The Use of Stock Options as Defensive Measures : The Impact of the 2001 Amendments to the Corporate Law on Corporate Control in Japan

Sôichirô Kozuka

I. INTRODUCTION

As a part of the overall revision of the corporate law of Japan that has been undertaken since the beginning of this century,[1] the issuance of stock options by a stock corporation was made possible by amendments to the Commercial Code in 2001.[2] Though at first considered to be mere deregulation, stock options have attracted the attention of many practicing lawyers as possible defensive measures against hostile takeovers.

Inspired by these practical concerns, some Japanese commentators have started to explore the issues regarding "poison pills," largely relying on the experience of the United States in the 1980s. However, Japanese corporate law differs from American (or Delaware) law both in the rules of the issuance of stock options and in the background regulation. This article examines how these differences affect the discussions over "poison pills" in Japan. Having briefly reviewed the background of the amendments in 2001 (II), the issues left undecided are discussed (III), followed by the implications on the arguments over corporate governance (IV).

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1 In the wake of a series of amendments to the corporate law concerning structural changes (mergers (1997 amendments), share exchanges (1999), and divisions of corporations (2000)), the corporate law of Japan, Book II of the Commercial Code and some relevant statutes, has been undergoing an overall review. As a result of this, four bills passed the Diet in 2001 and 2002. For an overview of them, see H. ODA, Corporate Law Reform in Japan 2001/2002 – Deregulation of Company Law? –, in: ZJapanR 14 (2002) 5. Besides a bill to further deregulate the repurchase of standing stocks that passed the Diet in 2003 and amendments to modernize the settlement system of stocks expected to be enacted later the same year, another project of fundamentally reviewing the corporate law is being undertaken toward enactment in 2005.

2 *Shôho,* Law No. 48/1899, as amended by Law No. 44/202; hereinafter ComC.

II. THE REGULATION OVER THE ISSUANCE OF STOCK OPTIONS

Prior to 2001, a stock option – the right to subscribe a share of the issuing company at a strike price determined in advance – had long been considered to lead inevitably to the issuance of a share at a discounted price. The reason is that a reasonable holder of a stock option will exercise his or her right only when the strike price is below the current price of the share. Under Japanese corporate law, the issuance of a share at a discounted price requires the authorization of the shareholders meeting by the supermajority, unless all the shareholders are given the right to subscribe.[3] The authorization must be specified and the issuance of shares pursuant to it shall take place in a certain period of time (prior to 2001 this was six months).[4] As a result, it used to be impossible to issue a stock option except in the case of a warrant bond, the issuance of which had been explicitly admitted by the Commercial Code since 1981.[5]

When the Japanese industry thought of issuing stock options to its directors and employees as a special type of remuneration, a bill was prepared by some Diet members to enable the issuance of stock options exclusively for this purpose. Thus in 1997 a stock option, under the name of "a right to subscribe a share" (*shinkabu hikiukeken*), was introduced into the corporate law of Japan.[6] Judging from the provision that always required the consent of the shareholders meeting by the supermajority, the traditional idea of regarding a stock option as a discounted issuance of a share appeared to have persisted at that time.

Theoretically, however, the holder of an option is faced by the uncertainty at the time of the issuance of the option. The difference *ex post* between the strike price and the current price at the time of the exercise of the right does not matter as long as the premium paid for the issuance of the option *ex ante* reflects the fair value of this uncertainty. In addition, it has come to be known that the fair value of the option *ex ante* can be worked out mathematically. Based on this understanding, the issuance of a stock option was generally liberalized in 2001.

The amended Code has introduced the term "stock option" (*shinkabu yoyakuken*) and provides that the board of directors can issue a stock option unless otherwise provided in the corporate charter.[7] The authorization of the shareholders meeting by the supermajority is required if and only if the option is issued to a person other than the present shareholders "under the particularly beneficial conditions."[8] It is interesting to note that the official proposal for the amendments of the corporate law published on 18 April 2001 stated that the envisioned amendments are aimed at mere "adjustments"

3 Art. 280-2 (1) ComC.
4 Art. 280-2 (4) ComC (prior to 2001 amendment). The time period under the present regulation is one year.
5 Artt. 341-8 – 341-18 ComC (prior to 2001 amendments).
6 Art. 280-19 ComC (prior to 2001 amendments).
7 Art. 280-20 ComC.
8 Art. 280-21 ComC.

between the regulation over warrant bonds on the one hand and stock options issued as remuneration on the other hand.[9] No reference was made to take-overs or defenses against them in the course of the discussions.

