesting of stock options that had been granted but were not yet vested.¹⁰⁸ In other words, an executive in a target corporation could receive substantial gains in the event of a premium acquisition¹⁰⁹ even though the executive made no contribution to the acquisition.¹¹⁰ As a result, management did not fiercely oppose being acquired; rather, management started to acquiesce to or welcome deals.¹¹¹ When personal benefits were large enough, management had a strong incentive to use defense devices as a bargaining tool in order to sell a corporation at a higher price.¹¹²

IV. THE CONTROLLING SHAREHOLDER REGIME AND THE MARKET FOR CORPORATE CONTROL

To this point, this Article has analyzed the doctrines and precedents

2005: *of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1530–31 (2007). “Executives can reap substantial financial benefits from stock options when their company is acquired in a premium bid. These benefits are multiplied by golden parachutes, which provide for severance payments, benefits, early vesting of pension rights, and accelerated vesting of unvested options.” Kahan & Rock, *supra* note 7, at 884.

¹⁰⁵ Gordon, *supra* note 104, at 1530–31.

¹⁰⁶ Golden parachutes emerged in the 1980s in response to hostile takeovers. See Jeffrey N. Gordon, “Say on Pay”: *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 331 (2009).

¹⁰⁷ Gordon, *supra* note 104, at 1533.

¹⁰⁸ *Id.* at 1533–34.

¹⁰⁹ Bebchuk, Coates IV & Subramanian, *supra* note 25, at 908; Kahan & Rock, *supra* note 7, at 884.

¹¹⁰ An outside bidder is able to offer a high-premium bid since she believes the current stock price of the target is undervalued. The target’s underperforming management team may be the reason for the target’s depressed stock price. Nonetheless, the target’s management team will benefit from golden parachutes and equity-based compensation if an M&A deal is consummated. However, if a high-premium bid is the result of negotiation, it can be said that the target management contributes to the highball bid.

¹¹¹ See Gordon, *supra* note 104, at 1534; Kahan & Rock, *supra* note 7, at 896.

¹¹² See Bebchuk, Coates IV & Subramanian, *supra* note 25, at 908.

relating to hostile takeovers and defenses in Delaware. Against this backdrop, this Part discusses the potential consequences for the M&A market if the controlling shareholder regime implements a poison pill in its corporate law system.

A. The Controlling Shareholder Regime and Takeover Defense

Based on ownership structures, the world economy is classified into two groups: (1) the dispersed shareholder regime found in the United States and United Kingdom, where the control of a public corporation is generally in the hands of public shareholders; and (2) the controlling shareholder regime in which a single person (or a group of dominant shareholders) can exercise effective voting control, not necessarily with corresponding equity holdings.¹¹³ Companies with a controlling shareholder are the dominant form among publicly traded firms in most countries outside these two Anglo-American economies.¹¹⁴ Until recently, M&A (particularly that which is initiated by a hostile bid) has been considered a phenomenon localized in the two dispersed shareholder economies.

As globalization developed and spread, corporate insiders in the rest of the world gradually came under pressure from the market for corporate control. For instance, in Japan, Livedoor and Steel Partners initiated hostile takeover bids, with Livedoor bidding on Fuji TV and Steel Partners bidding on Yushiro Chemical Industries and Soto.¹¹⁵ In Germany, Vodafone (headquartered in the United Kingdom) successfully took over Mannesmann.¹¹⁶ In Korea, Sovereign Asset Management—a foreign fund—almost caused one of Korea’s largest conglomerates, SK Group, to collapse while gaining massive profits from their hostile attack.¹¹⁷

¹¹³ Gilson, *supra* note 101, at 1643.

¹¹⁴ Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research* 14 (John M. Olin Ctr. for Law, Econ., & Bus., Harvard Law School, Discussion Paper No. 652, 2009), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_652.pdf.

¹¹⁵ Curtis J. Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 COLUM. L. REV. 2171, 2178–80 (2005). Steel Partners’ tender offer for Bull-Dog Sauce is another example of hostile takeover attempts in Japan. See Armour, Jacobs & Milhaupt, *supra* note 57, at 255.

¹¹⁶ *Vodafone Seals Mannesmann Deal*, BBC NEWS (Feb. 11, 2000), <http://news.bbc.co.uk/2/hi/business/630293.stm>.

¹¹⁷ See *infra* notes 143–148 and accompanying text; see also Press Release of Sovereign Global Investment, *Sovereign Seeks Reform at SK Corporation* (Apr. 14, 2003), http://www.sovereignglobal.com/4_1_1en.asp?ItemID=6 (“Crest Securities Limited recently became the single largest shareholder in SK Corporation (‘SKC’). Crest Securities Limited is a wholly owned subsidiary of Sovereign Asset Management Limited (‘Sovereign’) based in Monaco. Sovereign is a long-term investor without any affiliation to SKC’s existing shareholders or management. It is making this statement in response to media interest regarding the purpose of the investment in

Accordingly, there has been a growing concern within business circles about the expansion of corporate control contests because business elites themselves will be the most apparent victims in hostile takeovers. Since the changed rules in the corporate control game may generate adverse impacts on economic and political stability (such as massive layoffs due to acquisitions of domestic firms), governments have become more wary about this global trend and have made attempts to redesign anti-takeover systems. Local business lobbies strengthen such government movements.

In this respect, importing the Delaware poison pill system could be an attractive solution to relieve the fear of potential hostile takeovers, since the pill is an effective and less costly defensive device. Above all, as proven by U.S. takeover history, a pill makes a company *almost* takeover-proof.¹¹⁸ In addition, as mentioned above, a pill does not require shareholders' approval—only a board's resolution is necessary.¹¹⁹ Thus, a company can adopt a pill very quickly, such as when a company notices “abnormal” movement in a stock market via early warning systems, such as 13D filings. Moreover, a pill does not affect any significant strategic business plans or the financial status of a company beyond deterring a hostile takeover.¹²⁰

Suppose that a pill is not available in a particular jurisdiction. Facing a hostile bid, a target company could, for example, sell to a third party an important asset that a hostile bidder is interested in acquiring. Alternatively, a target could issue debt securities or assume obligations so that the capital structure of the firm is significantly changed. The target is then no longer the attractive firm that the prospective acquirer had pursued. As a result, the target can preserve its independence. The problem, however, is that the target corporation is harmed as well by its own decision to sell the crown jewels (sometimes at a fire sale price) or to change the capital structure since such defensive strategies would depress firm value and damage business opportunities in the future. In contrast, the effect of adopting a poison pill is either to deter a hostile bid or to negotiate the terms of acquisition without damaging the target itself.

B. Dominant Shareholders: Their Identity and Ownership Structure

As explained, amid the changing M&A landscape, dominant shareholders in controlling shareholder regimes have made attempts to neutralize hostile bids by adopting new defensive measures in their jurisdictions. Before analyzing the anticipated consequences of adopting a poison pill in such a jurisdiction, this Article starts by describing the

SKC.”).

¹¹⁸ See Kahan & Rock, *supra* note 7, at 875.

¹¹⁹ BAINBRIDGE, *supra* note 35.

¹²⁰ See generally Kahan & Rock, *supra* note 7, at 875.

identities of dominant shareholders. Basically, there are primarily two types of dominant shareholders.¹²¹ One is the government.¹²² For instance, a substantial fraction of Chinese economy is under the direct or indirect control by the Chinese government through state-owned enterprises (SOEs). The other common group of controlling shareholders is families, who are ubiquitous in Asia, Europe, Latin America, and even the United States.¹²³ This Article studies this second group.

Ownership structures that controlling shareholders rely on are important to analyze. The primary factor that determines corporate control is not the economic stake a dominant shareholder holds in a corporation, but the voting power she can exercise.¹²⁴ Until recently, most commentators have analyzed the controlling shareholder system based on a controlled structure (CS) model in which a single shareholder owns a majority or large plurality of a company's shares.¹²⁵ However, the CS model does not cover the ownership structure of all controlled companies.¹²⁶ The other half of the picture can be explained as a controlling-minority structure (CMS), in which a dominant shareholder is able to exercise control over a corporation while holding only a fraction of its equity¹²⁷—for example, while a dominant shareholder may hold only 5% of cash-flow rights, she may still exercise effective control over a company. According to Professors Bebchuk, Kraakman, and Triantis, such a radical separation of voting rights and cash-flow rights can occur in three principal ways: dual-class equity structures, stock pyramids, and cross-ownership ties.¹²⁸

C. Dominant Shareholders and Anti-Takeover Defenses

A dominant shareholder perhaps does not need a pill if she holds “absolute” control (i.e., more than 51% of voting rights). However, many controlling shareholders in the world do not hold absolute control—as long as the rest shareholders are widely dispersed, a shareholder with less than 50% of all votes can control a corporation. In this latter case, a dominant

¹²¹ As for the corporate ownership in the world, see La Porta, Lopez-de-Silanes & Shleifer, *supra* note 20.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ Although the economic stake and voting power are generally related, ultimately it is the voting power that gives a dominant shareholder control over a corporation.

¹²⁵ See Lucian Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 6951, 1999).

¹²⁶ *See id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

shareholder may consider a poison pill to fend off a hostile bid completely.

1. CMS: “Internal Defensive Device”

When a controlling shareholder refuses a high-premium bid that will be beneficial to shareholders as a whole, a controlling shareholder in a CS company has more legitimacy than one in a CMS company. This is because a CS controlling shareholder has a significant holding of economic interest corresponding to her voting rights, while a CMS controlling shareholder wields the control by voting leverage without corresponding economic interest. Also, a CS controlling shareholder is the very person who will lose opportunity cost the most when she does not accept an attractive bid from outside, since her economic interest in a corporation is large. On the other hand, the opportunity cost for a CMS controlling shareholder is minimal by comparison, since her economic interest in a corporation is relatively small.

Consider the CMS in terms of a defense device. Suppose that the top executives in a widely-held U.S. corporation hold 5% of the corporation’s economic interest. Facing a takeover bid, they urge the board to adopt a poison pill. Suppose also that the board agrees with management. Accordingly, the threat is eliminated and executives can continue to manage the corporation. On the other hand, suppose that there is a controlling shareholder in a CMS company outside the United States who holds 5% of the economic interest in the company and wields 51% of voting control. Here, the controlling shareholder, as opposed to the executives, does not need a pill to quell a hostile bid, although the controlling shareholder and executives have the same amount of economic interest in each company. In this sense, the CMS itself is a strong “internal defensive device” similar to a poison pill.

In fact, Germany opposed the European Takeover Directive in June 2000 based on its corporations’ comparative disadvantage in terms of voting power.¹²⁹ The goal of the European Takeover Directive was to lower the barriers for takeovers within the European Union and to establish common standards for such transactions.¹³⁰ To these ends, strict neutrality on the board of a target company was required.¹³¹ Germany believed, however, that its firms were more open to a takeover threat than were firms from France or Scandinavian member states since these countries continued to allow multiple voting rights.¹³² Likewise, the CMS—which has multiple

¹²⁹ CURTIS J. MILHAUPT & KATHARINA PISTOR, *LAW & CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD* 80 (2008).

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.* at 81.

voting rights—is able to block most hostile takeover attempts as an internal defense device of an ownership structure.

2. *Dominant Shareholders Often Do Not Have a Majority of Voting Rights*

As to the definition of “control,” the Second Circuit’s opinion in *Perlman v. Feldmann* is worth noting.¹³³ Feldmann, who held 33% of Newport, planned to sell his holding and shares held by his friends and associates (totaling 37% of the Newport stock) to a third party, Wilport, for a control premium.¹³⁴ The court held, seemingly in opposition to the established principle regarding the sale of control in the United States, that a dominant shareholder may not sell control at a premium if it would exclude non-dominant shareholders from reaping the profits.¹³⁵ Although a crucial point in *Feldmann* is whether non-dominant shareholders are entitled to share in control premiums, this Article emphasizes that the court deemed Feldmann to be a controlling shareholder despite the fact that he held only 33% (or 37% if including the shares of his friends and associates) of outstanding Newport stock. The Panel on Takeovers and Mergers (the Panel) in the United Kingdom, an independent body that supervises and regulates takeovers and other matters, has a similar position.¹³⁶ According to the Panel, “30% of the voting rights of a company is treated by the Code as the level at which effective control is obtained.”¹³⁷

When the rest of the shareholders are widely-dispersed and do not collaborate to form one opposing group, a shareholder with less than a majority of votes can exercise control more easily. It is true, however, that this controlling shareholder is exposed to the potential threat of a hostile takeover, unlike a controlling shareholder with 51% of voting rights, who can absolutely defend her controlled corporation. Thus, a controlling shareholder with less than a majority of votes may be interested in a new anti-takeover device, such as a poison pill, and may urge the government, legislature, or judiciary to adopt a new law that allows the implementation of a pill in a target company.

