RECHTSPRECHUNG / CASE LAW

Japanese Corporate Law: Two Important Cases Concerning Takeovers in 2005

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I. INTRODUCTION

This paper reports two 2005 cases involving takeovers. One case arose between an IT company and a major company in a media corporate group and attracted wide public attention through the media. The other case involved measures taken in preparation for a takeover, although no takeover was actually attempted.

Japanese corporate law has advanced in the takeovers field in 2005. The Ministry of Economy, Trade and Industry and the Ministry of Justice jointly published the "Guidelines on Takeover Countermeasures to Ensure and Enhance Corporate Value and the Common Interests of Shareholders" (hereinafter: Guidelines).[1] In principle, these two cases and the Guidelines place a high value on the protection of shareholders' interests. In Japanese corporate law, such protection is an important factor in deciding whether takeover countermeasures are acceptable.

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1 Shôji Hômu 1733 (2005) 26. MINISTRY OF ECONOMY, TRADE AND INDUSTRY / MINISTRY OF JUSTICE, *Kigyô kachi hôkoku-sho / Baishû bôei-saku ni kan suru shishin* [A Report on Corporate Value / Guidelines on Takeover Countermeasures], in: Bessatsu Shôji Hômu 287 (2005) 121. See also <*http://www.meti.go.jp/press/20050527005/3-shishinn-honntai-set.pdf*>.

II. RIGHTS ISSUED "IN TIME OF EMERGENCY" – THE LIVEDOOR CASE[2]

1. Facts

Y (Nippon Broadcasting System Inc.) was primarily engaged in the radio broadcasting business. Z (Fuji Television Network Inc.) was primarily engaged in the TV broadcasting business. These two companies belonged to the Fuji Sankei Communications Group (hereinafter: Group).

In February 2005, Y had capital of 4,150,000,000 yen and a total of 32,800,000 outstanding shares. Its shares were listed in the second section of the Tokyo Stock Exchange. In January 2005, Y held 22.5 percent of Z's outstanding shares. Y had subsidiaries, including 100 percent subsidiaries, and was the central shareholder in the Group.

Z held 12.39 percent of Y's outstanding shares – a total of 4,064,660 shares. After it made a bid to take over Y (hereinafter: Bid), Z held 36.47 percent of those shares – a total of 11,961,014 shares.

X (Livedoor Co. Ltd.) was engaged in the information technology business, dealing with computer networks, programs and content. It had capital of 24,030,000,000 yen. X had a subsidiary, P, running an investment business. P had capital of 10,000,000 yen.

On 17 January 2005, Z decided to begin the Bid with a view to buying as many of Y's outstanding shares as was necessary for it to acquire a controlling stake. Under the Bid, Z intended to purchase 12,335,341 shares, which, coupled with the shares it already held, amounted to 50 percent of the outstanding shares. The purchase price was 5,950 yen per share. The Bid period was 18 January 2005 to 21 February 2005. Y's board of directors approved the Bid at a board meeting held on 17 January 2005.

X held 1,756,760 of Y's shares, which amounted to approximately 5.4 percent of the outstanding shares. On 8 February 2005, during the Bid period, X, through P, acquired 9,720,270 of Y's shares – approximately 29.6 percent of the outstanding shares. X and P combined held about 35.0 percent of the outstanding shares.

On 10 February 2005, Z changed the conditions on its Bid. Under the new conditions, Z intended to purchase at least enough shares to obtain a total holding (existing holding plus new acquisitions) of 25 percent of the outstanding shares. The purchase price was 5,950 yen. The Bid period was extended until 2 March 2005. Y's board of directors approved the Bid, including the new conditions, at a board meeting held on 16 February 2005.

X and P had acquired 11,529,930 shares by 21 February 2005, and controlled 37.85 percent of the voting rights in Y.

Y's board of directors decided to grant Z rights to purchase new shares (hereinafter: Rights) at a board meeting held on 23 February 2005. Y issued a written announcement

2 Tokyo High Court, 23 March 2005, in: Hanrei Taimuzu 1173 (2005) 125; Hanrei Jihô 1899 (2005) 56; Kin'yû Shôji Hanrei 1214 (2005) 6.

of the Rights. The announcement stated that (a) the issue of the Rights was to maintain the corporate value of Y and to ensure the public nature of Y as a media company; (b) it would be incompatible with this public nature for X to become the controlling shareholder of Y; (c) Y decided to grant Z the Rights to accomplish the objective, approved by Y, of Y becoming a subsidiary of Z. Y planned to use the capital it would receive from the Rights issue for a studio project in a newly-developed coastal area. The total sum of the Rights issued was 15,872,090,320 yen. On 24 February 2005, Z changed the expiration date of its Bid from 2 March 2005 to 7 March 2005.

