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Takeover defences and the role of law: a Japanese perspective

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I. Introduction

Today, takeovers of publicly held business firms are understood as an effective and speedy means of resource allocation. Yet the legal framework surrounding takeovers, particularly hostile ones, is not simple. It appears to vary significantly from country to country.

With regard to takeover defences, the United States is rich both in its practical experience and academic literature. In contrast, Japan was poor at least until 2005. While courts in Delaware in the United States have shaped the law in this area over the past twenty-five years, Japanese law is not clear despite the existence of several statutory provisions of the Japanese Company Act and certain well-known cases in recent years. Although the United States is rich in its practical experience and academic literature, evidence seems to be inconclusive. Moreover, there is so much debate among commentators that opinions are quite divided among reasonable people. As a result, this area has produced (and still today produces) one of the most difficult issues in US corporate law.[2] First, while empirical studies generally show that hostile takeovers are good for the economy in the sense that they generally enhance the value of the target firms, it is unclear from the past empirical studies whether defence measures adopted by target boards, in particular 'poison pills', are good or bad for the target firms (and thus for the economy). Second, normative arguments in academic literature about what defensive measures should be legally permitted or prohibited, and to what degree, are quite split in the United States. In Delaware, however, the standard of

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[2] The text draws on H. Kanda, 'Does Corporate Law Really Matter in Hostile Takeovers?: Commenting on Professor Gilson and Chancellor Chandler', *Columbia Business Law Review*, 67 (2004).

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

In contrast, in Japan, until recently, no one could tell what the law was with respect to takeover defences. However, beginning in 2005, several well-known hostile takeover attempts took place in Japan, and a few cases were brought into court rooms. To date, more than three hundred public firms have introduced the 'Japanese version' of the poison pill since 2005. Discussion as to what should be the criteria with which a particular hostile bid is judged good or bad has been immense. Correspondingly, a few amendments to the relevant statutes have been made in 2005 and 2006.

In this chapter, I describe these developments and experiences in Japan: Section II describes the recent developments; Section III shows characteristics as found in the recent developments; finally, Section IV is my preliminary conclusion and offers implications from preceding sections.[3]

II. Developments

As Professor Curtis Milhaupt stated, 'the unthinkable has happened'.[4] In 2005, a battle for control over Nippon Broadcasting occurred. In response to the takeover attempt by Livedoor, the board of Nippon Broadcasting adopted a defence measure by issuing stock warrants (*shinkabu yoyaku ken*) to its de facto parent, Fuji TV in order to dilute Livedoor's stake. The Tokyo District Court enjoined the issuance and its decision was affirmed by the Tokyo High Court.

[3] For articles on the Japanese situation in English include S. Kozuka, 'Recent Developments in Takeover Law: Changes in Business Practices Meet Decade-Old Rule', *Zeitschrift für Japanisches Recht*, 21 (2006), 5; K. Osugi, 'What is Converging? Rules on Hostile Takeovers in Japan and the Convergence Debate', *Asian-Pacific Law and Policy Journal*, 9 (2007), 143.

[4] C.J. Milhaupt, 'In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan', *Columbia Law Review*, 105 (2005), 2171. See also J.B. Jacobs, 'Implementing Japan's New Anti-takeover Defense Guidelines, Part II: The Role of Courts as Expositor and Monitor of the Rules of the Takeover Game', *University of Tokyo Journal of Law and Politics*, 3 (2006), 102.

Nippon Broadcasting, a radio broadcaster, is part of the Fuji Sankei media group and was a de facto subsidiary of Fuji Television Network, Inc. ('Fuji TV'), Japan's largest media company. Somewhat anomalously, however, Nippon broadcasting held 22.5% of the outstanding shares of Fuji TV while Fuji TV held only 12.4% of Nippon Broadcasting's shares. In part to rectify the situation, on 17 January 2005, Fuji TV announced a cash tender offer for all of the outstanding shares of Nippon Broadcasting. The bid was approved by the board of Nippon Broadcasting.

In the midst of this tender offer, on 8 February 2005, Livedoor, an internet service provider, made a sudden announcement that it had just acquired approximately 29.6% of Nippon Broadcasting's shares. Livedoor acquired these shares through market purchase.[5] In combination with the shares previously owned, Livedoor's stake reached 38% of Nippon Broadcasting's shares. On the same day, Livedoor informed Nippon Broadcasting of its intent to acquire all of its outstanding shares.