3. *A Tale of Two Cities: Hostile Takeover Attempts in Tokyo and Seoul*

It is worthwhile to study two takeover attempts in Japan and Korea. In these countries, business groups are dominant players in their economies

¹³³ *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955).

¹³⁴ *Id.* at 174.

¹³⁵ *Id.* at 178; see also Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 793–94 (2003).

¹³⁶ Home, THE TAKEOVER PANEL, <http://www.thetakeoverpanel.org.uk/> (last visited Mar. 30, 2013).

¹³⁷ See *The Code (Including Downloads)*, THE TAKEOVER PANEL, <http://www.thetakeoverpanel.org.uk/the-code/download-code> (last visited Mar. 30, 2013).

and until recently hostile takeovers were almost nonexistent. In February 2005, Japanese internet service provider Livedoor (whose CEO was Takafumi Horie), initiated a takeover bid for Nippon Broadcasting System, Inc. (Nippon Broadcasting) when Livedoor owned roughly 38% of Nippon Broadcasting's stock.¹³⁸ Nippon Broadcasting was a subsidiary of Fuji Television Network, Inc. (Fuji TV), which is the virtual headquarters of the Fuji Sankei media group. Interestingly, Nippon Broadcasting, a subsidiary of Fuji TV, held 22.5% of Fuji TV's shares, while Fuji TV held only 12.4% of Nippon Broadcasting's shares.¹³⁹ As a defense measure, Nippon Broadcasting considered issuing warrants to Fuji TV in order to strengthen Fuji TV's control position and dilute Livedoor's stake.¹⁴⁰ Livedoor sued to enjoin this defensive measure, and the courts (Tokyo District Court and the High Court) ruled in favor of Livedoor.¹⁴¹ As a result, Livedoor obtained a controlling interest in Nippon Broadcasting. Eventually this battle for control was resolved peacefully. Livedoor sold its Nippon Broadcasting shares to Fuji TV, and in return Fuji TV obtained a fractional stake in Livedoor for a capital infusion.¹⁴²

A more dynamic episode took place in Seoul, South Korea, where controlling family shareholders commonly use intra-shareholding for their control in *chaebols* (business groups). In April 2003, Sovereign Asset Management Limited (Sovereign)¹⁴³ acquired 14.9% of the outstanding shares of SK Corporation (SKC), the largest oil refiner in Korea.¹⁴⁴ SKC was important strategically because it was the de facto holding company in SK Group and a large shareholder of SK Telecommunication (SKT), the largest telecommunication company in Korea.¹⁴⁵ According to Korean

¹³⁸ Milhaupt, *supra* note 115, at 2179.

¹³⁹ *Id.* at 2178.

¹⁴⁰ *Id.* at 2179.

¹⁴¹ *See id.* at 2179–80.

¹⁴² *Id.* at 2180.

¹⁴³ Sovereign was founded by New Zealanders Richard and Christopher Chandler. Sang-Bae Lee, *Hanguk tteonan Sovereign, Eotteon Hoesainga?* (한국 떠난 소버린, 어떤 회사인가?) [*Sovereign Is Leaving—What Kind of Corporation Is Sovereign?*], Meonitudei (머니투데이) [MONEY TODAY] (Aug. 23, 2005), (S. Kor.), <http://www.mt.co.kr/view/mtview.php?type=1&no=2005082311393489289&outlink=1>. Sovereign is a private investment institution investing in Asia, Eastern Europe, Latin America. *See id.*

¹⁴⁴ Young-Han Ji, *Sovereign 15% Jibun Budam “Sangsangchowol”* (소버린 15%지분 부담 “상상초월”) [*Burden of SK Telecommunication Will Be “More than Imaginable” If Sovereign Acquires More Than 15% of SK Corporation*], NAVER (Apr. 16, 2003), (S. Kor.), <http://news.naver.com/main/read.nhn?mode=LSD&mid=sec&sid1=101&oid=018&aid=0000026625>.

¹⁴⁵ SK Group is one of the largest corporate groups in Korea. As of 2012, SK Group is the sixty-fifth largest business entity in the world. *See Global 500—Our Annual Ranking of the World's Largest Corporations*, CNN MONEY (July 23, 2012),

law,¹⁴⁶ if Sovereign (a foreign fund) had acquired an additional 0.1% (i.e., 15%) of SKC's stock, SKC would have been deemed a foreign entity and would have lost its voting power on SKT.¹⁴⁷ Then, the entire business group (SK Group) could have virtually collapsed because complex chains of intra-shareholding between SKC and SKT could have been destroyed.¹⁴⁸

In this "tale of two cities," Livedoor's CEO Takafumi Horie was a Japanese citizen, whereas Sovereign was a foreign entity. In Japan, however, the presence of a "maverick" such as Horie, who does not follow Japanese business custom,¹⁴⁹ was deemed to be the result of globalization (more exactly, Americanization).¹⁵⁰ In addition, Japanese authorities became seriously concerned about more hostile takeover attempts from abroad. For example, Keidanren (a powerful Japanese business lobby) called for developing defensive measures to prevent "foreign predators" from taking control in Japan.¹⁵¹ In response, the Japanese government postponed a planned corporate law amendment that would give foreign business entities more leeway in M&A transactions.¹⁵² In Korea, after SK Group's experience, the business community, politicians, and the government proposed and considered legitimizing a poison pill in its corporate law.¹⁵³ They argued that it was unfair that Korean corporations were exposed to hostile takeover battles while foreign entities had full defensive measures including the pill.¹⁵⁴ Thus, an effective defensive

http://money.cnn.com/magazines/fortune/global500/2012/full_list/index.html.

¹⁴⁶ See Jeongitongsinsaepjabeob [Telecommunications Business Act] (S. Kor.); Jeongitongsinsaepjabeob Sihaengryeong [Enforcement Decree of the Telecommunications Business Act] (S. Kor.).

¹⁴⁷ See, e.g., Ji, *supra* note 144.

¹⁴⁸ See *id.*

¹⁴⁹ Before Livedoor's takeover attempt by Horie, there had been virtually no hostile takeovers in Japan. Many Japanese business and political leaders criticized Horie, since they believed that he used an undesirable foreign practice—hostile takeovers—that is inconsistent with Japanese sensibilities. See generally Milhaupt, *supra* note 115, at 2182.

¹⁵⁰ "Livedoor's unsolicited bid . . . marked [a] major departur[e] from the norm in the world of Japanese takeovers. As such, [it] generated a welter of controversy by creating the impression that a new brand of 'American' capitalism was infiltrating Japan." *Id.* at 2181–82.

¹⁵¹ MILHAUPT & PISTOR, *supra* note 129, at 92.

¹⁵² *Id.*

¹⁵³ See, e.g., Jung-a Song, *South Korea Considers Use of 'Poison Pills'*, FIN. TIMES (Nov. 9, 2009), <http://www.ft.com/intl/cms/s/0/c7ae4b6e-ccf0-11de-a748-00144feabdc0.html#axzz2JG1LwdeC>; Kim Yeon-hee, *Update 2-S: Korea Seeks Poison Pill Against Hostile M&A*, REUTERS (Nov. 9, 2009), <http://uk.reuters.com/article/2009/11/09/korea-poisonpill-idUKSEO200720091109>.

¹⁵⁴ For example, Federation of Korean Industries—a large Korean business lobby—argued that while the United States and European countries have defensive mechanisms such as poison pills, dual-class equity structures, and golden shares, Korea did not have any one of those mechanisms. See Myung-Yong Choi, *Jeongyeongryeon Jeokdaejeok M&A*

device such as a pill was necessary in order to lessen the adverse effects that hostile takeovers might bring into the Korean economy.¹⁵⁵ Those opposed to adopting the pill were concerned with protecting the interests of shareholders and prospective acquirers.¹⁵⁶

V. THE PILL: IS IT COMPATIBLE WITH AN IMPORTING JURISDICTION?

A poison pill should be viewed as only one component of the entire Delaware takeover mechanism involving various legal and economic infrastructures. The Delaware pill is valid as long as the complementary institutions of legal enforcement in the jurisdiction follow the general principles of Delaware takeover jurisprudence. A problem with the legal transplant of a pill is that many jurisdictions outside the United States do not have the other components of the Delaware takeover package (such as a relatively independent board, an efficient judiciary, and safety valves) that should be bundled with the pill.

A. The Composition and Nature of the Board

One of the lynchpins supporting the legality of a poison pill in Delaware is the existence of a board with a majority of outsiders, which can serve as an independent monitor over management.¹⁵⁷ In most controlling shareholder jurisdictions, there is no similar board.

1. *Is a U.S. “Independent” Board Truly Independent?*

Under U.S. corporate law, executives—agents of a corporation—are in charge of day-to-day management. Since shareholders are usually widely-dispersed, they are subject to the collective action problem¹⁵⁸ and do not have the power or incentive to monitor the executives. In order to rectify this managerial agency problem, the concept of an “independent” board

Bangeochaek Sigeup (전경련 “적대적 M&A 방어책 시급”) [*Federation of Korean Industries: Hostile M&A Defense Mechanisms Are Needed Urgently*], Meonitudei (머니투데이) MONEY TODAY, (Apr. 26, 2006) (S. Kor.), <http://www.mt.co.kr/view/mtview.php?type=1&no=2006042612310644681&outlink=1>.

¹⁵⁵ This view is prevalent in business communities in Korea. *See id.*

¹⁵⁶ For example, critics had a view that minority shareholders’ rights were already damaged by controlling shareholders. The adoption of a poison pill would decrease minority shareholders’ welfare more.

¹⁵⁷ *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949–50 (Del. 1985); *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1348 (Del. 1985).

¹⁵⁸ “Where all investors hold small stakes in the enterprise, no single investor has a strong incentive to invest time and money in monitoring management.” ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 12, at 371. This phenomenon is the collective action problem. For a more in-depth explanation of the collective action problem, see Bebchuk, *supra* note 33.

emerged, where directors monitor executives on behalf of shareholders.¹⁵⁹ Because this idea has been so popular, directors on the typical U.S. board have become less associated with corporate insiders. While most public corporations had a majority of inside directors in the 1960s,¹⁶⁰ in 1999 the average board consisted of only two inside directors and nine outside directors.¹⁶¹

However, there remains a recurring problem: outside directors are not necessarily “independent.” Even in the United States, which many commentators have lauded as the jurisdiction of the best corporate governance, a so-called “independent” board can be easily abused as a rubber stamp for CEOs and other top executives. For example, in *Smith v. Van Gorkom*,¹⁶² the Trans Union board was found to have breached the duty of care because the board approved its CEO’s decision to sell the corporation blindly without gathering the necessary information.¹⁶³ An intriguing feature in *Van Gorkom* is that four out of five “independent” directors were the chief executives of major corporations.¹⁶⁴ Arguably, they might have been too sympathetic to a retiring CEO and might have agreed with him on the acquisition issue without seeking enough information. Indeed, independent directors often have personal ties with executives.¹⁶⁵

¹⁵⁹ One of the most dramatic changes in the U.S. corporate governance since the second half of the twentieth century is the emergence of a *monitoring* board (rather than an *advisory* board) with a majority of “independent” directors. Gordon, *supra* note 104, at 1518.

¹⁶⁰ Kahan & Rock, *supra* note 7, at 881.

¹⁶¹ *Id.* at 882.

