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Hostile Takeover and Defenses— Implications from Delaware Law

Keynote Speeches

Hideki KANDA Jack B. JACOBS Curtis J. MILHAUPT

Panel Discussion

Japanese Legal Structure for Corporate Acquisition: Analyses and Prospects

Materials

Ministry of Economy, Trade and Industry and Ministry of Justice, “Guidelines Regarding Takeover Defense for the Purpose of Protection and Enhancement of Corporate Value and Shareholders’ Common Interest” (May 27, 2005)

Corporate Value Study Group, “Takeover Defense Measures in Light of Recent Environmental Changes” (June 30, 2008)

Bull-Dog Source (Supreme court judgment of August 7, 2007, Supreme Court Reports (civil cases) vol.61 no.5, p.2215)

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* The Japanese decisions are based on the translation by the Specified Field Research Project “The Transparency and Enrichment of Japanese Laws Concerning International Transactions in the 21st Century — Doing Cross-Border Business with/in Japan” instituted by the Ministry of Education, Culture, Sports, Science and Technology (MEXT), 2004.

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Global COE (Centers of Excellence) Program “Soft Law and the State-Market Relationship: Forming a Base for Education and Research of Private Ordering”

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Keynote Speeches

Takeover Defenses and the Role of Law in Japan

Hideki KANDA*

1. 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 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 in Delaware in the U.S. 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 Companies Act and certain well-known cases in recent years.

In Delaware, 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.¹

In contrast, in Japan, until recently, no one could tell what the law was with respect to takeover defenses. However, beginning 2005, several well-known hostile takeover attempts took place in Japan, and several cases were brought into court rooms. To date, more than five 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.

* Professor of Law, University of Tokyo. This paper draws on Hideki Kanda, *Takeover Defenses and the Role of Law: A Japanese Perspective*, in Michel Tison, Hans De Wulf, Christoph Van der Elst and Reinhard Steennot (eds), *Perspectives in Company Law and Financial Regulation* 413 (2009).

1 See Jack B. Jacobs, *Implementing Japan's New Anti-takeover Defense Guidelines, Part I: Some Lessons from Delaware's Experience in Crafting "Fair" Takeover Rules*, 3 *University of Tokyo Journal of Law and Politics* 83 (2006).

In this paper, I describe these developments and experiences in Japan. Section 2 describes the recent developments. Section 3 shows characteristics as found in the recent developments. Section 4 is my preliminary conclusion.²

2. Developments

As Professor Curtis Milhaupt stated, “the unthinkable has happened.”³ 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.⁴

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 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 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 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 May 27, 2005⁵ and on the same day, guidelines for defensive measures were released jointly by METI

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

3 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).

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

5 Ministry of Economy, Trade and Industry, *Corporate Value Study Group Report*, May 27, 2005.

and the Ministry of Justice (“Guidelines”).⁶ It must be noted that 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 mid-2005.

The Guidelines, although they are not the law, list three basic principles for the validity of pre-bid defense measures.⁷ 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 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 May 1, 2005. A joint-stock company is required to disclose its fundamental policy for its management in its annual business report.⁸ 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, 2005.⁹ 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, Tokyo Stock Exchange (“TSE”) has been serious in

6 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, May 27, 2005.

7 See supra note 6.

8 See Article 127, Ministry of Justice Companies Act Implementation Rule (2005).

9 Report of the Subcommittee on Corporate Governance, Liberal Democratic Party, July 7, 2005.

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 has made several important rules and guidelines concerning a few specific items.¹⁰ It is clear that “golden shares” or other “dead hand” poison pills are not permitted to the companies listed on the TSE.

With a few further court decisions¹¹ and related discussions, many publicly held 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.¹²

Under a 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 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 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

10 See generally Tokyo Stock Exchange, Interim Report of the Advisory Group on Improvements to TSE Listing System, March 27, 2007. Their rules and guidelines are found in TSE, Listing Regulations Sections 432-444 (“Code of Corporate Conduct”).

11 Tokyo District Court Decisions on June 1, 2005 and on June 9, 2005; Tokyo High Court Decision on June 15, 2005, 1900 Hanreijiho 156 (Nireco); Tokyo District Court Decision on July 29, 2005, 1909 Hanreijiho 87 (JEC).

12 See the material submitted to the METI Corporate Value Study Group on May 29, 2007. As of the end of July, 2008, 567 listed firms have pre-bid defense plans. See Amane Fujimoto et al., The Current Situation of Defense Plans against Hostile Takeovers, 1877 Shojihomu 12 (2009) (in Japanese).

