Hostile Takeovers, Defenses and the Role of Law: A Japanese Perspective

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1. Introduction

Today, takeovers of public 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 defenses, the United States is rich both in its practical experience and academic literature. In contrast, Japan was poor at least until 2005. While courts have shaped Delaware 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 not conclusive. 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 does produce) one of the most difficult issues in U.S. corporate law. First, while empirical studies generally show that hostile takeovers are good for the economy in the sense that they generally enhance the value of the target firms, it is unclear from the past empirical studies whether defense 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 judicial review for takeover defenses (including poison pills) has already been established. Delaware courts today apply the “enhanced business judgment rule” and require “proportionality” in reviewing takeover defenses. Thus, the takeover defenses upheld by the courts in Delaware fall within a certain range, and the law is predictable as to whether a particular defensive measure (including poison pill attempts) to be taken would be upheld or denied by Delaware courts.

In contrast, in Japan, until recently, no one could tell what the law was with respect to takeover defenses. 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 as good or bad has been immense. Correspondingly, a few amendments to the relevant statutes have been made in 2005 and 2006.

In this paper, I discuss these developments and experiences in Japan. Section 2 describes the recent developments. Section 3 shows characteristics as found in the recent developments. Finally, Section 4 is my preliminary conclusion offering implications from preceding sections.

2. Developments

As Professor Curtis Milhaupt stated, "the unthinkable has happened."[1] 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 defense 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.

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 January 17, 2005, Fuji TV announced a cash tender offer for all of

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[1] Curtis J. Milhaupt, In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan, 105 Columbia Law Review 2171 (2005). See also Jack 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, 3 University of Tokyo Journal of Law and Politics 102 (2006).

the outstanding shares of Nippon Broadcasting. The bid was approved by the board of Nippon Broadcasting.

In the midst of this tender offer, on February 8, 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.[2] In combination with the shares owned previously, 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 February 23, 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 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.[3] Accordingly, Nippon Broadcasting and Fuji TV abandoned the warrant issuance. Livedoor eventually obtained a majority of shares of Nippon Broadcasting.

[2] 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 trading method unlawful.
[3] Tokyo District Court Decisions on March 11, 2005 and on March 16, 2005. Tokyo High Court Decision on March 23, 2005, 1899 Hanreijiho 56.

The battle ended in a somewhat peaceful way. On April 18, 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 that in the Tokyo High Court decision 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 power to issue stocks and warrants only for the purpose of funding new capital, paying an incentive-based compensation and others. 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 relegated to shareholders. This, however, permits exceptional situations where the board is permitted to take defense 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 public firms in Japan and market participants. The Corporate Value Study Group, established by the Ministry of Economy and Trade and Industry ("METI") in 2004, released its interim report on May 27, 2005 and on the same day, guidelines for defensive measures were released jointly by METI and the Ministry of Justice ("Guidelines"). While the Nippon Broadcasting case involved a "post-bid" defense, 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 defense measures. First, the purpose of such defense measure must be to enhance corporate value and thus shareholders' value as a whole. Second, the adoption of such defense plan must be based on the shareholders' will. Finally, such defense measure must be necessary and satisfy proportionality, namely, they must be a reasonable and non-excessive means to accomplish the goal. Also, the Guidelines specifically discuss the issuance of stock warrants. They provide that if such warrants are issued by the 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 May 1, 2005. A joint-stock company is required to disclose its fundamental policy for its management in its annual business report. This rule applies to the fiscal year ending on or after May 1, 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 July 7, 2005. 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 December 13, 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 2/3 or more of the target shares. Finally, the 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. The TSE is still in the process of writing rules and guidelines, but to date, it made several important announcements concerning a few specific items. It is clear that "golden shares" or other "dead hand" poison pills are not permitted to 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.[4] Second, a post-bid defense 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.[5] In the later case, on July 20, 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 defense 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 of frustrating Yumeshin's hostile bid. Under the situation, on July 29, 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 public firms in Japan moved to adopt two types of pre-bid defense measures. The 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 May 25, 2007, 359 listed firms (out of total approximately 3,900 listed firms in Japan) have pre-bid defense 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.[6]