¹⁶² 488 A.2d 858 (Del. 1985). *Van Gorkom* is a very controversial case; the decision was 3–2, an unusually close call for the Delaware Supreme Court.

¹⁶³ The case emphasizes the significance of the decision-making process in a boardroom. But, on the other hand, *Van Gorkom* is criticized as “one of the worst decisions in the history of corporate law” Daniel Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985). Another insightful article on *Van Gorkom* is William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002).

¹⁶⁴ Among ten directors who served on the Trans Union Board, five were insiders and the other five were outsiders. “Of the outside directors, four were [CEOs] and one was the former Dean of the University of Chicago Business School.” *Van Gorkom*, 488 A.2d at 868.

¹⁶⁵ See, e.g., *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003). In *Oracle*, the Delaware Chancery Court determined the independence of the special litigation committee (SLC) of Oracle, which was set up in response to a derivative action that alleged illegal insider trading by Oracle’s directors and officers. *Id.* at 921–23. The court found that the members of the SLC, both of whom were professors at Stanford University, and the directors who were accused of insider trading were connected via the network of Stanford, compromising the SLC’s independence. *Id.* at 929–30. One accused director taught one of the SLC members at Stanford while the two other accused directors made significant contributions and donations to Stanford. *Id.* at 931–35; see also EISENBERG, *supra* note 38, at 980–81.

Of course, the economic debacles of Enron and WorldCom raised many questions on the independence of U.S. outside directors.¹⁶⁶ For instance, among fourteen directors of Enron's board, eleven were independent directors at the time of its corporate governance fiasco.¹⁶⁷

In sum, the independence of U.S. outside directors is not absolute. However, a typical U.S. board is required to have relatively sound independence. Most of all, the legitimacy of defensive devices, including a poison pill, is materially enhanced by the independent directors' review as seen in *Unocal* and *Moran*.¹⁶⁸ Therefore, an independent board is almost a necessary condition for a pill to be legitimate. Even *Van Gorkom*, which illustrates the weakness of U.S. "independent" boards, simultaneously indicates how much the U.S. judiciary cares about the independency of boards. In addition, in *Weinberger*, the Delaware court emphasized the independence of a committee in self-dealing arrangements between a controlling shareholder (a parent) and a subsidiary.¹⁶⁹ Such constraint of a dominant shareholder is rarely observed outside the United States. The Delaware court's lenient position as to a target company's reliance on the "just say no" pill is at least partially based on the court's confidence in a board's relative independence and the court's ability to punish a board if it is not sufficiently independent. Thus, without a relatively functional board, the legitimacy of a poison pill in a controlling shareholder regime—if imported—would not be well supported.

2. *With Whom Do Outside Directors Deal in the Controlling Shareholder Regime?*

As opposed to the state of affairs in the United States, many boards in controlling shareholder jurisdictions are not comprised of a majority of outside directors. Sometimes, there is no outside director at all if the

¹⁶⁶ Discussions with Professor Merritt B. Fox, Professor, Columbia Law School, in N.Y.C., N.Y. (discussing corporate law during author's J.S.D. studies at Columbia Law School, 2010–2011).

¹⁶⁷ Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV. 1175, 1176 (2011); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002).

¹⁶⁸ For example, the *Moran* court stated:

In addition, the directors must show that the defensive mechanism was "reasonable in relation to the threat posed." Moreover, that proof is materially enhanced, as we noted in *Unocal*, where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards.

Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (internal citation omitted).

¹⁶⁹ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 708–11 (Del. 1983).

corporate law and securities regulations do not require their presence. Even if outside directors constitute a majority, the quality of independence of a typical board in a controlling shareholder system is likely to be lower than in the United States.

In the first place, outside directors are virtually nominated and elected by a dominant shareholder who holds voting control. Additionally, since many outsiders have financial and non-financial incentives to be re-nominated (and thus reelected), they go along with a controlling shareholder's decisions. Certainly, a CEO in a typical U.S. corporation nominates many outside directors as well.¹⁷⁰ Nonetheless, a board in a controlling shareholder system is subject to more serious structural biases due to the inherent characteristics of the ownership structure. Consider the nature of corporate insiders' power in both jurisdictions. A typical U.S. CEO in a widely-held company can be referred to as a "consul."¹⁷¹ She is the most powerful person in a company, but her tenure is limited. Under this polity, outside directors are a consul's political "colleagues" (although inferior to the consul) and act in the rational anticipation that a CEO will step down at some point. In a hostile takeover situation, a board is on the management's side and rarely welcomes an external enemy, which is almost invariably a common threat to the board. The same board, however, is relatively active in disciplining management as to issues that fall outside a corporate control contest. These checks and balances systems operate more often when a vast majority of shareholders are discontent with the ongoing projects and visions of a company, which are reflected in the stock price.¹⁷² Outside (and sometimes even inside) directors challenge a CEO internally and sometimes fire her when management's performance is disappointing.¹⁷³

In a controlling shareholder jurisdiction, on the other hand, a controlling shareholder wields more power because she has her own voting rights, unlike a typical U.S. CEO who relies on other people's voting rights. In addition, the tenure of a dominant shareholder is deemed infinite because family dynastic succession is widely anticipated. Put simply, a well-

¹⁷⁰ See Bebchuk & Fried, *supra* note 26, at 655.

¹⁷¹ See Sang Yop Kang, *Reenvisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Embrace Each Other* 27 (2011) (unpublished J.S.D. dissertation chapter, Columbia University School of Law) (on file with Columbia University).

¹⁷² When shareholders are dissatisfied with management of a corporation, they may be willing to sell their shares of the corporation. As a result, the stock price of the corporation would go down.

¹⁷³ "The result of this more demanding standard for CEO performance was, according to the Booz Allen study, to shorten average CEO tenure from 9.5 years (1995) to 7.3 years (2001) and to shorten the average tenure of fired CEOs from 7.0 years (1995) to 4.6 years (2001)." Gordon, *supra* note 104, at 1533.

functioning system of checks and balances is virtually nonexistent, and a dominant shareholder is an “emperor” (rather than a “consul”).¹⁷⁴ Accordingly, outside directors are best described as “retainers” rather than “colleagues.” Since a dominant shareholder is basically a shareholder with voting control, her capacity as a controlling shareholder has nothing to do with a board’s decision or approval. In other words, a board is not able to fire a dominant shareholder, who can be removed only by the sale of her stock in the market.¹⁷⁵ Thus, an “independent” board, even if there is one, is not able to overturn a controlling shareholder’s empire.

Of course, a controlling shareholder may hold an official position in a corporation such as CEO. A CEO is a corporate “officer,” appointed and removable by a board. In theory, an independent board may be able to fire the controlling shareholder CEO. However, given that a controlling shareholder has the power to replace the entire board via her voting power, such a revolt is futile. Interestingly, a dominant shareholder may have incentive not to hold any official post in a corporation because having an official post such as CEO has little to do with a controlling shareholder’s power; a dominant shareholder in a controlled-corporation is powerful not because she is a CEO, but because she is a controlling shareholder. When a dominant shareholder holds any official role in a company, she is more exposed to legal liabilities. A controlling shareholder without an official title may lose the psychic utility generated from self-esteem and social prestige. However, she can recover it by granting herself an *unofficial* designation such as a chairperson in a corporation (not chair of the board), which does not carry legal responsibility but gives a controlling shareholder as much psychological satisfaction as the CEO title.

In response to this problem, authorities in Korea amended its Commercial Code to create a provision on the de facto directorship, targeting dominant shareholders who do not hold official titles but wield full control in business groups.¹⁷⁶ According to this provision, a person could be liable for transactions if she is construed to be a de facto director who is able to instruct corporate transactions. Nonetheless, it is well known that this provision is not very practical, since it is difficult to show that a controlling shareholder is the person who directs particular orders in business transactions behind the scene.

¹⁷⁴ Kang, *supra* note 171.

¹⁷⁵ Under these circumstances, outside directors in a controlling shareholder regime are less independent than those in the United States. However, this does not mean that outside directors in a controlling shareholder regime are meaningless. At least a board with outside directors in a controlling shareholder regime can work as an advisory board for a controlling shareholder.

¹⁷⁶ Sangbeob [Commercial Act], art. 401-2 (S. Kor.).

3. Reputational Constraints

It is often argued that a U.S. outside director has reason to oversee management more actively since she cares about her reputation.¹⁷⁷ This hypothesis is plausible, though not perfectly convincing, in the United States and has gained support in both academia and practice.¹⁷⁸ However, the extra-legal mechanism might not work well in controlling shareholder jurisdictions.

To begin, the mechanism of reputation—in the United States as well as in a controlling shareholder jurisdiction—constrains an outside director in two opposite ways depending on the “audiences” they face. On the one hand, a director cares about general word-of-mouth in the capital market and aims at public investors who seek a higher return by correcting agency problems. On the other hand, the same director is concerned about her reputation in another audience group, a business circle.

The problem is that the feedback from business elites to a director is more salient in a controlling shareholder system, in particular the CMS, than in the United States because of the very nature of ownership structure. A CMS economy is dominated by a handful of large business groups¹⁷⁹ (and as a result, a handful of dominant shareholders); therefore, a small number of controlling shareholders constitute a monopsony in the labor market for outside directors. Once an outsider is stigmatized as recalcitrant toward a controlling shareholder in one business group, her reputation will spread rapidly among other controlling shareholders and business groups. Given that public investors are powerless vis-à-vis dominant shareholders, such an outside director has a high chance of being ostracized by all business groups, and in essence, by the entire economy. As a result, even if a board consists of outside directors, a board’s independence could be

¹⁷⁷ “Reputation provides another sort of stick or carrot that could enhance director independence.” Gordon, *supra* note 104, at 1488.

¹⁷⁸ See, e.g., Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 753-754 (2007) (“As we and others have repeatedly pointed out, reputation is the coin of the realm in the world of business—no director wants to be associated with an unsuccessful enterprise, much less suffer the reputational harm associated with a fiduciary breach.”); Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921, 927 (2007) (“For outside directors who care about their reputations, even a small risk of legal liability in a world in which there are relatively effective courts and reliable auditors, may be enough to keep managers in line. They may give managers slack, but they will not tolerate dishonesty. They will not sacrifice their own reputations for the sake of a golfing buddy.”).

¹⁷⁹ As to business groups, see generally Tarun Khanna & Krishna Palepu, *The Right Way to Restructure Conglomerates in Emerging Markets*, HARV. BUS. REV., July 1999; Tarun Khanna & Krishna Palepu, *Why Focused Strategies May Be Wrong for Emerging Markets*, HARV. BUS. REV., July 1997; Kang, *supra* note 171.

seriously compromised.¹⁸⁰

B. The Judicial System in a Controlling Shareholder Regime

The Delaware judicial system has been touted as efficient in dealing with corporate governance matters;¹⁸¹ it has a highly regarded court, specializing in corporate cases (without a jury), and acts expeditiously.¹⁸² Delaware judges are experienced and well-versed in business trends, substantive corporate law, and litigation.¹⁸³ At the same time, Delaware has enjoyed another benefit. Since Delaware is by far the leading state in terms of venue of choice for incorporation, its judiciary experiences a great deal of litigation among corporations. Thus legal doctrines are interpreted in a more sophisticated way and the results in similar cases are relatively predictable.¹⁸⁴ In this sense, Delaware has established a valuable judicial network.¹⁸⁵ As a result, Delaware corporations, consumers of the corporate law adjudication, are able to make their business transactions proceed in a more stable way and avoid “unfair surprises” in potential legal cases.

In contrast, most controlling shareholder countries probably do not have efficient judicial institutions like the Delaware courts.¹⁸⁶ Most importantly, because the market for corporate control has been virtually nonexistent in these countries, judiciaries are not able to use precedents of their own. Alternatively, these countries may consult the highly-regarded Delaware case law to solve challenging legal problems associated with a poison pill. However, an inherent risk of this stopgap is that Delaware takeover doctrine is incompatible if applied without considering key differences in underlying circumstances in such foreign countries.