In response, on 23 February 2005, Nippon Broadcasting announced that its board had decided to issue stock warrants to Fuji TV exercisable into 47.2 million shares of Nippon Broadcasting stock. If exercised, the warrants would give Fuji TV majority control and dilute Livedoor's stake to less than 20%. Livedoor by that time had acquired approximately 40% of Nippon Broadcasting stock. The board decision was unanimous. Four outside directors voted for the decision and four directors affiliated with Fuji TV abstained from participation in the decision. The warrants were exercisable at 5,950 yen, the price offered in Fuji TV's tender offer. Nippon Broadcasting announced that the purpose of the issuance of warrants was to remain within the Fuji Sankei group, which would provide long-term benefits to its shareholders.

Livedoor sued to enjoin the issuance of warrants. The Tokyo District Court enjoined the warrant issuance as 'significantly unfair' under the Commercial Code. The court held that its primary purpose was to maintain control of the firm by incumbent management and affiliates by the Fuji Sankei Group. The Tokyo High Court affirmed.[6] Accordingly, Nippon Broadcasting and Fuji TV abandoned the warrant issuance. Livedoor eventually obtained a majority of shares of Nippon Broadcasting.

[5] The method of purchase deployed by Livedoor, called off the floor, after hour trading, was permitted during the period when a tender offer was pending. This method was much criticized, and the law was amended in July 2005 so as to make such a trading method unlawful.

[6] Tokyo District Court Decisions on 11 March 2005 and on 16 March 2005. Tokyo High Court Decision on 23 March 2005, 1899 *Hanreijiho* 56.

The battle ended in a somewhat peaceful way. On 18 April 2005, Livedoor agreed to sell its Nippon Broadcasting shares to Fuji TV at 6,300 yen per share, approximately the average price it paid for the shares. In return, Fuji TV obtained a 12.5% stake in Livedoor for a capital infusion of approximately $440 million, and the three companies established a joint committee to explore related ventures.

The rationales in the two decisions of the Tokyo District Court and the Tokyo High Court are not identical, but they have many common elements. To cite from the decision of the High Court, the court stated a basic principle of the 'power allocation doctrine'. Under this doctrine, shareholders elect directors. The board of directors has the power to issue stocks and warrants only for the purpose of funding new capital, paying incentive-based compensations and others. However, the board does not have power to take defensive measures against hostile bids. The decision of who should take control over the company must be delegated to shareholders. This, however, permits exceptional situations where the board is permitted to take defence actions as an emergency. Those situations are found where the bidder attempts to disrupt the firm. The court did not find such exceptional situation in the battle for control over Nippon Broadcasting.

This case was enough to call the serious attention of managers of all publicly held firms in Japan and market participants. The Corporate Value Study Group, established by the Ministry of Economy, Trade and Industry ('METI') in 2004, released its interim report on 27 May 2005[7] and on the same day, guidelines for defensive measures were released jointly by METI and the Ministry of Justice ('Guidelines').[8] It must be noted that while the Nippon Broadcasting case involved a 'post-bid' defence, these documents are for 'pre-bid' defensive measures, and public firms began to introduce a variety of pre-bid defensive measures beginning in mid 2005.

The Guidelines, although they are not the law, list three basic principles for the validity of pre-bid defence measures.[9] First, the purpose of such defence measure must be to enhance corporate value and thus shareholders' value as a whole. Second, the adoption of such a defence plan must be based on the shareholders' will. Finally, such defence

[7] Ministry of Economy, Trade and Industry, *Corporate Value Study Group Report* (27 May 2005).

[8] Ministry of Economy, Trade and Industry and Ministry of Justice, *Guidelines regarding Takeover Defenses for the purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests* (27 May 2005).

[9] Ibid.

measure must be necessary and satisfy proportionality, namely, they must be a reasonable and non-excessive means to accomplish the purpose. Also, the Guidelines specifically discuss the issuance of stock warrants. They provide that if such warrants are issued by a decision at the shareholders' meeting, its validity or compliance with the three principles would be presumed. If such warrants are issued by a board decision without a shareholders' meeting, necessity and proportionality would have to be strictly required.