[4] Tokyo District Court Decisions on June 1, 2005 and on June 9, 2005. Tokyo High Court Decision on June 15, 2005, 1900 Hanreijiho 156.
[5] Tokyo District Court Decision on July 29, 2005, 1909 Hanreijiho 87.
[6] [cite]

Under the typical trust based scheme, the firm issues stock warrants to a trust bank with designating 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 having 10% or more of the firm's outstanding stock appears, the firm asks him/her to disclose and explain its intent to hold such stake and what he or she would do for the firm. If the shareholder does not answer these questions or the target board thinks his/her explanation to be unsatisfactory, and he or she increases stake to 20% or more, then a defense measure would be triggered. Such defense 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 defense 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 defense schemes which ask for a decision at the shareholders' meeting either when it introduces a pre-bid defense plan and/or when it triggers such plan.[7] In practice, in some companies, the board proposal for introducing an advance warning type defense measure was not approved at the shareholders' meeting due to opposition of institutional investors. But most

[7] [further information to come]

companies successfully obtained shareholder approval. For those companies who introduced advance warning defense plans, it is unknown whether they will survive a judicial review when such plan triggers the pill, because to date, there has been no case in which that happened, except in the JEC case noted above.

In June, 2007, Steel Partners, a U.S. buy-out fund, commenced a hostile tender offer for all outstanding shares of Bulldog Sauce, a Worchester sauce manufacturer. As a post-bid defense, 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 June 24, 2007, and the plan was approved by more than 80% shares. SP sued to enjoin the issuance of the warrants. The Tokyo District Court held on June 28, 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 defense measure was approved at the shareholders' meeting. The court also held that since the defense 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 different grounds on July 9, 2007.

In a similar fashion, Steel Partners launched a hostile bid for all outstanding shares of Tenryu Saw Mfg. Co. ("Tenryu"), a saw blade manufacturer. In response, Tenryu adopted an advance warning defense plan with approval of more than 80% shares at the shareholders' meeting. Steel Partners' bid was unsuccessful because few shares were tendered.

3. 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. The most relevant are the provisions under the Company 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 the judicial development emphasize shareholder decision. However, Bulldog Sauce and Tenryu are exceptional companies in that they apparently have many stable shareholders. Usually, it seems not easy to obtain 2/3 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 defense plan without shareholders' approval? Indeed, certain firms did introduce such defense 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 U. S.

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 December 13, 2006. However, most of this area has been relegated to judicial development.

4. Preliminary Conclusion

What implications can we draw from all of these developments? In theory, there can be both good and bad takeovers (although some 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, defenses for frustrating hostile bids are justified if the defense enhances corporate value and they are not justified if the defense 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 as to who is the ultimate decision-maker. Today, for Japan, the most important inquiry that remains to be resolved is to what extent a target board can act to prevent hostile takeover attempts without asking shareholders' approval.

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	target (all listed companies)	bidder		
2003-2004	Soto and Yushiro	Steel Partners (tender offer)		
2004	UFJ Bank	Mitsui-Sumitomo Bank		
2004				METI Study Group established
November 2004				golden shares in an oil company issued to government
Jan-March 2005	Nippon Broadcasting	Livedoor	post-bid defense	warrants enjoined at courts
May 2005				METI Report METI/MOJ Guidelines
June 2005	Nireco		pre-bid defense	enjoined at courts
July 2005				Company Act passed in the Diet, effective on 1 May 2006 with exception of cash-out mergers effective on 1 May 2007
July 2005	JEC	Yumeshin (tender offer)	pre-bid, stock split	not enjoined at court