Judges in many countries rotate periodically and cover various legal areas (such as criminal, contract, torts, administrative, and family law) in their careers because they need to be familiar with as many cases as possible in order to supervise their junior judges when they are promoted to higher positions. Under these circumstances, having expertise in one

¹⁸⁰ It does not mean that outside directors in the controlling shareholder regime are futile. Although it is difficult for outside directors to resist a controlling shareholder’s decisions, they are able to advise the controlling shareholder. *See supra* note 175.

¹⁸¹ *See, e.g.,* William T. Allen, *The Pride and the Hope of Delaware Corporate Law*, 25 DEL. J. CORP. L. 70, 72 (2000) (“The fact that the Delaware system dominates others does not of course mean it is optimal. But I am willing to assume that it supplies a pretty efficient system of legal organization.”).

¹⁸² *See* Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 594 (2003).

¹⁸³ *See id.*

¹⁸⁴ *See id.*

¹⁸⁵ *Id.*

¹⁸⁶ For simplicity, this Article rules out the possibility that courts in such countries are corrupt, although this is a proper concern in some countries.

particular area of law (e.g., corporate law) is impractical, because judiciaries prefer generalist judges to specialist ones. In addition, some jurisdictions do not require a judge to have any experience as a lawyer. Hence, a judge can start her judicial career in her mid-20s without any exposure to real business transactions.¹⁸⁷ Such a system may have merit; however, a key disadvantage is that a court is not well-equipped to handle complicated business and takeover cases.

Moreover, timing is often of the essence in business transactions. Thus, business people need a judiciary like the Delaware courts that expedites cases and quickly resolves uncertainties surrounding transactions. Unfortunately, courts in most countries are not fast. For example, it is not uncommon for a typical dispute to be resolved in ten or more years in the Indian judiciary, although it shares a common law heritage with its counterpart in the United States.¹⁸⁸ With this delay, even the best statutes and case law are not able to meaningfully protect the interests of parties in takeover transactions. Thus, injured parties (e.g., victims of a poison pill) are often concerned about whether they should bring suits in the first place.

C. Does a Ballot Box Safety Valve Work in a Controlling Shareholder Regime?

As discussed, Delaware corporate law provides a couple safety valves to the pill: the protection of the shareholder franchise (*Blasius*) and a board's duty to act as auctioneer in certain circumstances (*Revlon*).¹⁸⁹ These two safety valves support the legality of the poison pill. When the poison pill is introduced in a controlling shareholder jurisdiction's corporate law, these safety valves will most likely fail to work properly.

1. Delaware Does Not Allow "Just Say Never"¹⁹⁰

The court in *Time* noted that a target board can just say no to a hostile bid by flatly refusing to redeem a poison pill.¹⁹¹ However, the shareholders have recourse in the face of a board with the "just say no" pill—they are able to replace the directors in a proxy contest so that new directors will redeem the pill.¹⁹² In this sense, even the "just say no" pill is not really invincible as long as the voting mechanism is preserved to reflect the real

¹⁸⁷ For example, East Asian countries such as Japan, Korea, and China adopt this career judge system.

¹⁸⁸ John Armour & Priya Lele, *Law, Finance, and Politics: the Case of India*, 43 *LAW & SOC'Y REV.* 491, 510 (2009).

¹⁸⁹ See Armour, Jacobs & Milhaupt, *supra* note 57, at 245.

¹⁹⁰ Professor Marcel Kahan coined the phrase "just say never." Gordon, *supra* note 76, at 522 n.40.

¹⁹¹ For a more in-depth explanation of "just say no," see *id.* at 522–31.

¹⁹² See *id.* at 523.

intent of all shareholders. However, target boards have made attempts to block shareholders' recourse to the ballot by inventing mutants of a standard poison pill, such as a "dead hand provision."¹⁹³ In such a provision, only the incumbent directors or their designated successors were entitled to redeem a pill.¹⁹⁴ In *Carmody v. Toll Brothers, Inc.*,¹⁹⁵ the court explained that "it would make little sense for shareholders or the hostile bidder to wage a proxy contest to replace the incumbent board"¹⁹⁶ since even a newly elected board in favor of the deal would be precluded from redeeming the pill.¹⁹⁷ Explaining that the provision effectively disenfranchised shareholders who wished to elect a board committed to redeeming the pill,¹⁹⁸ the *Toll Brothers* court invalidated the dead hand provision. In *Quickturn Design Systems, Inc. v. Shapiro*, the "slow hand pill," another variation of the standard pill that is non-redeemable for six months after a change in board control, was invalidated as well.¹⁹⁹

The "just say no" defense is equivalent to the "just say wait" defense.²⁰⁰ The Delaware jurisprudence approved the "just say no" defense, through which a board can buy time to persuade shareholders to agree on an incumbent's business strategy.²⁰¹ A board that pursues airtight protection would like to thwart a proxy fight to redeem a poison pill. This strategy is the "just say never" defense, which is stronger than the "just say no" defense.²⁰² However, a board in Delaware is not allowed to use the "just say never" pill, which makes the ballot box safety valve (associated with *Blasius*) powerless by tainting the shareholder referendum on a corporate control issue.

¹⁹³ As to a "dead hand provision," see *Carmody v. Toll Bros, Inc.*, 723 A.2d 1180, 1184 (Del. Ch. 1998).

¹⁹⁴ Jacobs, *supra* note 32, at 348.

¹⁹⁵ As for *Toll Brothers*, Professor Bainbridge explains, "In addition to fairly standard flip-in and flip-over features, the Toll Brothers pill provided that it could be redeemed only by those directors who had been in office when the shareholder rights constituting the pill had become exercisable (or their approved successors)." Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 17 (2003).

¹⁹⁶ *Toll Brothers*, 723 A.2d at 1187; see also Bainbridge, *supra* note 195, at 17 ("[The dead hand] provision was intended to close the proxy contest/redemption loophole in standard poison pills by precluding newly elected directors from redeeming the pill.").

¹⁹⁷ Bainbridge, *supra* note 195, at 17.

¹⁹⁸ See *id.*

¹⁹⁹ *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

²⁰⁰ As Professors Kahan and Rock explain, "Thus, the ultimate effect of the pill is akin to 'just say wait': it leaves the decision on whether to accept a bid to the outside board members, but only until shareholders can replace the board, and in the meantime discourages defensive board actions." Kahan & Rock, *supra* note 7, at 910.

²⁰¹ *Id.* at 909–11.

²⁰² As for the "just say never" defense, see generally Gordon, *supra* note 76.

2. *The CMS with a Pill: “Double Discrimination” against a Hostile Bidder*

It is then fair to ask whether a controlling shareholder regime—the CMS in particular—preserves the ballot box safety valve. To begin, interference with the shareholder franchise is an innate problem of the CMS ownership structure since the very definition of the CMS assumes that a dominant shareholder is able to distort the voting mechanism.²⁰³ Suppose that a dominant shareholder holds a small fraction of a corporation’s economic interest (e.g., 5%) while exercising a large stake of voting rights (e.g., 40%) through stock pyramiding, dual class common stocks, and intra-shareholding.²⁰⁴ In the takeover context, such voting leverage mechanisms are in themselves strong defensive devices to a CMS dominant shareholder, even in the absence of a poison pill. As discussed, this is exactly the reason why Germany opposed the European Takeover Directive in June 2000.²⁰⁵

Therefore, if the “just say no” pill is allowed in a CMS jurisdiction, a dominant shareholder would be excessively protected from hostile takeovers under a “double discrimination” mechanism against a hostile bidder. The first discrimination takes place between a dominant shareholder and the rest of the shareholders (including a hostile bidder); it is based on the *inflation* of a dominant shareholder’s voting rights legalized by the CMS. As a result, the voting power of the remaining shareholders (including a hostile bidder) is *deflated*. The second discrimination takes place between a hostile bidder and the other shareholders (including a controlling shareholder); it is based on the dilution of the hostile bidder’s economic interest and voting rights generated by the poison pill. Accordingly, other shareholders (including a controlling shareholder) will benefit. As a result of the accumulation of “double discrimination” imposed by both the CMS and a pill, a hostile bidder’s likelihood of winning a takeover battle is substantially reduced.

3. *Can a Prospective Acquirer Overcome the CMS with a Pill?*

In Delaware, boards are permitted to indefinitely maintain the pill to block a bid, while shareholders are protected from managerial moves to impede their voting against incumbent management.²⁰⁶ In that sense, the conflicting interests between management’s autonomy and shareholders’ fundamental right to vote are relatively balanced. When the Delaware pill is imported to a jurisdiction with the CMS, however, this balance is no

²⁰³ As for the problem of voting distortion, see generally Bebchuk, Kraakman & Triantis, *supra* note 125.

²⁰⁴ As for voting leverage mechanisms such as stock pyramiding, dual class common stocks, and intra-shareholding, see *id.*

²⁰⁵ See MILHAUPT & PISTOR, *supra* note 129, at 80–81.

²⁰⁶ See Bebchuk, Coates IV & Subramanian, *supra* note 25, at 907.

longer maintained due to the very definition of the CMS.

Table 1, below, provides a numerical example.²⁰⁷ Suppose that a prospective acquirer considers two companies as takeover targets: one is a CMS firm (Company CMS) and the other is a widely-held firm (Company WH). Both have pills that would be triggered when an uninvited bidder acquires 20% of their shares. A dominant shareholder in Company CMS holds 5% of the common stock of Company CMS. Likewise, a management team in Company WH holds 5% of the common stock of Company WH. In terms of voting power, however, the dominant shareholder of Company CMS exercises 40% via voting leverage, while management in Company WH holds 5% voting rights commensurate to its cash-flow rights.

At first, it seems that a prospective acquirer may purchase up to 19.9% of the shares of each company before the poison pills are triggered. In fact, however, the acquisition of 19.9% of the shares of Company CMS is far more difficult than the acquisition of 19.9% of the shares of Company WH. As to Company WH's stock, a prospective acquirer may purchase 19.9% of the shares out of the 95% free float in a widely-held company (excluding 5% that management owns). The effective percentage of shares that a prospective acquirer should purchase is 20.94% of all available shares, which is 19.9% of the 95% free float. In contrast, regarding Company CMS's stock, she must buy 19.9% of all shares out of the 60% public float (excluding the 40% of votes that the controlling shareholder holds). The effective percentage of shares that she must purchase is 33.16% of all available shares, which is 19.9% out of the 60% free float.

Even if a hostile bidder could acquire 19.9% of the shares of each company, she would need to overcome other difficulties related to proxy contests at each company so that her director candidates will redeem the pill. Again, waging a proxy contest in Company CMS is far more difficult than in Company WH. In Company CMS, in order to obtain control (i.e., 50.1%), the prospective acquirer has to have the support of 30.2%²⁰⁸ of the shares out of the remaining 40.1%.²⁰⁹ The effective percentage of votes that she needs from the rest of the shareholders is 75.3%, which is 30.2% out of 40.1%. In contrast, for Company WH, a prospective acquirer has to gain

²⁰⁷ For the purpose of simplification, this Article assumes that in Company CMS, a CMS controlling shareholder has multiple voting shares while a prospective acquirer can only obtain one-share-one-vote stock. In Company WH, the one-share-one-vote rule is equally preserved among all shareholders, including management.

²⁰⁸ Since the bidder currently has 19.9% of votes, she needs 30.2% more in order to gain a majority of votes.

²⁰⁹ $100\% - 19.9\%$ (the acquirer's fraction) $- 40\%$ (the controlling shareholder's fraction) $= 40.1\%$

30.2% of the votes from shareholders out of the remaining 75.1%.²¹⁰ Here, the effective percentage of additional votes that she needs is 40.2%, which is 30.2% out of 75.1%. Since management has the advantage in waging a proxy contest,²¹¹ the 40.2% hurdle is demanding to a prospective acquirer. However, a prospective acquirer still has a chance at success. On the other hand, the 75.3% bar is extremely high to a challenger, so it is almost impossible for a prospective acquirer to gain control of Company CMS. In sum, a bidder in a CMS jurisdiction (compared to a bidder in a dispersed shareholder jurisdiction) faces two more difficult obstacles with respect to a poison pill: one in purchasing shares in the market and the other in soliciting votes in a proxy contest. Table 1 summarizes these results.