III. THE FAIRNESS OF THE ISSUANCE OF STOCK OPTIONS

1. *The Issuance Subject to Injunction*

The issuance of a stock option in contravention of statutes or corporate charters can be enjoined by an order of the court at the request of a shareholder.[10] Therefore, if the court finds the price of the option "particularly beneficial" to the subscriber, while the issuing company, presuming that the price is not beneficial, has not acquired the consent of the shareholders meeting, the issuance is subject to injunction. So is the issuance that is "substantially unfair."[11] These regulations have been transplanted from that of the issuance of new shares. However, of course, the meaning of "particularly beneficial" or "substantially unfair" may not be the same as has been understood with regard to the issuance of new shares.

As to whether the option price is "particularly beneficial" or not, many commentators argue that the fair value of the option, worked out in reliance on some mathematical model such as the *Black-Scholes* formula, should be the standard.[12] According to this idea, only the issuing price (premium) is relevant, no matter how the strike price is set. However, the official interpretation indicated by an attorney of the Ministry of Justice during the debates in the Diet referred to the total sum of the issuing price and the strike price, as compared with the projected market price of the share at the time of the exercise of the right.[13] Here a persistent idea is observed that the issuance of an option is a variety of the issuance of a new share and that the holder of an option is favored if the total amount paid by him or her is less than the market price of the share to be issued. However, the same government attorney mentioned the use of the *Black-Scholes* formula in his intervention, though it appeared that he assumed the formula to be a tool for projecting the market price of the share.[14] After all, it cannot be denied that there remains some confusion over the interpretation of "particularly beneficial."

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9 HÔMUSHO MINJI KYOKU SANJI KANSHITSU, SHÔHO TÔ NO ICHIBU WO KAISEI SURU HÔRITSU-AN YÔKÔ CHÛKAN SHIAN NO KAISETSU [Ministry of Justice, Civil Affairs Bureau, Commentary on the preliminary proposal on the outline of amendments to some parts of the Commercial Code], Point 3, reproduced in: Shôji Hômu 1593 (2001) 5.

10 Art. 280-39 (4) ComC, applying Art. 280-10 *mutatis mutandis*.

11 *Id.*

12 T. FUJITA, *Opushon no hakkô to kaisha-hô (jô)* [The issuance of options and the corporate law (Part 1)], in: Shôji Hômu 1622 (2002) 18.

13 Cited in: FUJITA, *supra* note 12, at 26, note 28.

14 Cited in: FUJITA, *supra* note 12, at 26, note 29.

The meaning of the "substantial unfairness" of the issuance of an option is still less clear. In the case of the issuance of a share from which the regulation has been transplanted, the established case law is the subjective test that examines the primary intent of the management. The issuance of a share is held as "substantially unfair" if the primary intent lies in diluting the voting rights of a shareholder rather than acquiring fresh capital. Since it is not so difficult for a company to find the need for fresh capital, the issuance of a share has seldom been enjoined on this ground.[15] This is why the issuance of a new share has been the most effective measure for a target company to defend itself against a hostile takeover under the Japanese corporate law.

Some commentators assume that this case law can be relied on with regard to the issuance of an option as well.[16] However, the situation is quite different from the case of a new share. On the one hand, a stock option is not issued to satisfy the immediate demand for fresh capital. On the other hand, the dilution of voting rights is merely potential rather than actual at the stage of the issuance of a stock option. Therefore, the subjective test, if adopted, cannot be the same as that employed traditionally with regard to the issuance of a new share.