2

	target	bidder		
June 2006				SEA amendments passed in the Diet, effective dates vary
December 2006				TOB regulation amendments effective; target right to ask a question, mandatory bid rule if the bidder attempts to acquire 2/3 or more
June 2007	Bulldog Sauce	Steel Partners (tender offer)	post-bid defense w/ shareholder approval, etc.	court did not enjoin
July 2007	TOC	property company		hostile bid unsuccessful
2005-2007				Tokyo Stock Exchange made rules from time to time

Pre-bid Defense Plans in Japan (as of May 25, 2007)

359 companies in total
9% of total listed companies (3,900)

283 companies listed on Tokyo Stock Exchange Section One
16% of total listed companies on TSE Section One (1,753)

	introduced by a decision at the shareholders meeting	introduced by a decision by the board
Rights Plan	10	none
Advance Warning	307	42

Pre-bid Defense Plans in Japan
(as of May 25, 2007)

359 companies

introduced	triggering	special comm	
board	board	Y	25
		N	7
	special comm	Y	1
	sh meeting	Y	0
		N	9
sh meeting	board	Y	267
		N	25
	special comm	Y	10
	sh meeting	Y	1
		N	14

special comm is set up in 304 companies out of total 359

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Bulldog Sauce Case (2007)

On May 16, Steel Partners ("SP") commenced a hostile tender offer with the bid price of 1,584 yen per share. The tender offer period was set until June 28. Stock price was 1,336 yen per share, so the bid price was with a 18.5% premium.
On June 7, Bulldog Sauce board made a decision to adopt a defense action, issuance of stock warrants, conditioned on shareholder approval. Three warrants would be issued to each share for all existing shareholders, and each warrant would become one share. If the warrants become shares, SP's stake would reduce from 10.25% to 2.82% (without considering the tender offer). SP would receive warrants pro rata, but when other shareholders' warrants become shares, SP's warrants would be bought back by the company in cash at 396 yen per warrant, namely, the economic loss SP would suffer by dilution would be compensated for.
On June 14, SP brought the case to court for injunction.
On June 15, SP extended the tender offer period to August 10 and raised the bid price to 1,700 yen per share.
On June 24, the annual shareholder's meeting approved the defense action (issuance of warrants) by majority of 88.7% of attended shares, 83.4% of all voting shares.
On June 28, Tokyo District Court rendered the decision of not enjoining the issuance of warrants.
On July 9, Tokyo High Court affirmed.
On July 10, the warrants were issued (effective on July 11).
On July 27, Tokyo High Court permitted SP's appeal to the Supreme Court.
On August 9, the warrants will become shares (effective on August 10).

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Takeovers: Why So Popular Today?

- Background for popularity
  - capital markets
  - speed
  - deregulation
  - as a result, takeovers serve as quick means for resource allocation

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Takeovers and Defenses: US

- Evidence
  - empirical studies are not easy to assess
    - hostile takeovers are generally good
    - defenses may be good or bad
- Endless Debates among Reasonable People
- Therefore, one of the most difficult issues in US corporate law

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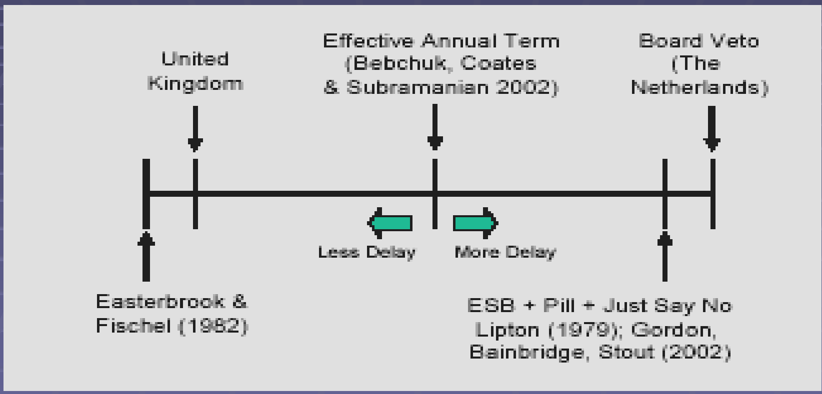
Continuum of Views on Takeover Defenses