Table 1		
Ownership Structure	Corporation A (CMS)	Corporation B (Widely-Held)
Corporate Insider's Cash Flow Rights (%)	5	5
Corporate Insider's Voting Rights (%)	40	5
Public Float (%)	60	95
Effective Percentage of Shares an Acquirer Should Purchase When She Purchases 19.9 %	$19.9 / 60 = 33.16 \%$	$19.9 / 95 = 20.94 \%$
Effective Percentage of Votes from the Rest of Shareholders that an Acquirer Needs for a Majority	$30.2 / 40.1 = 75.3 \%$	$30.2 / 75.1 = 40.2 \%$

4. The CMS with a Pill: In Between "Just Say No" and "Just Say Never"

Consider another perspective on the relative strength of the CMS pill. Suppose that there is a straight horizontal line that describes the degree of deterrence created by a defensive device. As illustrated in Figure 1 below, the scale starts from the left and increases to the right.²¹² Initially, consider three different types of poison pills such as the *Interco* pill, *Time* pill ("just say no"), and *Toll Brothers* pill ("just say never"). The reference point is

²¹⁰ $100\% - 19.9\%$ (the acquirer's fraction) $- 5\%$ (management's fraction) = 75.1%

²¹¹ See Bebachuk, *supra* note 33.

²¹² Thus, the end of the left side represents a defense device with the least deterrence effect, and the end of the right side represents a defense device with the most deterrence effect.

the “just say no” pill²¹³ upheld in *Time*. In *Time*, while a board is able to refuse to redeem a pill, the board is subject to a limit—the pill would be redeemed if a challenger wins a proxy contest. In this sense, the *Interco* pill is weaker than the “just say no” pill in terms of deterrence power. As explained,²¹⁴ under the *Interco* pill, a board is *required* to redeem a pill when it faces a non-coercive bid; thus, the board does not have the option of flatly refusing an outside bid. On the other hand, the “just say never” pill, such as a dead-hand provision in *Toll Brothers*, is stronger than the “just say no” pill. Under the “just say never” pill,²¹⁵ even shareholder franchise is futile; redeeming such a pill is not a viable option to a challenger even if she wins a proxy contest. Therefore, in Figure 1, on the far left side is the *Interco* pill, which marks the weakest deterrence power to a hostile bid.²¹⁶ On the far right side is the “just say never” pill, which marks the strongest deterrence power. The “just say no” pill is situated in the middle of these two points.

However, if a *Time* pill is coupled with another strong defensive device, such a combination is located further to the right on the scale. For example, the combination of “just say no” and an ESB carries a far stronger deterrent effect than that of a standalone “just say no” pill.²¹⁷ Similarly, the CMS ownership with a pill increases the deterrent power of the standalone “just say no” pill so that it is located in the middle of “just say no” and “just say never.” In sum, the deterrent power of each defensive measure is roughly situated in the following order from weakest to strongest: the *Interco* pill, the *Time* pill (just say no), the *Time* pill plus either an ESB or a CMS, and the *Toll Brothers* pill (just say never).²¹⁸

²¹³ See *supra* notes 74–78 and accompanying text.

²¹⁴ See *supra* notes 72–73 and accompanying text.

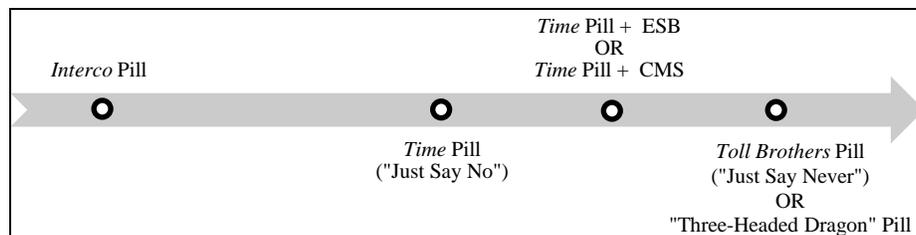
²¹⁵ See *supra* notes 193–199 and accompanying text.

²¹⁶ In Figure 1, the *Interco* pill marks the weakest deterrence power to a hostile bid. It does not mean that the *Interco* pill is the weakest among all pills. It only means that the *Interco* pill is weakest among the six pills explained in Figure 1.

²¹⁷ As to the deterrent effect of the “just say no” pill with an ESB, see Bebchuk, Coates IV & Subramanian, *supra* note 25.

²¹⁸ In the interest of simplicity, this Article assumes that the combination of a pill and a CMS and the combination of a pill and an ESB are situated at the same point in Figure 1.

Figure 1: The Deterrence Power of Various Pills



5. The CMS with a Pill: Could It Damage *Blasius*?

As Chancellor Allen famously stated in *Blasius*, “[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”²¹⁹ Therefore, even if Delaware courts are highly deferential to a board (and management) and do not second-guess business judgments made by a board,²²⁰ they are more intrusive when the primary purpose of a board’s conduct is to interfere with the shareholder franchise.²²¹ As to the inquiry of whether using a combination of a pill and an ESB amounts to undermining the shareholder franchise, reasonable minds can disagree. Nonetheless, it is true that the board with such a combination can more easily abuse its discretionary power in order to perpetuate itself. In that sense, a pill—usually the “just say no” pill upheld in Delaware—with an ESB is less likely to be consistent with the tenet of *Blasius*, but it is not definitely inconsistent with *Blasius*.

When a jurisdiction allows the CMS, a combination of an imported pill from the United States (Delaware) and the CMS will generate consequences similar to a combination of a Delaware pill and an ESB. This is because the built-in nature of the CMS, which provides a controlling shareholder with multiple votes, distorts the shareholder referendum. In principle, an original Delaware pill would be legally upheld by the possibility that shareholders can indirectly redeem it by replacing a board. Accordingly, the legal legitimacy of the combination of a pill and the CMS is questionable since the ballot box safety valve is tainted by the very nature of the CMS where the values of shareholders’ votes are not equal among shareholders. To make matters worse, a dominant shareholder in a CMS may implement a staggered board in addition to a pill. This combination of defensive tactics—Delaware’s “just say no” pill, a CMS, and a staggered board—would be what this Article calls a “three-headed dragon,” which is more inclusive and powerful than the combination of the “just say no” pill

²¹⁹ See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

²²⁰ As to the business judgment rule, see *supra* notes 53–54.

²²¹ See *Blasius*, 564 A.2d at 660.

and a staggered board.²²²

In sum, when the Delaware pill is adopted in a controlling shareholder jurisdiction, the transplanted “just say no” pill would be transformed into the more invincible “three-headed dragon” pill, which could be as powerful as the “just say never” pill. Therefore, once a pill is allowed in this jurisdiction without careful assessment of the accumulative effect caused by the CMS and an ESB, the market for corporate control will be almost entirely stifled by the de facto “just say never” pill, which is invalid in the United States. Indeed, the “three-headed dragon” pill could make the shareholder franchise system (thus, the tenet of *Blasius*) futile. The updated deterrent power of each defensive measure is roughly situated in the following order, from weakest to strongest: the *Interco* pill, the *Time* pill (“just say no”), the *Time* pill plus either an ESB or a CMS, and the “three-headed dragon” pill or the *Toll Brothers* pill (“just say never”).²²³

6. *Defensive Measures and Proportionality*

As explained, adopting Delaware’s “just say no” pill blindly leads to too much deterrence against hostile takeovers in a jurisdiction. However, it is noteworthy that a poison pill is the most powerful anti-takeover defensive device. In other words, without the pill, the importing jurisdiction’s present defense system may generate too little deterrence compared to other jurisdictions that allow the pill. In this sense, it does not follow that any additional defensive measure is unnecessary or harmful to a controlling shareholder jurisdiction. If the jurisdiction needs new defensive measures, it should carefully review whether the combined effect of newly adopted and existing defensive measures would be proportional to hostile takeover threats from outsiders under the current climate and institutions. For example, as a less powerful anti-takeover device, the *Interco* pill may be considered.

In addition, it seems that a CMS based on intra-shareholding is a relatively weak ownership structure compared to a structure based on either stock-pyramiding or dual class common stocks. As seen in the SK Group episode, if a hostile bidder is able to find a weak intra-shareholding chain within a business group, the entire group’s control structure could collapse.

²²² In terms of the deterrence power to a hostile bid, the “three-headed dragon” pill is stronger than the combination of the “just say no” pill and an ESB since the “three-headed dragon” pill includes the CMS feature in addition to the “just say no” pill and an ESB.

²²³ In terms of the deterrence power to a hostile bid, the “three-headed dragon” pill and the “just say never” pill are stronger than the “just say no” pill. Between the “three-headed dragon” pill and the “just say never” pill, however, it is difficult to generalize which one is stronger than which. In the interest of simplicity, this Article assumes that the “three-headed dragon” pill and the “just say never” pill have the same degree of deterrence power to a hostile bid. Thus, the two pills are situated at the same point in Figure 1.

This reality should be taken into account in determining the proportionality of an anti-takeover legal system in a jurisdiction that considers importing a defense measure.

D. Would *Revlon* Protect Non-controlling Shareholders in a Controlling Shareholder Regime?

In addition to the ballot box safety valve based on *Blasius*, another safety valve to the “just say no” defense is a target board’s *Revlon* duty.²²⁴ According to *Revlon*, when a corporation enters into the *Revlon* mode—sale of a corporation, changes in long-term strategy in the face of a bid, or fundamental change of control—the board should act as a neutral auctioneer among bidders rather than as a corporate defender.²²⁵ Therefore, the board is not able to flatly refuse a bid enhancing shareholder wealth. If a controlling shareholder jurisdiction imports the *Revlon* duty when it adopts the pill in its legal system, non-controlling shareholders could be more protected, at least when a controlling shareholder incurs the *Revlon* duty.

In developing countries, however, there are limitations of *Revlon*’s application to the controlling shareholder regime. Consider two types of controlling shareholders in developing countries.²²⁶ Some controlling shareholders expropriate substantially all corporate value at the expense of non-controlling shareholders through a one-time transaction, just as a government imposes prohibitive taxes on its people.²²⁷ Such controlling shareholders will leave corporations as shells, since the corporation has nothing left to take.²²⁸ Essentially, they are “roving controlling shareholders.”²²⁹ In contrast, other controlling shareholders extract from non-controlling shareholders based on a long-term plan.²³⁰ They transfer a fraction of corporate value through periodic, ongoing transactions, just like a rational government levies sustainable taxes on its people.²³¹ Accordingly, such controlling shareholders will stay within corporations for

²²⁴ See Armour, Jacobs & Milhaupt, *supra* note 57, at 245–46.

²²⁵ See *Revlon, Inc. v. MacAndrews & Forbes*, 506 A.2d 173, 182 (Del. 1986).

²²⁶ As for two types of controlling shareholders in developing countries, see Sang Yop Kang, *Controlling Shareholders—Roving or Stationary* (2011) (unpublished J.S.D. dissertation chapter, Columbia University School of Law) (on file with Columbia University). Professor Mancur Olson coined the terms “roving bandits” and “stationary bandits” to explain the evolution of a political system. Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567 (1993). Olson’s logic of political economy is reinterpreted in the context of corporate governance scholarship in Kang’s article.

²²⁷ See generally Kang, *supra* note 226.

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

a long time (mostly, they rely on family succession).²³² In this sense, they are “stationary controlling shareholders.”²³³

A roving controlling shareholder regime is the worst ownership system in terms of investor protection, since inefficient enforcement allows controlling shareholders to pillage corporate assets although the laws declare protection of non-controlling shareholders.²³⁴ Suppose that a jurisdiction dominated by roving controlling shareholders imports Delaware’s poison pill and doctrines, including *Revlon*. In that case, roving controlling shareholders will place the poison pill in corporations when they need it. In theory, the *Revlon* duty should be implemented in the jurisdiction. Nonetheless, in a world dominated by powerful roving controlling shareholders, the duty exists only as law-on-the-books and would rarely be enforced by the authorities.²³⁵ In sum, dominant shareholders would cherry pick corporate laws, using their right (i.e., a poison pill) without honoring their obligation (i.e., *Revlon* duty), which in principle should be bundled with the right.