In the course of these quick developments, a couple of changes in the relevant statutes were made. First, the Ministry of Justice ('MOJ') promulgated a disclosure rule for defensive measures, effective on 1 May 2005. A joint-stock company is required to disclose its fundamental policy for its management in its annual business report.[10] This rule applies to the fiscal year ending on or after 1 May 2005, and it means that most public firms began to disclose such policy in 2006. Second, the Subcommittee on Corporate Governance at the Liberal Democratic Party discussed this area in the first half of 2005 and released an important report on 7 July 2005.[11] This report endorsed one type of poison pill using a trust scheme by making clear of its tax implications. In addition, the report called for a few changes of tender offer regulation. The bill for wide-range reform of the Securities and Exchange Act ('SEA') (which includes the tender offer regulation) was passed in the Diet in June 2006, and the proposed changes by the Subcommittee were included. The relevant part of the regulation became effective on 13 December 2006. In this connection, the Financial Services Agency ('FSA'), which has jurisdiction over tender offer regulation, made detailed rules under the amended SEA. Among others, when a tender offer is commenced, the target board has the legal right to ask questions to the bidder and the bidder must answer them in their public documents. A European-style mandatory bid rule (which requires the bidder to bid for all outstanding shares) was introduced, but only where the bidder attempts to acquire two-thirds or more of the target shares. Finally, Tokyo Stock Exchange ('TSE') has been serious in promulgating rules and guidelines to avoid possible confusions in the stock market it operates as a result of possible hostile battles and unexpected measures that might be taken by both sides. TSE is still in the process of writing rules and guidelines, but to

[10] See Article 127, Ministry of Justice Companies Act Implementation Rule (2005).

[11] Report of the Subcommittee on Corporate Governance, Liberal Democratic Party (7 July 2005).

date, it has made several important announcements concerning a few specific items.[12] It is clear that 'golden shares' or other 'dead hand' poison pills are not permitted for the companies listed on the TSE.

In the course of these developments, two further court decisions were made. First, a pre-bid defensive scheme using stock warrants, adopted by the board of Nireco, a provider of various controlling and measuring systems, was enjoined by the Tokyo District Court and Tokyo High Court in June 2005.[13] Second, a post-bid defence adopted by the board of Nippon Gijutsu Kaihatsu (Japan Engineering Consultants Co., 'JEC'), a consulting firm in construction, was approved by the Tokyo District Court in July 2005.[14] In the latter case, on 20 July 2005, Yumeshin, a construction firm, launched a hostile tender offer for all outstanding shares of JEC. In response, JEC announced a stock split. JEC asserted that it adopted an advance warning defence plan (see below) and Yumeshin violated the process asked for by the plan. At that time, it was unclear whether the bidder was permitted under the SEA to change the bid price during the bid period if an unexpected thing happened, such as a stock split, but eventually, the FSA permitted such change. This means that a stock split would have no effect in frustrating Yumeshin's hostile bid. Under the situation, on 29 July 2005, the Tokyo District Court decided not to enjoin the stock split. On the same day, JEC announced an issuance of stock warrants. After this, JEC found a white knight, which launched a competing bid with a higher price. Yumeshin's bid turned out to be unsuccessful (as Yumeshin ended up with holding 10.59% of JEC stock). Eventually, JEC withdrew the issuance of warrants, and the battle ended.

With these court decisions and related discussions, many publicly held firms in Japan moved to adopt two types of pre-bid defence measures. One is a poison pill scheme using a trust or similar structure, and the other (more popular one) is a scheme known as advance warning. As of 25 May 2007, 359 listed firms (out of total of approximately 3,900 listed firms in Japan) have pre-bid defence plans. For listed firms on the TSE Section One, 283 firms out of total 1,753 have adopted such plans. Among 359 firms, 349 have adopted some form of advance warning plan, and 10 have trust-type or similar warrant schemes.[15]

[12] See generally Tokyo Stock Exchange, *Interim Report of the Advisory Group on Improvements to TSE Listing System*, 27 March 2007.

[13] Tokyo District Court Decisions on 1 June 2005 and on 9 June 2005. Tokyo High Court Decision on 15 June 2005, 1900 *Hanreijiho* 156.

[14] Tokyo District Court Decision on 29 July 2005, 1909 *Hanreijiho* 87.