ESB: effective staggered board
source: Bebchuk, Coates & Subramanian (2002)

Takeovers and Defenses

	entry: adoption	triggering or non-triggering	exit: abolishment
U.S. style (rights plan), dilution	stock option or warrant		proxy-out fiduciary-out
European style, veto shares (golden shares, multi-voting shares, etc.)	special class of shares		break-through
Japanese "advance warning" style			

Takeovers and Defenses

	US	Japan	EU
tender offer regulation	market rule	mandatory tender offer rule (1/3 rule) mandatory bid rule (where to acquire 2/3)	mandatory bid rule
board discretion	board discretion	?	board neutrality

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Takeovers and Defenses

mandatory bid rule / board passiveness	no	yes
yes		UK
no	U.S.	Germany

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Takeovers and Defenses: US Delaware Judiciary

- The standard of review is somewhat clear.
  - enhanced BJR + proportionality
- The actual cases are within a certain range: thus, if litigated, the result may be predictable, though future is somewhat difficult to predict.

Good and Bad Takeovers

- "Good or bad" should be judged from the economic perspective, namely, whether the takeover is good for the firm, not for any single set of constituency.
- Hostile takeovers may be good or bad.
- MBOs may also be good or bad.
- In Japan, MBOs and other transactions have been criticized as "false business," in particular by delisiting and re-listing activities as value diversion from public shareholders. However, the standard should be firm value. We also care about fair allocation of the value.
- Thus, the role of law should be to accomplish these goals, namely, encourage good takeovers and fair treatment and discourage bad takeovers and unfair transactions.

Takeovers and MBOs: Japan

- Poor experience of hostile takeovers in the past.
- MBOs were also rare.
- Sudden rise in 2005 and 2006. There will be more takeovers and MBOs in the future.
- Amendments to the Commercial Code since 2001 and the New Company Act of 2005 were not intended to take any position about takeovers and/or defenses. But they have an effect of facilitating both takeovers and defenses by providing wider discretion both to the bidder and the target.
- The Securities and Exchange Act ("Financial Instruments and Exchange Act" from September 30, 2007) is more important today by providing "fair" rules in takeovers of public firms, in particular by recent amendments regarding tender offers and ownership disclosure.
- Stock exchanges began to supply rules and guidelines.

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Who Plays the Policing Role in the U.S.?

- Three different institutions have the capacity to police the use of the poison pill (and takeover process more generally):
  - independent directors
  - shareholders
  - courts
- A critical feature of the U.S. infrastructure is that all three institutions operate as important checks on the misuse of defensive tactics generally and the poison pill in particular.
- Stock exchanges are also an important player in rulemaking for takeovers and MBOs.

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Who should be the ultimate decision-maker?

UK	US	Japan
shareholders	independent directors courts shareholders	?

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Role of Law

- Shareholder Value vs. Firm Value
  - In theory, maximizing firm value should be the goal, and where the firm is not insolvent, maximizing firm value is identical to maximizing shareholder value.
  - In practice, shareholder value is easier to obtain, and thus a good proxy of firm value.
- Rules vs. Standards
  - A complex question, contingent on many factors, including enforcement infrastructure (e.g. whether class action is recognized).
  - Legal certainty might support clear rules in Japan (and even in the US) in the future.
  - Ultimately, law may not matter much (see major jurisdictions).

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Implications for Japan

- Hostile takeovers may become more popular in the future.
  - Stable stockholdings may be disappearing.
  - A takeover may become a quick and less costly means for acquisition.
- Correspondingly, defenses may be widely employed.
  - If litigated under corporate law, the court face a difficult question without clear guidance from the Company Act provisions.
- MBOs will also become more popular in the future.
- Courts and stock exchanges will play a more important role in the future.

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