In a jurisdiction with a vast majority of “stationary controlling shareholders,” the *Revlon* duty is also likely to be inapplicable. Cherry picking might be one reason. Another reason derives from the very nature of a stationary controlling shareholder. Usually, a stationary controlling shareholder is by definition a family controlling shareholder who is going to stay in a company infinitely through family succession.²³⁶ *Revlon*, however, postulates an “end-game” situation where a target is to be put up for sale, to break-up, or to go through a change of control in an M&A market.²³⁷ Thus, the *Revlon* mode would rarely be triggered by a family

²³² *Id.*

²³³ Kang, *supra* note 226.

²³⁴ *Id.* In such a jurisdiction, government agencies often collude with business tycoons, and even courts may acquiesce to, or ignore, suspicious transactions by corporate insiders.

²³⁵ Corporate governance fiascos in Russia are exemplary. During the late 1990s, corporations in Russia had serious corporate governance problems such as diverting corporate assets by managers or controlling shareholders. “A 51% shareholding interest in a Russian company conveys to the owner a license to steal from the remaining 49%.” Editorial, *Investor Hell*, J. COM., June 15, 1998, at 6A. In Russia, allegedly, some local governments were actively involved in corporate scandals: “Supported by the local government, the manager installed Cossack guards, held his own shareholder meetings, locked out the owners, diluted the owners’ stock, and ignored dozens of court rulings against him over the years.” Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Enterprises Fiascoes*, 75 N.Y.U. L. REV. 1720, 1742 (2000) (citing Mark Whitehouse, *Germans Cry Foul in Gypsum Plant Feud*, MOSCOW TIMES, Nov. 29, 1997; Mark Whitehouse, *Under Siege*, MOSCOW TIMES, Dec. 9, 1997).

²³⁶ See generally Kang, *supra* note 226. A controlling shareholder has an infinite time horizon through family succession. Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633, 643 (2007).

²³⁷ Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL.

controlling shareholder since she plays in a “repeated game.” Put simply, a stationary family corporation is not likely to be put up for sale, to break-up, or to go through a change of control in an M&A market. In that sense, the *Revlon* principle would be only a decoration in the legal system, even if it is enforceable. Even in the United States, reliance on *Revlon* is not very conducive to a prospective acquirer and shareholders who oppose management’s refusal of an outside bid.

E. Summary: Transplanted Pill in a Big Picture

It is clear that a poison pill should not be treated as an isolated aspect of the Delaware takeover law system. Accordingly, the legality of a poison pill should be supported in the context of other legal and socio-economic institutions such as: (1) a relatively well-functioning independent board, (2) an efficient judiciary and enforcement mechanism, (3) the ballot box safety valves (based on *Blasius* and *Revlon*), and (4) investor protection. Sometimes these institutions do not work well, even in the United States. They would probably be less efficient in a controlling shareholder regime.²³⁸ Without efficient institutions, the legitimacy of an imported poison pill from the United States, particularly the “just say no” pill, would be questionable in controlling shareholder jurisdictions.

VI. THE POISON PILL, EXECUTIVE COMPENSATION, AND THE SALE OF CONTROL

In the United States, the evolution of executive compensation since the 1990s has transformed the pill from an entrenchment device to a negotiation tool, at least to some degree. For this reason, the market for corporate control has still survived despite the pill’s strong deterrent effect against a hostile bid. Even if the pill is incorporated in the legal system of a controlling shareholder jurisdiction, it is difficult to expect the same phenomenon.

A. Severance Pay and Friendly Deals

In 1991, the average large firm CEO in the United States made 140 times of what the average worker made.²³⁹ By 2003, this increased to over

L. REV. 1189, 1203–04 (2002).

²³⁸ In Part VI, this Article argues that without economic incentive devices that compensate existing corporate insiders, the “just say no” pill is likely to be abused as an entrenchment tool.

²³⁹ Stephan M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX L. REV. 1615, 1619 n.16 (2004) (citing *CEOs and Their Indian Rope Trick*, ECONOMIST, Dec. 11, 2004, at 61).

500 times.²⁴⁰ In contrast, the average CEO-employee compensation ratio is not that high outside the United States. For example, the average Japanese CEO makes sixteen times the pay of an average Japanese industrial worker and the average German CEO makes about twenty-one times the pay of the average German factory worker.²⁴¹ Perhaps one reason for such a sharp distinction is the different cultural norms in each jurisdiction. For example, in countries that place a higher value on social democracy and egalitarianism, a huge income disparity is not socially and politically tolerated.²⁴²

The hostile deals that once brought controversy and fear to Corporate America in the 1980s suddenly quieted down as the pill was legalized and firmly established in the Delaware takeover system.²⁴³ However, the evolution of U.S. executive compensation made market participants adapt to the new takeover environment. For example, a generous severance package corresponding with large executive compensation might incentivize incumbent management to leave a company when an outside bid for acquisition is offered.²⁴⁴ Therefore, friendly M&A activities filled the vacuum left by hostile deals stifled by the pill. With the evolution of executive compensation, the pill was repurposed as a negotiation leverage tool enhancing the welfare of shareholders. However, many commentators and market participants are still suspicious of its entrenchment purpose.²⁴⁵

²⁴⁰ *Id.*

²⁴¹ EISENBERG, *supra* note 38, at 649. Professor Eisenberg relied on GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS* 206–209 (1991). It is noteworthy that Crystal’s work was written in 1991. As mentioned above, the U.S. CEO–employee compensation multiple was about 500 in 2003. In that sense, it would be fair to compare 2003 U.S. data and 2003 data from Germany, Japan, or other countries. At this moment, however, the author of this Article does not have credible data available to compare the compensation disparity in the United States and other countries in the same recent year. In addition, the point of this Article is to show that there is a huge gap between the United States and other countries in terms of executive compensation rather than to show the exact difference of each jurisdiction’s executive compensation level. For this purpose, Crystal’s 1991 work, which was quoted by Professor Eisenberg (2005), is still valid.

²⁴² Whether U.S. executive compensation is “exorbitant” in absolute and comparative terms is an interesting and worthwhile topic to analyze, but it is beyond the scope of this Article. Rather, the focus here is on how such a sharp contrast between the level of executive compensation in the United States and that of other countries can affect incentives of corporate insiders *with pills* when they are approached by control-changing bids.

²⁴³ *See, e.g., Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985); *Paramount Commc’ns v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

²⁴⁴ *See Kahan & Rock, supra* note 7, at 892 n.99 (“For example, both greater use of stock options and greater restrictions on takeover defenses make it more likely that an unsolicited bid will be consummated, but managers are likely to favor the former over the latter.”).

²⁴⁵ For example, “If all the proffered justifications for allowing target management to ‘just say no’ do not withstand analysis, then what is the real explanation? The short answer, I think, is management entrenchment.” Ronald J. Gilson, *Just Say No to Whom?*, 25 *WAKE*

Suppose that a pill is placed in the corporate law system in a jurisdiction with a low compensation ratio between the CEO and a rank-and-file employee. It is less likely that such a jurisdiction has a practice of offering generous severance packages to departing corporate insiders. Thus, corporate insiders have little reason to accept hostile bids that deprive them of jobs, pecuniary benefits, and psychic utility without any compensation for such losses. Accordingly, they will use the pill in order to quell friendly deals as well as hostile takeovers.

One may argue that such a jurisdiction is able to develop an executive compensation system just as the United States did in 1990s; the U.S. CEO-employee compensation multiple increased from 140 to 500 (a 257% increase),²⁴⁶ and market participants learned how to live with a pill by designing severance packages with more generous terms.²⁴⁷ Of course, some countries can dramatically change their pay tradition as a pill is instated in their takeover laws. However, in many countries, the differences in culture, traditional values, political arrangements, and understanding of capitalism would make it difficult to accept the practice of Anglo-American executive compensation based on a large income disparity. Consider these differences from real episodes in the United States, Germany, and Korea.

Michael Ovitz—then CEO of Walt Disney Company—was a central figure in one of the most important executive compensation cases in the United States.²⁴⁸ He did not perform well, and his termination was discussed among the board. Finally, he left Disney and received approximately \$140 million in the form of severance pay after just about one year in Disney.²⁴⁹ Another example of “pay without performance”²⁵⁰ in severance pay can be taken from the finance industry. When Stanley

FOREST L. REV. 121, 127 (1990). “The emergence of shareholder activism in the early 1990s, combined with important changes in the Delaware case law around the same time, made institutional investors acutely aware of the potential for managerial entrenchment behind [a staggered board]/pill combination.” Bebchuk, Coates IV & Subramanian, *supra* note 25, at 900.

²⁴⁶ $[(500 / 140) - 1] \times 100\% = 257\%$.

²⁴⁷ As for market participants’ adjustment to Delaware takeover law with a poison pill, see Kahan & Rock, *supra* note 7, at 896, 898 (“Such compensation devices provide substantial incentives to managers to accept an unsolicited takeover bid Shareholders, then, do not love the pill, but they have learned to live with the pill.”).

²⁴⁸ There are a series of cases in relation to Walt Disney Company’s executive compensation. See, e.g., *In re Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).

²⁴⁹ *Id.* at 279.

²⁵⁰ The expression “pay without performance” is borrowed from the title of a book written by two corporate law professors. LUCIAN BEBCHUK AND JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2006). The two authors explained problems of American executive compensation practice in another article as well. See Bebchuk & Fried, *supra* note 26.

O'Neal was ousted from Merrill Lynch for his disappointing performance in 2007, he departed with \$161.5 million.²⁵¹ Likewise, it is not uncommon that underperforming top executives in the United States can “exit gracefully” with generous severance pay. They are even applauded and touted as “good men” at the time of control change because they voluntarily step down from their corporate positions and accept a value-enhancing merger or acquisition. In addition, they are often able to reap a substantial profit from equity-based compensation when high-premium bids are offered. This is an interesting phenomenon because these departing executives may be the reason for their companies’ depressed stock prices, and high bid prices are actually the level of prices that stocks should be worth with management of average capability.

Outside the United States, however, this generous severance pay is rare. In Germany, Vodafone, a British telecommunications firm, acquired Mannesmann, a German conglomerate, in 2000.²⁵² Although the agreement was ultimately friendly, Vodafone initiated a hostile bid at first. This deal brought sensation in Europe since it was the first “hostile” takeover (in terms of the nature of the first bid) of a German firm by a foreign firm.²⁵³ One controversy surrounding this deal was an “appreciation award” granted to Klaus Esser (then chief executive) and other managers of Mannesmann²⁵⁴—in particular, Esser was granted £10 million (about €15 million). Initially Esser had fought the Vodafone bid, but he suddenly “gave up resistance against Vodafone the day he knew about his compensation package.”²⁵⁵

In the United States, the question of executive compensation is generally left to the board of directors’ business judgment.²⁵⁶ Accordingly, even if some disgruntled shareholders bring lawsuits for monetary damages, it is difficult to find that corporate insiders breach any fiduciary duty. Surprisingly, to those who are accustomed to the “global” executive compensation standard (which is actually the American standard), Esser and key players designing the appreciation award were criminally prosecuted on

²⁵¹ See Miles Weiss, *Merrill Lynch’s O’Neal Departs With \$161.5 Million*, BLOOMBERG (Oct. 30, 2007), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a52OIGkiBx0Q>.

²⁵² MILHAUPT & PISTOR, *supra* note 129, at 69.

²⁵³ See *Fallout from Mannesmann: Breach of Trust?*, ECONOMIST (Mar. 20, 2003), <http://www.economist.com.hk/node/1596006> [hereinafter *Fallout*].

²⁵⁴ *Id.*; see also MILHAUPT & PISTOR, *supra* note 129, at 70.

²⁵⁵ See *Fallout*, *supra* note 253 (quoting Martin Peltzer, a lawyer in Frankfurt).