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.¹³ In practice, in most companies, the board proposal for introducing an advance warning type defense measure was put for approval at the shareholders' meeting, and in fact 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.¹⁴

In May, 2007, Steel Partners, a U.S. buy-out fund, commenced a hostile tender offer for all outstanding shares of Bulldog Sauce, a Worcester sauce producer.¹⁵ Bulldog Sauce did not have any pre-bid defense plan. 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 July 9, 2007. Tokyo High

13 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.

14 See supra note 11.

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

Court found that SP was an “abusive bidder” and held that the defense measure was lawful.

Steel Partners appealed to the Supreme Court. On August 7, 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 defense 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.¹⁶

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

Under the circumstances, the Corporate Value Study Group at the METI presented two policy discussions in its report on June 30, 2008.¹⁷ First, it pointed out that relying too much on the approval at the shareholders’ meeting is sometimes misleading and not recommended, because it would encourage inefficient building of stable shareholding. Second, it pointed out that cashing out the bidder is not desirable, because it would encourage inefficient bids.

Report by the Corporate Value Study Group in 2008

	Obtaining time, information and opportunity of negotiation	Dilution where destroying firm value is clear	Dilution where a decision is made as to whether firm value decreases
Cash payment	Not necessary	Not necessary	Showing reasons where cash payment is not necessary
Approval by the shareholders meeting	Not necessary	Not necessary	Providing code of conduct for the board of directors
Approval by the special committee	Not necessary	Not necessary	Providing code of conduct for the board of directors

16 See Tokyo High Court Decision on May 12, 2008, 1282 Hanrei Times 273 (Pikoi), where a defense action that is similar to the one adopted by Bulldog was attempted without shareholder decision and the court enjoined it.

17 Ministry of Economy, Trade and Industry, Corporate Value Study Group, Takeover Defense Measures in Light of Recent Environmental Changes, June 30, 2008.

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.¹⁸ 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 is an exceptional company in that it apparently has many shareholders friendly to the management. 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 very few proposals to clarify the rule, or improve the situation, by introducing new legislation. One 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

18 Under the Companies Act of 2005, defense 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 2/3 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.

been relegated to judicial development.

4. 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, 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 frustrate or stop hostile takeover attempts without asking shareholders' approval.

Developing an Infrastructure for Hostile Takeovers: The Delaware Experience

Jack B. JACOBS*

I. INTRODUCTION

In 2005, I was honored to be invited to Tokyo to address a group of highly sophisticated Japanese academics, lawyers and businesspersons about Delaware's experience in creating rules governing the proper response of corporate directors to hostile takeover bids. What occasioned the invitation was that six months earlier, a distinguished group of expert business and legal representatives, called the "Corporate Value Study Group," authored the *Takeover Guidelines for Protecting and Enhancing Corporate Value and the Interests of Shareholders As A Whole* ("Guidelines").¹ Before then, Japan had no existing legal rules or infrastructure for regulating board responses to hostile bids. The Guidelines, which were promulgated in May, 2005 by the Japanese Ministry of Economy, Trade and Industry ("METI") and the Japanese Ministry of Justice ("MOJ"), were intended to supply those rules, with the enforcement infrastructure being the Japanese courts.

The Guidelines adopted the Corporate Value Study Group's ("CVSG") recommendations that in responding to hostile takeover bids, boards of Japanese companies should be guided by certain principles derived largely from judge-made Delaware fiduciary law. Significantly, however, the Guidelines themselves were not "hard law;" that is, they were not formal legislation or administrative regulations. Rather, they were more akin to nonbinding admonitory principles that implicitly, yet consistent with the Delaware model, appeared to contemplate binding enforcement by the Japanese courts in specific cases. The judicial enforcement would take place within a legislative and administrative rulemaking framework

* Justice of the Delaware Supreme Court

1 JAPANESE MINISTRY OF ECON., TRADE AND INDUS., MINISTRY OF JUSTICE, "TAKEOVER GUIDELINES FOR PROTECTING AND ENHANCING CORPORATE VALUE AND THE INTERESTS OF SHAREHOLDERS AS A WHOLE 3 (May 27, 2005), available at http://www.meti.go.jp/policy/economicorganization/pdf/shishin_hontai.pdf. The Guidelines implemented recommendations contained in a voluminous report, ("the Corporate Value Report") also authored by The Corporate Value Study Group, which in turn was the product of a nine month investigation, conducted by the Corporate Value Study Group, into United States and European anti-takeover precedents and defense techniques. CORPORATE VALUE STUDY GROUP, CORPORATE VALUE REPORT 5 (April 27, 2005), available at http://www.meti.go.jp/policy/economic_organization/pdf/houkokusyo_hontai_eng.pdf.

