The Possible Implications of Japanese Court Decisions on Defensive Measures for Japanese Corporate Governance

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I. Introduction

In Japan, the number of M&A transactions, in particular hostile M&A transactions, has increased dramatically over the last few years. As a result, a significant number of Japanese public companies have introduced defensive measures, most often, so-called "Advance Warning System (*jizen-keikoku-gata*)" which is somehow unique and certainly different from such defensive measures as have evolved in US.

Why have such Japanese public companies gone to such direction? Is there anything to do with the governance structure of Japanese public companies? Anyway, is it a correct direction from the US standpoint?

II. Japanese Corporate Governance as Reform by the Company Law

- The new Company Law (effective on May 1, 2006) drew a very clear line between a "public" company (*kokai kaisha*) and a "private" company in terms of corporate governance. While a private company has much more flexibility as to how to structure its corporate governance, a public company has a very limited flexibility. Accordingly, most "listed" companies must have either (a) the three Committees (and the Executive Officer(s)) or (b) the Board of Statutory Auditors.

- Up to now, a relatively small number of the listed companies have opted for the committee system. The most important characteristic of this system is that a majority of the members of each Committee must be "Outside Directors" (*shagai torishimariyaku*). The existence of Outside Directors would be helpful if the same argument as the Delaware case law on the validity of defensive measures were applicable to the adoption by Japanese listed company of defensive measures. Then, why has a relatively small number of the listed companies opted for this system?

III. Overview of Delaware case law on the validity of defensive measures

- Before the landmark Unocal decision in 1985, the Delaware court applied either of the two traditional tests: (a) the business judgment rule and (b) the entire fairness standard.

- However, the two traditional tests had a problem with the tendency to oversimplify the situation– in fact, the target management's decision to adopt defensive measures normally requires business consideration but it has the risk of possible conflicts of interest.

- The Unocal test is: (a) "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership" and (b) directors also must show a defensive measure is "reasonable in relation to the threat posed". With respect to (a), directors must "satisfy that burden "by showing good faith and reasonable investigation" and "such proof is materially enhanced … by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards." Accordingly, the Unocal test recognized the importance of outside independent directors' involvement.

III. Overview of Delaware case law on the validity of defensive measures (cont'd)

- On the other hand, the Unocal test should not be used where the company is put for sale since, in such a case, the target's directors "no longer faced threats to corporate policy and effectiveness, or to the stockholder's interests" and the "directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stock holders at a sale of the company." ("Revlon duties").

- The importance of the Revlon duties is that if the target management decides to sell its company to a preferred purchaser, it is not supposed to adopt a defensive measure to defeat another unsolicited purchaser. What I wish to emphasize here is that in US the management is expected to play a more important role than the shareholders when it adopts a defensive measure regardless of whether there is a contest for a control.

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IV. Overview of Japanese case law on the validity of defensive measures

- In Japan, the original rule developed by the court in case of hostile takeovers is "primary purpose" rule.
- However, the "primary purpose" rule has two fundamental problems: (1) there is too much emphasis on the cash needs; and (2) it cannot be applied to the issue of the warrants as by its nature there is no immediate cash need.
- Accordingly, the court had to take a slightly different approach when livedoor challenged Nippon Broadcasting System ("NBS")'s proposed issue of warrants to Fuji Television Network ("Fuji TV"). The court struck down NBS' issue of warrants to Fuji TV to defeat livedoor's attempt to acquire the control over NBS by ruling that, in the contest for control over a corporation, the corporation should not be permitted to issue warrants to a third party for the primary purposes of preserving the management's control of the corporation unless there are any special circumstances that may justify the issue of the warrants from the viewpoint of protecting the corporation's interest or its shareholders' interest.
- The court reached this conclusion from the theory of allocation of authorities between the shareholders and the board – the board's authority comes from the shareholders, so the board should not prevent changes in the shareholders in the contest for control situation.

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IV. Overview of Japanese case law on the validity of defensive measures (cont'd)

- The Tokyo High Court basically supported this decision and clarified that such special circumstances exist where: (1) the hostile bidder is not intending to promote in good faith a rational management of the target company; and (2) the acquisition of control of the target company by the hostile bidder would cause irreparable damages to the company.