The more fundamental problem with the subjective test is that it merely refers to the intent of the management of the target company and not to the nature of the bid or bidder. Therefore, whether the offer to purchase standing shares is coercive or not never comes into consideration. Nor does the intent of the acquirer matter, whether it aims to bust up the target company or to replace the management in order to run the target company more efficiently. In this sense as well, the subjective test is not suitable where the stock option is used as a defensive measure and its fairness is disputed. A new test may be needed.

2. *The Trigger for the Exercise of the Stock Option*

No matter how the relevant provisions are interpreted, it is unlikely that those acquirers that suffered from stock options issued by the target company can make use of the injunction, since the dilution takes place after the rights are exercised, not at the time of the issuance of the options. The acquirer may not even be the shareholder of the target company when the stock options are issued. Therefore, the acquirer may have to look for other measures to rely on.

15 The exception was a case where Company A issued new shares and had Company B subscribe them, while Company B issued new shares with about the same worth to Company A. It was obvious that neither of them acquired fresh capital through this "cross issuance" scheme and that the aim of the whole scheme lay in diluting the voting rights of a raider that held a substantial percentage of shares of both companies. See *Shûwa KK v. KK Chûjitsuya,* in: HANREI JIHÔ 1317 (1989) 28 (Tokyo District Court, 25 July 1989), translation in English in: Y. YANAGIDA ET AL., Law and Investment in Japan (2nd ed. 2000, Cambridge) 550.

16 K. EGASHIRA, *Kabushiki kaisha, yûgen kaisha-hô* [Laws of Stock Corporations and Limited Liability Companies] (2nd ed. 2002, Tokyo) 611, note 2.

In order for a stock option to be workable as a poison pill, the exercise of the right must be triggered by a certain event. It is mentioned in the Commercial Code as "conditions for the exercise of the stock option," which can be set by the board of directors in advance.[17] A typical example may be "…exercisable when one shareholder has acquired twenty percent or more of the outstanding shares." If the trigger event is dependent on the action taken by the corporation, as in the case where the exercise of the option is subject to the decision of the board of directors,[18] the acquirer who suffered may be able to attack the validity of such a decision.

A more likely design of the "poison pill" is that the trigger event for the exercise of the option is provided broadly and objectively, referring to the acquisition of a certain portion of standing shares by one person or one group. In this case, room for cancellation of the stock options may be necessary in order for a friendly M&A to be successful. The event that cancels the standing options may also be set in advance, when the options are issued.[19] The latter event may probably be the decision of the board of directors, since it is almost impossible to define a friendly M&A – as distinguished from a hostile take-over – in advance. Under these circumstances, the acquirer has no means at hand, since the acquirer offering a hostile takeover apparently has no right to claim cancellation of the stock options.[20]

IV. THE IMPLICATIONS ON CORPORATE GOVERNANCE

Corporate governance has recently been one of the major issues of Japanese corporate law. Various comments or proposals have been made with regard to the liability of directors, the effective enforcement of audit, the role of shareholders' derivative suits, and the structure of corporate organs to ensure better governance.[21] It is, therefore, all the more interesting to note that stock options have not attracted much attention in this context. In other words, market forces have almost been neglected by Japanese corporate lawyers when the governance of corporations is discussed.

It is obvious, however, that discussions are needed about whether a takeover is a discipline of the capital market over managers or whether it encourages myopic decisions

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17 Art. 280-20 (2) no. 6 ComC.

18 It is not without question whether a trigger of the kind mentioned in the text is valid and enforceable. See a cautious reservation in: E. KORONUMA, *Kôkai kaisha ni okeru shurui kabushiki, shinkabu yoyaku-ken no kôyô to mondai-ten* [The use and issues of class shares and stock options in public corporations], Minshôhô Zasshi, 126, no.4/5 (2002) 465, note 56.

19 Art. 280-20 (2) no. 7 ComC.

20 KUROMUNA, *supra* note 18, at 463. However, if the trigger event is a discriminatory or otherwise unfair one, the condition attached to the stock option could be held void, as contrary to the public policy (Art. 90 Minpô [Civil Code]).