If all of the Rights were exercised, 47,200,000 shares would be issued – 144 percent of Y's outstanding shares. If all of the Rights were exercised and the new shares were issued, X's shareholding in Y would decline from 42 percent to 17 percent. Z's shareholding in Y would reach 59 percent, even without including the shares it held before the proposed Rights issue.

X filed an application for a provisional disposition suspending the issue of the Rights and maintained that the proposed Rights issue would be in a grossly unfair manner under Article 280-10 of the Commercial Code.[3] Article 280-10 was held to be applicable to the issue of rights to purchase new shares under Article 280-39 Paragraph 4 of the Commercial Code. The Tokyo District Court allowed the provisional suspension.[4] Y filed an application for an objection to this decision. The Tokyo District Court dismissed Y's application and allowed the provisional suspension.[5] Y appealed.

2. *Held*

Appeal dismissed.

In principle, an issue of rights to purchase new shares is considered to be in a "grossly unfair manner" under Article 280-10 (employed by Article 280-39) if such rights are issued, where a struggle for the controlling stake has already arisen, with a primary purpose of reducing the percentage shareholding of a specific shareholder attempting to acquire the controlling stake through a hostile takeover, and to maintain and ensure the controlling stake for the incumbent management or a specific shareholder who supports and influences the incumbent management.

The issue of rights with a primary purpose of maintaining and ensuring a controlling stake is not allowed on the grounds that directors are in a fiduciary relationship with the

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3 *Shôhô*, Law No. 48/1899; English translation: NISHIMURA & PARTNERS, Commercial Code of Japan (Tokyo 2004); German translation: O. KLIESOW / U.S. EISELE / M. BÄLZ, Das japanische Handelsgesetz (Cologne 2002). All references to the Commercial Code in this article refer to the pre-2005 version of the Code.

4 Tokyo District Court, 11 March 2005, in: Hanrei Taimuzu 1173 (2005) 143, Kin'yû Shôji Hanrei 1213 (2005) 2.

5 Tokyo District Court, 16 March 2005, in: Hanrei Taimuzu 1173 (2005) 140, Kin'yû Shôji Hanrei 1213 (2005) 21.

shareholders, who are the owners of the company. However, in exceptional cases, the issue of rights with such a primary purpose is not considered to be in a grossly unfair manner if there are exceptional circumstances that justify the rights issue from the viewpoint of protection of the interests of shareholders as a whole.

The board of directors is allowed to issue rights to purchase new shares with the primary purpose of maintaining or ensuring a controlling stake under certain circumstances, as long as that issue is necessary or appropriate as a countermeasure against a takeover. The reason for this is that takeover bidders who have acquired shares for an abusive purpose do not deserve to be protected and that where such takeover bidders are given a free hand, the interests of other shareholders will be prejudiced. The circumstances in which a rights issue where the board of directors has such a primary purpose is allowed include, for example, (1) where a hostile takeover bidder is purchasing shares for the purpose of raising the share price and forcing parties related to the company to buy the shares at a high price, while having no intention of participating in management ("greenmailing"); (2) where a takeover bidder is purchasing shares for the purpose of so-called "scorched-earth management" – for instance, while temporarily in control of the management of the target company, the bidder forces the company to transfer to the bidder or the group companies of the bidder such necessities for the management of the company as intellectual property rights, know-how, confidential company information, and key customers or clients; (3) where a takeover bidder is purchasing shares with the intention of appropriating the assets of the company to use as securities for debts or as funds to repay the bidder, or the group companies of the bidder, after the bidder takes control of the company; (4) where a takeover bidder is attempting to exploit the company – for instance, by purchasing shares to temporarily gain control of management, then selling or disposing of real estate, securities and other valuable assets that are, at the time, not directly related to the business and using the proceeds to declare a large dividend and/or use that large dividend to raise the share price and then sell at a profit.