²⁵⁶ MILHAUPT & PISTOR, *supra* note 129, at 72 (“[U]nlike U.S. corporate law, which is largely silent on the question of executive compensation and leaves it to the business judgment of the board of directors, German statutory law sets the outer limits of compensation packages.”).

the grounds of breach of trust.²⁵⁷ *Fortune* magazine vividly described the Mannesmann case in an article titled “In Germany, High Pay Is a Crime.”²⁵⁸ However, BGH (*Bundesgerichtshof*, the Federal Court of Justice in Germany) reversed the trial court’s decision.²⁵⁹ Finally, the retrial court terminated the criminal trial on the condition that the accused pay a total of €5.8 million to various public-interest organizations.²⁶⁰

Another example of a top executive’s severance pay being tried in a criminal court came in Korea.²⁶¹ During the aftermath of the Asian Financial Crisis in 1997, many Korean companies with liquidity problems were sold to foreign investors at deeply discounted prices. In 2003, Lone Star acquired a controlling stake (51%) in Korea Exchange Bank (KEB),²⁶² which was one of the largest national banks in Korea. However, the prosecutor’s office in Korea accused Lee Kang-Won, then chief executive of KEB, of intentionally making KEB’s financial condition look worse than it was in order to facilitate the friendly deal.²⁶³ Allegedly, Lee received \$1.5 million for his future services in the bank as a consultant, which could be construed as compensation for smoothing the deal. After enduring five years of hardship under criminal investigation and trial, Lee was found not guilty of the charge of dereliction of duty by selling KEB at an intentionally low price.²⁶⁴ Although Lee was chief executive of one of the largest banks in Korea—a relatively large economy in the world²⁶⁵—generous severance

²⁵⁷ For details on this criminal trial, see *id.* at 69–74.

²⁵⁸ *Id.* at 71 (quoting *In Germany, High Pay Is a Crime*, FORTUNE, Oct. 13, 2003).

²⁵⁹ *Id.* at 73.

²⁶⁰ *Id.* at 74. In particular Esser, who received €15 million, was required to pay €1.5 million. *Id.*

²⁶¹ See generally Sung-Hyun Kim, ‘Lone Star Sageon’ Onyeonmane ‘Mujoe’ Jongjibu (‘론스타 사건’ 5년 만에 ‘무죄’ 종지부) [*Lone Star Case – Not Guilty in 5 Years*], MEONITUDEI (머니투데이) [MONEY TODAY] (Oct. 14, 2010) (S. Kor.), <http://www.mt.co.kr/view/mtview.php?type=1&no=2010101415392042484&outlink=1>;

Jung-a Song, *Prosecutors Call Sale to Lone Star ‘Illegal’*, FIN. TIMES (Dec. 7, 2006), <http://www.ft.com/intl/cms/s/0/1fc0ac50-85a2-11db-b12c-0000779e2340.html#axzz2YR1Rdwr4>; Peter Stein & Alison Tudor, *Lone Star Reaches Deal to Sell KEB to Hana Bank*, WALL ST. J. (Nov. 15, 2010), <http://online.wsj.com/article/SB10001424052748703326204575616590933846442.html>.

²⁶² Cynthia J. Kim, *Ex-ministry Official Acquitted of Selling KEB . . . at Low Price*, KOREA HERALD (Oct. 14, 2010), <http://www.koreaherald.com/national/Detail.jsp?newsMLId=20101014000947>.

²⁶³ Stein & Tudor, *supra* note 261; Song, *supra* note 261.

²⁶⁴ Kim, *supra* note 261. However, he was sentenced to an eighteen-month jail term for other crimes (such as accepting about \$50,000 from one of the bank’s suppliers). *Id.*

²⁶⁵ Korea used to be the eleventh largest economy in the world before the Asian financial crisis. *South Korea’s Meltdown*, ECONOMIST (Dec. 11, 1997), <http://www.economist.com/hk/node/108827> (“As other countries struggled to contain the financial crisis that has swept the region, policymakers from Thailand to Hong Kong realised that South Korea’s economy, the world’s 11th largest, was on the brink.”).

pay was not made available to him. In the U.S. pay system, Lee would not have risked imprisonment to receive such a “small” amount of money.

In sum, while generous severance pay is legally permissible in the United States, it could be treated as a “bribe” (at least by the public opinion and prosecutors) in other countries.²⁶⁶ Of course, there is certainly public outcry regarding the exorbitant level of pay for executives in the United States. In countries with a strong ethos of social democracy or egalitarianism, however, the public exudes much more serious political resistance to high pay for corporate insiders. The public sentiment in these countries is: how dare corporate insiders who underperform and incur the change of control receive even a \$1 severance pay while most employees suffer from massive layoffs arising from the merger or acquisition. Without a sufficient amount of severance pay available, corporate insiders—either a CEO or a controlling shareholder—have two choices. The first option is that they agree with a friendly deal and receive a relatively small amount of money functionally equivalent to the U.S. severance pay.²⁶⁷ The second option is to resist any type of M&A. As for the first option, corporate insiders realize that they may even face criminal punishment. Although they might ultimately be found not guilty, they risk the possibility of lengthy criminal trials. In addition, their reputations could be irreversibly damaged, making it practically impossible for them to return to the business world. Therefore, resisting any type of M&A is often the only available alternative to corporate insiders. Without sufficient compensation, corporate insiders have virtually no reason to initiate negotiations for a M&A that will take their jobs. Consequently, when it is imported to a country with social democracy or egalitarianism, the pill—the most effective takeover defensive device—is likely to quell almost all M&A deals in the domestic economy.

B. Control Premium and Friendly Deals

The previous subpart mainly focused on the role of executives’ compensation in M&A transactions. Outside the United States, although professional managers run some widely-held corporations, dominant shareholders are usually key players in strategic transactions. Of course, controlling shareholders are often corporate executives as well, and executive compensation is important to them. However, controlling shareholders are more interested in control premiums than executive compensation when they sell corporations to a prospective acquirer, since

²⁶⁶ In this sense, the U.S. severance pay could be characterized as a “legally permissible bribe.”

²⁶⁷ Mr. Lee’s case in KEB is an example. See *supra* notes 261–265 and accompanying paragraph.

the amount of money involved in the sale of control is generally larger than it is for executive pay.

1. Total Value of Control (and Control Premium)

Suppose that a dominant shareholder has significant votes in a corporation, but they do not amount to a majority (e.g., 30% votes). She is not perfectly insulated from a threat of acquisition without a pill, so a prospective acquirer has a chance (albeit a small one) to take over the corporation by purchasing shares in the market. Suppose that her jurisdiction implements a pill in its legal system. Then, it will be almost impossible for a prospective acquirer to take over the corporation in a hostile way. The only viable option would be to pay the dominant shareholder for the sale of control with a sufficient premium (which will change the controlling shareholder's intention about remaining in control). The problem is how "sufficient" the premium should be.

In general, a controlling shareholder has two sources of "utility" (or happiness) from managing a corporation: (1) the pecuniary benefits and (2) non-pecuniary benefits (NPB), e.g., social prestige, reputation, psychic utilities, and social influence, including political power.²⁶⁸ The pecuniary benefits to a controlling shareholder can be divided further into two sub-categories. One is monetary benefits distributed to *all* shareholders (including a controlling shareholder) according to their pro-rata economic stake in a corporation (e.g., capital appreciation of the stock as well as dividends); in other words, "pro-rata pecuniary benefits" (PPB).²⁶⁹ The other is monetary benefits available *exclusively* to a controlling shareholder irrespective of her fraction of economic interest in a corporation.²⁷⁰ These benefits can be referred to as "exclusive pecuniary benefits" ("EPB").²⁷¹ Then, the total value of control (TV) that the current controlling shareholder

²⁶⁸ For a more detailed explanation of non-pecuniary benefits see Gilson, *supra* note 101; Kang, *supra* note 171; Kang, *supra* note 226.

²⁶⁹ See Kang, *supra* note 226, at 118–23 (expressing PPB as ND₀).

²⁷⁰ In other words, a controlling shareholder can transfer corporate value to her own pockets at the expense of non-controlling shareholders. See Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, AM. ECON. REV., May 2000, at 22, 22–23 ("First, a controlling shareholder can simply transfer resources from the firm for his own benefit through self-dealing transactions. . . . Second, the controlling shareholder can increase his share of the firm without transferring any assets through dilutive share issues, minority freeze-outs, insider trading, creeping acquisitions, or other financial transactions that discriminate against minorities.").

²⁷¹ See Kang, *supra* note 226, at 118–23 (expressing EPB as SD₀). The current controlling shareholder is going to be paid cash flows of both PPB and EPB infinitely if she is a family controlling shareholder whose heir is expected to inherit the control power of a corporation. As to an infinite time horizon of a controlling shareholder through family inheritance, see Gilson, *supra* note 236.

can enjoy is the sum of PPB, EPB, and NPB.²⁷² She will sell control only if the payment a prospective acquirer offers is more than TV.

Table 2
TV (Total Value of Control) = PPB + EPB + NPB

2. *Issues Related to the (Subjective) Value of Non-Pecuniary Benefits of Control*

The above formula for TV is based on the assumption that NPB is capitalized in monetary terms. However, imagine that a current controlling shareholder places NPB at a value that is “priceless” (or “prohibitively high”). An extreme form of the “endowment effect”²⁷³ can explain this possibility. To a current controlling shareholder, a corporation is her own corporation that has been built and developed for a long time; accordingly, she places more subjective value on control and NPB than a prospective purchaser.²⁷⁴ Thus, a current dominant shareholder with priceless NPB would not sell the control of a corporation without regard to how much a third party offers. To such a controlling shareholder, the only successor may be her own children who share her genes and protect her legacy. To a controlling shareholder who is not willing to sell control of a corporation, a pill can make her more insulated from the risk of a hostile takeover. With priceless NPB and a pill, a friendly sale of control would not often take place as well.

Consider other cases where a current controlling shareholder is willing to sell control in exchange for the corresponding premium. Put differently, now NPB is not priceless. Thus, if a pill is adopted, a controlling shareholder is able to use it as a price negotiation tool for control. Even in those cases, if there is no buyer who is willing to pay such a premium, a

²⁷² More precisely, control premium which exclusively belongs to a controlling shareholder is only EPB + NPB. PPB is not a component of control premium available to only a controlling shareholder since pro-rata pecuniary benefits are shared with the other shareholders.

²⁷³ “Endowment effect” refers to “the fact that people often demand much more to give up an object than they would be willing to pay to acquire it.” Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193, 194 (1991). As to the concept of the endowment effect, Kahneman et al. relied on one of Richard Thaler’s articles. See *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980). If a controlling shareholder’s endowment effect is extreme, her psychic value of her controlled corporation is priceless. Thus, she would not sell control of her corporation to an outsider.

²⁷⁴ A well-known example of the endowment effect is that of an owner of a coffee mug. To part with the mug, the owner requires more compensation than it is worth. See generally Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990).

transaction of control sale would not often take place.²⁷⁵ As to large corporations in particular, there are several reasons why there are not many potential buyers of control. For example, as Professor Merritt Fox explains, “A typical acquirer does not—mostly is not able to—buy a large corporation like IBM, but a company with small or mid-capitalization.”²⁷⁶ Even if an acquirer can afford it, she is reluctant to take a high risk by purchasing a large corporation with a high premium.²⁷⁷ Perhaps the potential acquirer does not want to “put too many eggs in one basket.”

In addition, as I explain elsewhere, NPB could be deemed a luxury good that only relatively wealthy “consumers” (generally, controlling shareholders in large corporations) can “consume.”²⁷⁸ Thus, it is possible that the relative value of the NPB of a large controlling shareholder is higher than that of a small controlling shareholder.²⁷⁹ This phenomenon makes a large corporation more expensive and less affordable to a prospective acquirer. The endowment effect generates another limitation to a potential buyer since the controlling shareholder places high subjective value on control.²⁸⁰ Moreover, if a prospective acquirer is a foreign entity, she is subject to “familiarity bias”²⁸¹ and would discount the value of

²⁷⁵ For example, Professor Merritt B. Fox explains a potential acquirer’s risk averseness in a takeover:

A potential acquirer, in deciding whether it is worth paying what it would need to pay to acquire a target that the acquirer feels is mismanaged, must make an assessment of what the target would be worth in the acquirer’s hands. This assessment is inherently risky and the acquirer’s management is likely to be risk averse.