[15] See the material submitted to the METI Corporate Value Study Group on 29 May 2007.

Under a typical trust based scheme, the firm issues stock warrants to a trust bank with designated shareholders as beneficiaries of the trust. When a hostile bid occurs, the pill is triggered, and the trust bank transfers the warrants to the shareholders. The warrants have a discriminatory feature and the bidder has no right to exercise them, as the terms and conditions of the warrants usually provide that the warrants are not exercisable by the shareholders who own 20% or more of the firm's outstanding stock.

The advance warning plan varies from company to company but its typical style is as follows. The board, sometimes with approval of the shareholders' meeting, makes a public announcement that if a shareholder attempts to increase its stake to 20% or more of the firm's outstanding stock, before the shareholder does so, the shareholder is required to disclose and explain, in accordance with the details specified in the announcement, its intent to hold such stake and what the shareholder would do for the firm. If the shareholder does not answer these questions or the target board thinks the shareholder's explanation to be unsatisfactory, then a defence measure would be triggered. Such defence measure is typically to issue stock warrants to all shareholders but the shareholder having 20% or more cannot exercise the warrants. Instead, such shareholder's warrants can be redeemed at a fair price at the option of the company. Thus, typically, warrant issuance has an effect of 'cashing out' the hostile bidder.

In most plans (304 plans out of total 359), judgment for triggering is to be made by a special committee composed of independent individuals. In some companies' plans, such defence measures are to be triggered after approval at the shareholders' meeting.

Because the Tokyo High Court decision on Nippon Broadcasting and the METI-MOJ Guidelines emphasize shareholder decision, most public companies adopt defence schemes which ask for a decision at the shareholders' meeting either when it introduces a pre-bid defence plan and/or when it triggers such a plan.[16] In practice, in most companies, the board proposal for introducing an advance-warning-type defence measure was put for approval at the shareholders' meeting, and in fact obtained shareholder approval. For those companies who introduced advance-warning defence plans, it is unknown whether they will survive a judicial review

[16] Out of 359 advance warning plans, 307 plans were introduced by approval at the shareholders' meeting. The remaining 42 plans were introduced by board decisions only. See supra note 12.

when such a plan triggers the pill, because to date, there has been no case in which that has happened, except in the JEC case noted above.

In May 2007, Steel Partners, a US buy-out fund, commenced a hostile tender offer for all outstanding shares of Bulldog Sauce, a Worcester sauce producer.[17] Bulldog Sauce did not have any pre-bid defence plan. As a post-bid defence, the board of Bulldog Sauce intended to issue stock warrants to all stockholders, including Steel Partners and its affiliates (collectively 'SP'), with the condition that SP cannot exercise the warrants. The warrants have a redemption feature, by which the warrant holders other than SP receive common stocks in exchange for turning the warrants into the company whereas SP receives cash. Thus, the scheme was structured as a scheme diluting the voting right of SP without an economic loss to SP ('economic' does not include the value of voting right). The Bulldog board introduced the proposal at the annual shareholders' meeting on 24 June 2007, and the plan was approved by more than 80% of the shares. SP sued to enjoin the issuance of the warrants. The Tokyo District Court held on 28 June 2007 that the scheme was valid.

The court held that strict judicial scrutiny adopted by the High Court decision on Nippon Broadcasting case does not apply here because the defence measure was approved at the shareholders' meeting. The court also held that since the defence measure provides 'just compensation' to the hostile bidder, it does not violate the proportionality principle. In other words, the court's position is that 'necessity' is presumed because shareholders decided and 'proportionality' is subject to judicial review (and it was held to be satisfied in this case). Steel Partners appealed, but the Tokyo High Court affirmed on 9 July 2007. Tokyo High Court found that SP was an 'abusive bidder' and held that the defence measure was lawful.

Steel Partners appealed to the Supreme Court. On 7 August 2007, the Supreme Court affirmed. The Supreme Court's opinion was somewhat similar to that of the Tokyo District Court. The highest court held that because the defence measure was approved by shareholders, the necessity requirement was met, and because it provided SP with just compensation, the proportionality test was satisfied. It also held that because the measure satisfied the proportionality test, it did not violate the purpose of the principle of equal treatment of shareholders.