In principle, an issue of rights to purchase new shares should be suspended on the grounds that the rights are issued in a grossly unfair manner if the rights are issued for the purpose of maintaining or ensuring a controlling stake in circumstances where the struggle for the controlling stake has already begun. However, it is impossible to suspend a rights issue which would influence the possession of a controlling stake if the company establishes prima facie evidence that there are exceptional circumstances which justify such a rights issue from the viewpoint of protection of the interests of shareholders as a whole. Or, to be more specific, that there exist circumstances where the takeover bidder's real aim is not rational management, and the bidder's possession of the controlling stake will cause the targeted company irremediable damage.

3. *Comment*

An issue in this case was whether an issue of rights to purchase new shares would be an issue in a grossly unfair manner if such rights were issued under the circumstances where the struggle for the controlling stake in the company has already begun (so-called "time of emergency").[6] Under the new Company Law[7], which has come into operation on 1 May 2006, this case would fall within the scope of Article 247 Number 2.

According to the Inage-ya / Chûjitsu-ya case,[8] which concerned an allotment of new shares to a third party as a measure taken in "time of emergency", an issue of new shares would be in a grossly unfair manner if the primary purpose of the issue is to reduce the percentage shareholding of a specific shareholder and maintain the controlling stake held by the incumbent management. This is known as the "primary purpose rule". According to the Livedoor case, the "primary purpose rule" is applicable to the issue of rights to purchase new shares in "time of emergency".

The Livedoor case enunciates four classifications, which are merely exemplary and not exhaustive.[9] These are where the takeover bidder is acquiring shares: (1) for the purpose of greenmailing; (2) for the purpose of scorched-earth management; (3) with the intention of appropriating the assets of the target company to use, for example, as security for the debts of the bidder; and (4) for the purpose of temporarily forcing the target company to dispose of those of its valuable assets that currently have no relation to its business, and to declare high dividends. These classifications justify the rights issue as a takeover countermeasure from the viewpoint of protecting the interests of the shareholders as a whole. The target company bears the burden of proof that there exists justification for the rights issue from that viewpoint. That is, for example, the rights issue falls within one of the four classifications and is necessary and appropriate from that viewpoint.

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6 For commentary on this issue, see E. TAKAHASHI, *Dai-san-sha ni yoru shinkabu yoyaku-ken hakkô no sashitome* [The Issue and Suspension of Issue to Third Parties of Rights to Subscribe for New Shares], in: Kaisha-hô hanrei hyakusen (Bessatsu Jurisuto No. 180) (2006) 78.

7 *Kaisha-hô,* Law No. 86/2005.

8 Tokyo District Court, 25 July 1989, in: Hanrei Taimuzu 704 (1989) 84; Kin'yû Shôji Hanrei 826 (1989) 11; Hanrei Jihô 1317 (1989) 28. For commentary, see H. BAUM, Marktzugang und Unternehmenserwerb in Japan (1995) 147 *et seq.*; K. YOSHIMOTO, *Ichijirushiku fu-kôsei na hôhô ni yoru dai-san-sha wariate zôshi* [Third Party Allotment of New Shares in a Grossly Unfair Manner], in: Kaisha-hô hanrei hyakusen (Bessatsu Juristo No. 180) (2006) 66.

9 TAKAHASHI, *supra* note 6, 79.

III. RIGHTS ISSUED "IN TIME OF PEACE" – THE NIRECO CASE[10]

1. *Facts*

Y (Nireco Corporation) was primarily engaged in the business of producing and selling automation and measuring devices. Its predecessor company was founded by a German company in Japan, and was dissolved after World War II. Y was incorporated and inherited the technology of the original company. Y had capital of 3,072,352,740 yen. It could issue up to 39,400,000 shares and had 10,005,249 outstanding shares. Y was listed on the Jasdaq Securities Exchange (hereinafter: Jasdaq).

X was incorporated under the law of the British Cayman Islands in the West Indies in September 2003, and its primary business was to invest in the shares of Japanese listed companies. On 31 March 2005, X held 285,000 of Y's outstanding shares. X's shareholding in the outstanding shares was 2.85 percent.