Merritt B. Fox, *The Securities Globalization Disclosure Debate*, 78 WASH. U. L. Q. 567, 571–72 n.11 (2000).

²⁷⁶ Professor Fox has also pointed out this phenomenon generally observed in the M&A market. Fox, *supra* note 166.

²⁷⁷ See, e.g., Fox, *supra* note 275.

²⁷⁸ See Kang, *supra* note 226. “[A luxury good has] an income elasticity of demand that is greater than 1: a 1 percent increase in income leads to *more* than a 1 percent increase in demand for a luxury good.” HAL R. VARIAN, *INTERMEDIATE MICROECONOMICS: A MODERN APPROACH* 281 (W.W. Norton & Company ed., 7th ed. 2006).

²⁷⁹ As for NPB of a large controlling shareholder, see Kang, *supra* note 226. The unit value of NPB becomes larger as the size of the corporation grows, so that, for example, a large corporation that is three times larger than a small corporation gives more than three times the psychic utility to a controlling shareholder than a small corporation does.

²⁸⁰ Compare an extreme form of the endowment effect and a normal form of the endowment effect. Under an extreme form, the endowment effect makes the control premium “priceless.” On the other hand, under a normal form, the endowment effect makes the control premium “expensive.”

²⁸¹ In behavioral finance, “familiarity bias” is widely known as the tendency for investors to invest the vast majority of their capital in assets and securities that are familiar to them. As to the familiarity bias see Gur Huberman, *Familiarity Breeds Investment*, 14 REV. FIN.

control and NPB. Due to the widened price gap between a seller and a buyer, it is less likely that a prospective acquirer would purchase the control of a large corporation. In sum, if a pill is adopted and used as a price negotiation tool, a sale of control, particularly of a large corporation, would not often take place.

3. Issues Related to Egalitarianism

The control premium is generally far higher than severance pay.²⁸² For example, if Lee Kang-Won had been a controlling shareholder of KEB, instead of chief executive, he would not have considered selling control to Lone Star for only \$1.5 million. When the culture and norms of a jurisdiction do not allow a large income disparity (although large monetary compensation might be legally allowed), such a country is not likely to allow a control premium that is available only to a current controlling shareholder and that excludes the rest of the shareholders as well as other constituencies in a corporation. This view is strengthened by the fact that a large fraction of the control premium is from exclusive pecuniary benefits (EPB), which a controlling shareholder receives by illicit self-dealing. These benefits might be socially endured as long as there is no apparent evidence for their presence. However, when the value of illicit self-dealing is formally capitalized in the corporate control market and as a result a current controlling shareholder is paid in the form of money, this process may create large social and political problems. Put differently, in a country with egalitarianism, a control sale could take place more easily when the control premium is equally shared with all shareholders according to their cash-flow rights. Facing the de facto equal treatment rule in sale of control imposed by social norms (irrespective of whether such a legal doctrine exists in a jurisdiction), a current controlling shareholder would not have much reason to sell control to a third party in the first place; rather, she would like to remain as a controlling shareholder.²⁸³ The pill reinforces a

STUD. 659 (2001).

²⁸² While a typical top manager does not have a substantial amount of shares, a typical controlling shareholder does. Thus, a controlling shareholder's control premium takes into account her equity investment, which is not significant to a top manager. In addition, when a controlling shareholder takes a top manager position in a corporation, the controlling shareholder's control premium could include her severance pay as a manager as well. In that sense, generally, the amount of money to a decision-maker in a friendly deal is larger in the form of a control premium available to a controlling shareholder than in the form of a severance pay available to a top manager.

²⁸³ Even if a controlling shareholder in a country with social democracy and egalitarianism is willing to sell the control despite all the aforementioned predicaments, there might be another barrier to a control sale, i.e., labor law. If labor law strongly protects employees from layoffs, a potential acquirer has little incentive to purchase the control since layoffs are a primary source of synergy in M&A that an acquirer pursues.

controlling shareholder's entrenchment.

C. Does the Pill Block Entire Sales of Control?

As seen in this Part, in a country with a strong sense of social democracy and egalitarianism, a likely consequence of adopting a pill system is that corporate insiders (both executives and dominant shareholders) will use a pill as an entrenchment tool and fiercely resist any bid. In addition, those corporate insiders have social and political justifications, which are often pretexts to use a pill to its full extent. For example, by resisting any bid, they are deemed defenders of employees whose welfare would be affected adversely by an M&A.²⁸⁴ Since this corporate insiders' position is well-supported in such a jurisdiction, the market for corporate control, which is deemed to be a market disciplinary device, would become less meaningful.

Consequently, there are three alternatives when company performance is disappointing: (1) management is permitted to let the performance keep deteriorating until *bankruptcy*, which is the worst scenario; (2) when the situation is serious and M&A is considered inevitable, management may rely on *fire sales* of companies at a deeply depressed prices rather than high-premium sales gained in a normal M&A; or (3) underperforming corporate insiders would seek a *government bailout* in which they may remain or be replaced. Although the pill would be likely to interfere with most M&A, the pill does not entirely block M&A as seen in (2). Perhaps a fire sale is another form of friendly M&A. However, since it is an involuntary friendly deal, it may be undesirable to a domestic economy.

On the other hand, in a country with a weak sense of social democracy and egalitarianism, not only would a pill be used for entrenchment, but it may also be used as a price negotiation tool (which only favors a controlling shareholder). As explained, however, it is plausible that a family controlling shareholder has a very high reserve price for her control (in particular for NPB) that few prospective acquirers are willing to pay.

In this respect, there are two noteworthy global factors. First, sovereign wealth funds (SWFs)—government-sponsored entities that invest assets such as foreign reserves in domestic and international financial

²⁸⁴ In M&A transactions, it is often the case that many employees are laid off. In *Unocal*, when deciding a defensive measure, directors can consider the impact of a takeover on constituencies other than shareholders ("i.e., creditors, customers, employees, and perhaps even the community generally"). *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). This discretion to the board can be used as an entrenchment tool for an incumbent management team. For example, a target board and managers can argue that since an M&A would be harmful to employees, they oppose an M&A, even if it creates more value.

markets²⁸⁵—became an important new type of acquirer in the international M&A market.²⁸⁶ Since SWFs retain the vast amount of foreign reserves, they are capable of and willing to pay for control and NPB, even if the reserve price of a controlling shareholder is high.²⁸⁷ SWFs could be active in the market of fire sales as well. Second, a drastic change in macro-economic environments can give another chance to foreign entities to pursue cross-border M&A. For example, suppose that Country A is under a systematic financial crisis. Then, a target in Country A (even if a controlling shareholder uses a poison pill to enhance her negotiation leverage for the price) will become very attractive to a business entity in Country B (provided Country B is not under macro-level financial distress) for two reasons. First, due to the financial crisis in Country A, a local controlling shareholder's reserve price of control could be lowered. Therefore, purchasing control is more affordable to a prospective acquirer in Country B. Second, an exchange rate system is distorted due to national financial difficulties so that the currency of Country A becomes drastically cheaper than the currency of Country B. Consequently, a Country B business entity has enhanced purchasing power in terms of its domestic currency so that it is more willing to purchase control of a local target in Country A.²⁸⁸

In sum, a pill adopted in a controlling shareholder regime would make control sales more difficult. However, the pill would not entirely block M&A in such a jurisdiction. Fire sales would still be available. In addition, SWFs and business entities with favorable macro-economic environments could be potential acquirers.

VII. CONCLUSION

In the United States, the “‘just say no’ [pill] was a much more problematic defense in the corporate governance world of the 1980s than it is today, with differently constituted boards and different incentive

²⁸⁵ See Katharina Pistor, *Sovereign Wealth Funds, Banks, and Governments in the Global Crisis, Towards a New Governance of Global Finance?*, 10 EUR. BUS. ORG. L. REV. 333, 339 n.15 (2009); Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1347 (2008).

²⁸⁶ During discussions with Professor Curtis J. Milhaupt, he hinted that sovereign wealth funds are willing to pay high control premiums for non-pecuniary benefits of control. Milhaupt, *supra* note 85.

²⁸⁷ SWFs become more interested in equity investments. “Many governments have recently announced plans to shift investment strategies for sovereign assets from conservative holdings of government bonds to higher-risk/higher-return investments in equities or corporate acquisitions.” Gilson & Milhaupt, *supra* note 285, at 1347–48.

²⁸⁸ If a target in Country A is under a deep pressure of fire sales, an acquirer in Country B is able to reap a great deal of profits.

compensation regimes.”²⁸⁹ If a jurisdiction outside the United States considers adopting a pill system, it should take into consideration whether its legal and socio-economic institutions are close to those of the United States in the 1980s or post-1980s. Without a highly developed legal and socio-economic infrastructure, the pill would remain a very “problematic defense in the corporate governance world” of such a jurisdiction. In that sense, the pill should be adopted through “bundling” so that when such a jurisdiction “buys” the pill, it should “buy” other Delaware doctrines in relation to the pill.

Market adaptation via executive compensation was another important reason why the pill did not quash a material fraction of M&A activities in the United States. A similar consequence would not be expected in a country with a strong ideology of egalitarianism; even most friendly deals would be crowded out when such a country adopts a pill system. The pill may enhance a controlling shareholder’s negotiation leverage, which increases her reserve price for sale of control. Accordingly, a sale of control, another type of a friendly deal, may be impeded by a controlling shareholder’s higher reserve price. Even if a sale of control takes place, however, most shareholders are excluded from sharing the benefits of a control sale if equal treatment is not required. This phenomenon cuts against a core rationale of adopting the pill, i.e., protecting weak non-dominant shareholders.²⁹⁰ Furthermore, when a jurisdiction complies with the equal treatment rule (either via legal requirement or a non-legal norm), it undercuts a controlling shareholder’s incentive to sell. Then the newly imported pill system would also suppress the sale of control, with some exceptions (e.g., SWF-involved deals and fire sales incurred by idiosyncratic or macro-level systemic problems).

In sum, importing a pill would cause too much of a chilling effect towards a market for corporate control. Nonetheless, the defensive system without a pill may not be enough to protect control of business entities. In that context, it is desirable to have an institution with expertise, impartiality, and efficiency to determine an allowable level of the pill’s deterrence on a case-by-case basis. Unfortunately, such a sophisticated institution is impractical for many controlling shareholder countries. As a crude solution, it may be worth considering a less preclusive defensive

²⁸⁹ Kahan & Rock, *supra* note 7, at 900.

²⁹⁰ One of the rationales of a poison pill is that a pill can protect value for all shareholders including weak non-controlling shareholders. As a faithful agent for shareholders, a target board can use a poison pill to reject a low-ball bid from an outsider, which would be harmful to non-controlling shareholders as well as to a controlling shareholder. However, if a pill is used only to protect a controlling shareholder who would like to capture the entire control premium for herself and the pill does not protect the remaining shareholders’ value, the rationale of utilizing a pill to protect the entire shareholders’ value would lose justification.

measure.²⁹¹ By proposing a theoretical framework, this Article calls for rigorous country-based studies in the near future to develop a “proportional” takeover defense system in a particular jurisdiction.

²⁹¹ Although it is beyond the scope of this Article, one possible solution is the *Interco* pill, which is less preclusive than the “just say no” pill. Alternatively, after careful evaluation of the takeover doctrines in a particular jurisdiction, a new enactment such as the Exon-Florio Amendment to the 1988 Trade Act may be useful (with/without a less powerful pill) as long as a drastic change of control in a corporation creates “national security” issues. *See* Pub. L. No. 100-418, § 5021, 102 Stat. 1107 (codified at 50 U.S.C. app. § 2170 (Supp.1989)). A careful review of a particular jurisdiction in an independent project should be done before enacting possible solutions.