that would be created shortly after the Guidelines were issued.²

Unlike the Delaware model, which had over 30 years to evolve, Japan had no model in place, since until 2001 it never experienced hostile takeovers. Presumably the expectation of METI, MOJ, and the CVSG was that the Guidelines would enable Japan either to bypass, or to accelerate at light-speed, the development of its own model by transplanting the Delaware model to Japan. The important question that the Guidelines implicitly raised was whether this assumption would prove to be accurate; that is, whether Japan's courts would create a common law anti-takeover regulatory regime resembling that of Delaware, or whether Japan's regulatory scheme would develop its own unique characteristics. That question was the subject of a paper that I delivered at the University of Tokyo School of Law in 2005. In that paper I predicted that in developing its own takeover jurisprudence, Japan would experience a unique doctrinal evolution that might—or might not—resemble that of Delaware.³

Today, Professor Curtis Milhaupt, of Columbia Law School, and I again find ourselves in Tokyo, to participate in this Symposium to assess the future direction and form of that evolution. What has happened in Japan since the Guidelines were first adopted? We know that between 2005 through 2007, over 400 Japanese companies adopted takeover defense measures.⁴ We know that during that period, there were roughly ten hostile bids for Japanese companies, some of which resulted in Japanese court decisions. One decision—which arose out of Steel Partners' 2007 hostile bid for Bull Dog Sauce,⁵ marked the first significant fork in

2 Two legislative changes took place during this period. The first was a disclosure rule for defensive measures promulgated by the MOJ. See Article 127, Ministry of Justice Companies Act Implementation Rule (2005). The second was an amendment in 2006 of the Securities and Exchange Act ("SEA") that relevantly approved a poison pill defense using a trust structure and authorized the Financial Services Agency ("FSA") to make detailed rules relating to tender offers. One of those rules permits the target company board to ask the bidder questions, which the bidder must answer in their public documents. Another was an EU style mandatory bid rule, which applies only where the bidder attempts to acquire 2/3 or more of the target company shares. In addition, the Tokyo Stock Exchange adopted administrative certain rules and guidelines. Hideki Kanda, *Takeover Defenses and the Role of Law: A Japanese Perspective* (March 31, 2008), Manuscript at 5-6 (cited herein as "Kanda").

3 Jack B. Jacobs, *Implementing Japan's New Anti-Takeover Defense Guidelines Part I: Some Lessons From Delaware's Experience in Crafting "Fair Takeover Rules*, 2 NYU Journal of Law & Business, 323, 350 (2006) (cited herein as "Jacobs, *Lessons from Delaware*").

4 Report, *Takeover Defense Measures in Light of Recent Environmental Changes* (Corporate Value Study Group, June 30, 2008) at 2 (reporting that "more than 500 Japanese companies have adopted takeover defense measures"); Curtis J. Milhaupt, *Bull-Dog Sauce for the Japanese Soul? Courts, Corporations, and Communities—A Comment on Haley's View of Japanese Law*, (May 5, 2008) unpublished draft article, forthcoming in ___L. Rev. ____(2008) (cited herein as "*Milhaupt, Bull Dog Sauce.*") at 1 ("about 400 publicly traded Japanese firms have adopted some form of shareholder rights plan" and describing the form of those plans as "highly unusual"); Ronald Dore, *Japan's conversion to Investor Capitalism*, (August 16 2008), unpublished draft article, forthcoming in ___ L. Rev. ____(2008) (cited herein as "*Dore*") at 4 ("About 400 firms have adopted such measures.").

5 *Steel Partners Japan Strategic Fund (Offshore), L.P. v. Bull-Dog Sauce Co., Ltd.*, 1805 Shoji Homu 43 (Tokyo D. Ct., June 28, 2007) ("*Bull-Dog Sauce I*"); 1806 Shoji Homu 40 (Tokyo High Ct., July 9, 2007)

the road of that evolution. The *Bull-Dog Sauce* case, which was decided by three different Japanese courts—a trial court and two appellate courts—generated two quite different applications of the Guidelines and, thus, two quite distinct rationales for upholding the particular anti-takeover defense in that case.

That divergence of views within the Japanese judiciary raised three questions. First, did the original Guidelines give sufficient guidance to the judiciary presumably being charged with their application and enforcement? Second, given Japan's unique business and legal culture, is the Delaware-style common law judicial lawmaking approach the most appropriate to regulate Japanese board responses to hostile takeovers, or is that better accomplished by legislation, administrative rulemaking, or some combination thereof? And third, if the Japanese judiciary is the appropriate rule-making institution, how will the judges allocate the decision-making power as between the directors and the shareholders of Japanese target companies, and what will be the standard for judicial review of Japanese anti-takeover defensive board conduct?