On 14 March 2005, Y's board of directors decided that Y was to grant its shareholders rights to purchase new shares (hereinafter: Rights). Y published a "Securities Plan" (hereinafter: Plan) explaining the Rights plan to Jasdaq. Under the Plan, the shareholders to be granted the Rights were those shareholders who were recorded in the register of shareholders on 31 March 2005. These shareholders were to be given two Rights per share without consideration. Y decided to issue the Rights as a rational means of: (a) preventing its corporate value being prejudiced through abusive takeovers, and (b) maximizing the corporate value when takeover bids were made to Y. The maximum number of Rights to be issued was the number of outstanding shares on 31 March 2005 multiplied by two. One new share per Right was to be issued. The date of the Rights issue was 16 June 2005. The sum to be paid upon exercise of a Right was one yen. The period for the exercise of the Rights was 16 June 2005 to 16 June 2008. There was a condition on the Rights-holders exercising their Rights. The condition was that Y's board of directors recognized the existence of a specific shareholder and announced such existence between 1 April 2005 and 16 June 2008. A specific shareholder was a person such as a takeover bidder or a person with a particular relationship with that former person where the latter person, together with the former person, held 20 percent or more of Y's outstanding shares. Only persons to whom the Rights were issued could exercise the Rights issued to them. Agreement from Y's board of directors was required before the Rights could be transferred. The board decided that it would not agree to any such transfer.

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10 Tokyo High Court, 15 June 2005, in: Hanrei Taimuzu 1186 (2005) 254; Kin'yû Shôji Hanrei 1219 (2005) 8; Hanrei Jihô 1900 (2005) 156. For commentary, see M. KAWAMURA, *Tekitaiteki baishû ni tai suru jizen no taikô-saku toshite okonatta torishimari yakkai no shinkabu yoyaku-ken hakkô ga ichijirushiku fu-kôsei na hakkô ni ataru to sareta jiken* [The case where the issue by the board of directors of rights to subscribe for new shares as an advance countermeasure against hostile takeovers was held to be grossly unfair], in: Kin'yû Shôji Hanrei 1227 (2005) 67.

X filed an application for a provisional suspension of the Rights issue. The Tokyo District Court allowed the provisional suspension.[11] Y filed an application for an objection to this decision. The Tokyo District Court dismissed Y's application and allowed the provisional suspension.[12] Y appealed.

2. *Held*

Appeal dismissed.

The board of directors has the power to issue rights to purchase new shares by way of an allotment to shareholders (Commercial Code Article 280-20 Paragraph 2 Number 12), and to restrict the transfer of the rights (Commercial Code Article 280-20 Paragraph 2 Number 8). The Commercial Code does not restrict the subject matter of the rights (the period for exercising the rights, conditions on exercising the rights, factors or conditions of cancellation), or the means of using the rights. It is therefore not inconceivable that the rights be used as a countermeasure against abusive hostile takeovers.

Directors have a duty not to cause harm to shareholders in exercising those powers because of the fiduciary relationship they have with shareholders as the owners of the company.

However, there is a fear that the Rights would cause harm to shareholders that is unrelated to takeovers.

The Rights are granted to the shareholders on 31 March 2005 at the rate of two Rights per share, without consideration. Where the conditions for the exercise of the Rights are met, the Rights-holders can acquire one share per Right for the price of one yen, which is virtually no consideration. The Rights plan has the effect of tripling the number of outstanding shares without increasing the value of Y's assets, as is the case with share splits. There is therefore a possibility that, if the new shares are issued as a result of the exercise of the Rights, the value of Y's shares would in the future decline to one third of their current market price.

Shareholders who acquire Y's shares after the ex-rights day for the Rights (28 March 2005) must bear the risk, if the Rights are not cancelled and the new shares are issued through exercise of the Rights before 16 June 2008, of their percentage shareholding being diluted to about one third. Those shareholders must bear this risk regardless of whether they are a takeover bidder with an abusive intention. Under the Plan, it is unpredictable whether and when in the future the conditions for the exercise of the Rights would be met. Even if the probability that the conditions are met is very low, one should

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11 Tokyo District Court, 1 June 2005, in: Hanrei Taimuzu 1186 (2005) 274; Kin'yû Shôji Hanrei 1218 (2005) 8.

12 Tokyo District Court, 9 June 2005, in: Hanrei Taimuzu 1186 (2005) 265; Kin'yû Shôji Hanrei 1219 (2005) 26.

not underestimate the risk that their shareholding in Y would be diluted to one third and that the value of the shares would substantially decrease when the Rights are exercised. It is impossible to deny that these circumstances will have the effect of putting a strong downward pressure upon any rise in the share price of Y over the next three years.