- In the Nireco case, the Tokyo District Court considered the validity of a defensive measure taken BEFORE the takeover battle starts. The court took a very different position from the Unocal – it held that in peacetime the management should not be permitted to issue warrants that can become exercisable after the contest for a control arises because if there is no contest for a control, a defensive measure should be introduced with the shareholders' approval.

- On the other hand, the Tokyo District Court is willing to allow the management to buy time if an unsolicited bidder to shows up. In the Japan Engineering Consultants ("JEC") case, the court upheld JEC's implementation of stock splits as a defensive measure to defeat unsolicited offer by Yumeshin by ruling that the target's management may demand the acquirer to provide its proposal after the acquisition so that the target's shareholders can consider it and, if the acquirer fails to provide such proposal, the management may take certain action appropriate to protect the shareholders' interest.

IV. Overview of Japanese case law on the validity of defensive measures (cont'd)

- I suspect that these rulings are somehow affected by the court's lack of trust on the management – it may be prompted by the lack of real "independent directors" for Japanese companies. If a shareholder cannot reply on "independent directors", it may be better for the shareholders themselves to decide it than let the management so decide. This is because the management's adoption of a defensive measure always involves potential conflicts of interest.

- If you look into the reality that the shareholders meeting is not an organ appropriate to make such important decision in a timely fashion and that the management can easily manipulate the direction of the shareholders' meeting, the placing of too much focus on the shareholders' power seems to be very dangerous. In any event, this court's lack of trust on "independent directors" may have some negative impact on listed companies' willingness to adopt the committee system that require a majority of directors to be "Outside Directors."

V. Corporate Value Study Group's view on what are valid defensive measures

In May 2005, the Corporate Value Study Group released the so-called Corporate Value Report (the "Report").

A. The same level of takeover defensive measures as adopted in the U.S. and Europe (such as shareholders' rights plan and golden shares) could be introduced to Japan under the Company Law, if that disclosure rules regarding takeover defensive measures is also established.

B. The validity of takeover defensive measures should be determined by looking into "Corporate Value Standard".

C. In order to eliminate excessive defensive measures and make such measures reasonable from the perspective of corporate value improvements:

   1) defensive measures must be adopted in "peacetime" and contents thereof must be disclosed and accounted for properly;

   2) defensive measures must be so designed that such can be cancelled by resolution of a general meeting of shareholders (as a result of a proxy fight); and

   3) at least one of the following mechanics must be adopted not to allow any such decision that is made for the purposes of "self-protection" of the board of directors:

V. Corporate Value Study Group's view on what are valid defensive measures (cont'd)

- to emphasize a decision of independent personnel, including outside directors/statutory auditors, with respect to maintenance and cancellation of defensive measures
- to establish objective conditions to cancel defensive measures beforehand;
- to obtain (i) approval as to adoption of defensive measures and (ii) authorization to decide on cancellation of such measure when any takeover is commenced, from shareholders in peacetime.

- I do not think that the concept of "Corporate Value" is very clear, which makes it difficult for me to reply on the "Corporate Value Standards".

- After the Report was published, a significant number of listed companies have adopted a Japanese style but relatively weak defensive measure – the "Advance Warning System". Under the AWS, if the director determines (upon the recommendation of a special committee consisting of independent directors or statutory auditors or external advisors) that the shareholder's shareholding may damage the Corporate Value, then the director is permitted to issue new shares or warrants or to take any other defensive measures.

- The problem of the AWS is the independency or accountability of the special committee that plays an important role when the management decides to adopt actual, more effective defensive measures such as issue of "poison pill" warrants. If the members are outside directors or statutory auditors, their independence is an issue. If the members are external advisors such as lawyers, their accountability is an issue.

VI. Closing

- It seems that Japanese case law has developed from the Delaware case law to a different direction by emphasizing the shareholders' involvement in the management's adoption of any defensive measure.
- Such shareholders' involvement may be appropriate if it aims that the defensive measure can be cancelable by the shareholders' approval. However, it may not make sense if the management can craft any defensive measure they deem appropriate only because they seek the shareholders' approval when they adopts the defensive measure.
- The existence of a special committee is better than nothing, but the accountability of a member who is not a director may be problematic.
- Ideally, a listed company should move to the committee system with "real" independent directors who are supposed to be involved in the adoption and implementation of a defensive measure like US.