21 These issues are discussed in M. HAYAKAWA, Die Reform des Gesellschaftsrechts vom Mai 2002 und Corporate Governance in Japan, in: ZJapanR 14 (2002) 31.

and devastates the stable management of corporations. Very recently, after some lawyers noticed the possibility of using stock options as defensive measures, research on the American experience with "poison pills" has become popular among Japanese academics. It should be kept in mind, however, that the regulatory background of Japan differs from that of the United States.

On the one hand, Japanese stock companies are rather vulnerable to hostile acquisitions. The principle of "one share – one vote" is strictly required:[22] even after the designing of equity securities was made flexible in 2001, disproportionate allocation of voting rights such as placing a cap over the voting rights of a large shareholder is not allowed. More direct restriction over the transfer of shares, by a provision in the charter that subjects the transfer to the approval of the board of directors,[23] is not available for listed companies, since stock exchanges do not allow such a provision in the charter in the case of listed companies. Judging from these backgrounds, the argument that poison pills equip the management with tools to negotiate with the bidder on equal footing[24] may have some good reason.

On the other hand, under the Securities and Exchange Act (*Shôken torihiki-hô*) of Japan, a bidder must not make a discriminatory tender offer. The bidder is allowed to make a partial offer but is obligated to purchase on the pro rata basis if securities are tendered at a higher price than the bidder offered to accept.[25] Therefore, as long as the procedure of tender offer is complied with, the offer is likely to be less coercive.[26]

Further, the efficiency of the securities market may need to be explored. In a less efficient securities market, too much reliance on bidding and takeovers will not result in the market discipline of the governance of public corporations; instead, the opportunities will be exploited by green mailers or racketeers. If this is the case, it may be wise not to impose too many limitations on the use of defensive measures.

Whether or not corporate managers can employ defensive measures as "poison pills" as in the United States depends, at least partially, on how these policy issues are determined in Japan. The liberalization of the issuance of stock options in the amendments of 2001 is not a sufficient condition for this.

22 Art. 241 (1) ComC.

23 Art. 204-2 ComC.

24 K. TAKEI, *Shôhô kaisei to kigyô bôei senryaku* [Amendments to the corporate law and defensive measures of corporations], in: Jurisuto 1250 (2003) 2.

25 Art. 27-13 (5), Securities and Exchange Act.

26 This is all the more so because a so-called cash-out merger is considered to be impossible under the present Commercial Code of Japan. The coercive scheme of two-step merger that was frequently observed in the United States in the 1980s cannot be practiced in Japan. However, the Act on Special Measures to Revitalize the Economy *(Sangyô katsuryoku saisei tokubetsu sochi-hô)* permits, in the case of a merger approved by the Minister in charge, payment of cash to the shareholders of the merged (target) company rather than issuing shares of the merging (acquiring) company, thus enabling the cash-out merger in limited cases. Art. 12-9 of the Act.

V. CONCLUSION

The possibility to use stock options as defensive measures against hostile takeovers has crept into the corporate law of Japan somewhat by chance. In the course of preparing for the 2001 amendments, hardly any discussions about it were held. As a result, much has remained unresolved, both with regard to technical questions about statutory provisions on stock options and with regard to policy issues over the benefit and harm of takeovers. It is hoped that lawyers in Japan – both practicing and academic – and finally the courts will address these issues squarely in the coming years. At the same time, it will make up for a point overlooked in the discussions on the governance of public corporations: market discipline over management.

ZUSAMMENFASSUNG

Im Zuge der umfassenden Reformen des japanischen Gesellschaftsrechts wurde unter anderem die Ausgabe von Aktienoptionen erleichtert. Dies war lediglich als eine Maßnahme zur Deregulierung und Flexibilisierung des Aktienrechts gedacht. Praktiker haben jedoch schnell erkannt, daß die erleichterte Ausgabe von Aktienoptionen sich auch als Verteidigungsinstrument gegen feindliche Übernahmen einsetzen lassen könnte. Ein solcher Nebeneffekt der Reform ist vom Gesetzgeber nicht bedacht worden und hat eine Reihe von bislang erst wenig diskutierten Fragen aufgeworfen. Der Beitrag setzt sich mit Voraussetzungen und Grenzen des Verteidigungsinstruments auseinander.

(Die Redaktion)