With the abovementioned unstable factors, Y's shares will not be an attractive investment option and will not arouse any interest in purchase, and the tendency to hold back from purchasing the shares will grow stronger. (Moreover, the Rights are granted without consideration so the shares lose value to the extent of the proper value of the Rights). As a result, it is highly likely that the value of the shares will remain low over the long term. Even existing shareholders to whom the Rights are issued bear both the risk of a fall in the share price and the risk of losing an opportunity for capital gain long term. This sort of harm is unexpected damage which would not arise if the Rights were not issued.

If a hostile takeover bidder ("the specific shareholder") appears and the new shares are issued by exercise of the Rights, existing shareholders, including X, can recover from the harm caused by the decline in the value of the shares by acquiring new shares. However, even existing shareholders are forbidden from transferring their own Rights. Existing shareholders do not have a means of supplementing the loss caused by the low share value unless the hostile takeover bidder appears and the new shares are issued. Therefore, it is impossible to deny that existing shareholders will suffer the above-mentioned damage. This sort of damage is not damage which existing shareholders, who are general investors and not takeover bidders, should be forced to endure.

Thus, the Rights issue would cause damage which existing shareholders should not have to endure. The Rights issue is therefore in a grossly unfair manner.

3. Comment

An issue in this case was whether an issue of rights to purchase new shares would be in a grossly unfair manner if the rights were issued under circumstances where there is no struggle for the controlling stake in the company (so-called "time of peace"). This case was reported a few months after the Livedoor case. The Nireco case does not establish any standards like the four classifications in the Livedoor case. In the Nireco case, the Court reached its conclusion simply through consideration of the facts in the case.[13] The Rights granted to the shareholders could be separated from the shares. Agreement from Y's board of directors was required to transfer the Rights, and the board decided not to agree to any transfers. Since Y was a listed company, its shares were transferable.

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13 T. FUJITA, *Nippon hôsô shinkabu yoyaku-ken hakkô sashitome jiken no kentô (ge)* [A Study on the Case of Nippon Hôsô and the Suspension of Issue of Rights to Subscribe for New Shares (2)], in: Shôji Hômu 1746 (2005) 8. T. YAMASHITA / H. KANDA (eds.), *Shôhô hanrei shû* [Collected Cases in Commercial Law] (2nd edition, Tokyo 2006) 115.

A remaining question is whether the classifications established in the Livedoor case concerning rights issued in "time of emergency" are applicable to cases of rights issued in "time of peace". This remains unresolved.

IV. CONCLUSION

In both cases, the issue was whether the issue of rights to purchase new shares as a countermeasure against takeovers could be allowed, and the Courts do suggest some room for allowing such a rights issue. The Livedoor case related to rights issued in "time of emergency", while the Nireco case involved rights issued in "time of peace". In the former case, the Court stated four classifications as a standard for deciding whether a rights issue is acceptable. In the latter case, the Court reached its conclusion simply through consideration of the facts in the case. Just before the Nireco case began, the Ministry of Economy, Trade and Industry and the Ministry of Justice jointly published the Guidelines.[14] The Guidelines lay out guiding principles on the conditions under which countermeasures can be adopted in "time of peace" to prepare for takeovers. These two cases and the Guidelines place a high value on the protection of shareholders' interests.

Thus, in 2005, Japanese corporate law has advanced in the field of takeovers. These two cases make it clear that the incumbent management of a company should not employ countermeasures for the purpose of self-preservation. It is expected that those countermeasures that are allowed by the Courts would not prevent economically rational takeovers. The Nireco and Livedoor cases are, in this sense, milestones for Japan in creating a fair judicial framework for protecting the interests of shareholders in hostile takeovers, which are set to become everyday business in Japan.

ZUSAMMENFASSUNG

Die Autoren stellen mit den Fällen Livedoor *und* Nireco *zwei wichtige Entscheidungen aus dem Jahre 2005 zu feindlichen Übernahmen und Abwehrmaßnahmen vor.*

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14 MINISTRY OF ECONOMY, TRADE AND INDUSTRY / MINISTRY OF JUSTICE, *supra* note 1.