[17] For a detailed description and analysis of this case and the court decisions, see S. Osaki, 'The Bull-Dog Sauce Takeover Defense', *Nomura Capital Market Review*, 10 (2007), No.3, 2.

The Steel Partners' tender offer ended on 23 August 2007. Only 1.89% of all outstanding shares were tendered. On 30 August 2007, Bulldog Sauce introduced an advance warning style pre-bid defence plan.

In a similar fashion, in May 2007, Steel Partners launched a hostile tender offer for all outstanding shares of Tenryu Saw Mfg. Co. ('Tenryu'), a saw blade manufacturer. In response, Tenryu adopted an advance warning defence plan with approval of more than 80% shares at the shareholders' meeting.[18] Steel Partners' bid was unsuccessful because only 2.69% of all voting shares were tendered (Steel Partners ended up with 11.73% of all voting shares of Tenryu).

III. Characteristics

The developments described above show a few characteristics in this area in Japan. First, the rule in the statute is not clearly written and as a result whether and when a given defensive measure is legal is relegated to proper interpretation of the relevant statutory revisions.[19] The most relevant are the provisions under the Companies Act, Articles 210 and 247, which provide that the issuance of stock or stock warrants is enjoined if such issuance is significantly unfair. The courts have been struggling to find an appropriate test of judicial review.

Second, the Japanese discussion and judicial development emphasize shareholder decision. However, Bulldog Sauce and Tenryu are exceptional companies in that they apparently have many shareholders friendly to the management. Usually, it seems not easy to obtain

[18] This pre-bid plan explicitly stated that the plan does not apply to the tender offer by Steel Partners which was pending at that time. It applies to all future tender offers and other stock acquisitions.

[19] Under the Companies Act of 2005, defence plans using the class of shares are possible. For instance, a firm may issue a special class of shares which does not have voting power for the part of the shares exceeding the 20% stake of all outstanding shares. To issue such shares, the firm's charter must state its content. A firm issuing common shares may convert them into such special class shares by a charter amendment, which requires two-thirds approval at the shareholders' meeting. However, in practice, no company has introduced such class shares yet. There is discussion in academia as to whether such shares are always lawful, and the Tokyo Stock Exchange takes the view that such shares are not appropriate for existing listed firms, as opposed to firms making IPOs. In November 2004, an oil company issued a 'golden share' (a special class share) which gave the holder of the share a veto right over all proposals submitted to its shareholders' meetings. However, the share was issued to the government, and it was understood that the oil company should be permitted to issue such shares to the government from a national public policy standpoint.

two-thirds approval at a shareholders' meeting. What happens if the firm obtains simple majority approval at a shareholders' meeting? What if the firm introduces a pre-bid defence plan without shareholders' approval? Indeed, certain firms did introduce such defence plan without shareholders' approval, but as noted above, those plans have not yet been triggered, and thus it is not clear whether the plan will be held valid by the courts if triggered.

Third, with the important exception of the emphasis on shareholder decision, the rule developed in recent years is similar to the one which was shaped in the United States, particularly in Delaware, in the past twenty-five years. 'Necessity and proportionality' is the standard of judicial review. However, to date, the scope of permitted discretion of a target board seems much narrower in Japan than in the US.

Finally, there has been almost no proposal to clarify the rule, or improve the situation, by introducing new legislation. The only proposal that was made in the past was the one to introduce a European style 'mandatory bid' rule, and as noted above it was partially recognized in the amendments to the SEA as effective on 13 December 2006. However, most of this area has been relegated to judicial development.

IV. Preliminary conclusion

What implications can we draw from all of these developments? In theory, it is often said that there can be both good and bad takeovers (although economists might say that distinction between these two cannot be made). Good or bad must be judged from an economic perspective. In this sense, the position of the Guidelines is correct in that takeovers enhancing corporate value are good ones and those reducing corporate value are bad ones. Correspondingly, defences for frustrating hostile bids are justified if the defence enhances corporate value and they are not justified if the defence decreases corporate value. A far more important question, however, is who should be the ultimate decision maker on this point? The board, shareholders or judges?

Rules in this area vary from country to country. They are, however, within a reasonable range in all jurisdictions. What is different is who the ultimate decision maker is. Today, for Japan, the most important question that remains to be resolved is to what extent a target board can act to frustrate or stop hostile takeover attempts without asking shareholders' approval.