The first question prompted the CVSG to issue a Supplemental Report that apparently was intended to offer the Japanese courts further guidance as to how (in the CVSG's view) the Guidelines should properly be interpreted and applied in various circumstances, including those involved in *Bull Dog Sauce*.⁶ The second and third questions, however, remain unanswered and form the subject of what we will be discussing today.

Before doing that, allow me to answer one question that you are likely asking yourselves: what do I, an American judge who is not a Japanese law scholar, bring to this discussion? I certainly claim no special expertise from the Japanese legal perspective. That expertise belongs to Professor Milhaupt, who is one of America's most prominent Japanese Law scholars, and with Professor Hideki Kanda, who is perhaps Japan's preeminent Japanese comparative corporate law scholar. Both of these gentlemen will grapple with these issues in their own remarks, which follow mine. My goal is far more modest: to set the stage for their remarks by recounting how the American institutional framework for expounding and enforcing takeover rules evolved under U.S. federal securities law and Delaware fiduciary law. My hope is that Japanese policymakers may find Delaware's experience useful in deciding what Japanese institution or institutions should shape the future direction and form of Japan's takeover jurisprudence.

II. EVOLUTION OF AMERICA'S ANTI-TAKEOVER LAW-MAKING INSTITUTIONAL FRAMEWORK

One cannot meaningfully discuss the evolution of Delaware's institutional framework for regulating anti-takeover board behavior without understanding the broader American

(*Bull-Dog Sauce II*"); 1909 Shoji Homu 16 (Sup. Ct., Aug. 7, 2007) (*Bull Dog Sauce III*).

⁶ On June 30, 2008, the Corporate Value Study Group published a Report entitled *Takeover Defense Measures in Light of Recent Environmental Changes* (the "2008 Supplemental Report"). One of the "environmental changes" discussed in that Report was the trilogy of *Bull-Dog Sauce* decisions.

institutional setting of which Delaware is a part. Since 1933 corporate takeover regulation in the U.S. has been governed under two parallel institutional schemes: federal and state. The existence of, and changes to, the federal takeover regulatory scheme influenced the evolution of anti-takeover regulation at the state level, and vice versa.

Before 1968, corporate takeovers were accomplished primarily through proxy contests, which were federally regulated. After tender offers emerged as a takeover vehicle, they too were regulated at the federal level—at least initially. But, the federal scheme left unregulated the responses of target company boards to hostile takeover bids. That created a regulatory gap which became filled at the state level and, in large measure, by the courts of Delaware. What next follows is how this came about.

A. Tender Offers Before And After Williams Act Federal Regulation

The evolution of the American (and Delaware) institutional framework for regulating corporate board anti-takeover defenses began with the use of tender offers as a primary takeover tool. Before then, most hostile takeovers were accomplished by replacing the target company board in a proxy contest. In that area the states did not play a significant role, because proxy contests were regulated under federal law, specifically, Section 14(a) of the Securities Exchange Act of 1934 and the implementing Proxy Rules promulgated by the U.S. Securities and Exchange Commission (“SEC”).⁷ That federal framework has been the source of proxy contest regulation for almost 75 years. To the extent state courts became involved, their involvement was limited to cases where in the course of a proxy contest, relief was needed against the target company incumbent board taking inequitable action to frustrate the shareholders’ right to replace them by electing the dissident board candidates.⁸

The emergence of the tender offer as a primary takeover tool is what drove the evolution of the American regulatory structure at both the federal and the state levels. Before the passage of the Williams Act in 1968,⁹ neither federal securities nor state corporate law regulated tender offers. This absence of regulation was a major advantage of a tender offer over other acquisition forms, and led to the enormous growth in the volume of tender offers during the 1960s decade.

Before the Williams Act was adopted, tender offers were often strategically abused, to the benefit of the bidder and the detriment of target company stockholders. A favorite form of

7 See 15 U.S.C. §§ 78a-78mm and SEC Rules 14(a) and 14(b), 17 C.F.R. § 240.14a, et. seq.

8 See, e.g., *Schnell v. Chris Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971) (invalidating, as inequitable board conduct, a by-law amendment advancing the annual stockholders meeting date and thereby unfairly shortening the dissident shareholders’ ability to wage a proxy contest to replace the board); see also, *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 907 (Del. Ch. 1980) (invalidating an advance notice by-law that no dissident slate could comply with in a timely way to become eligible to wage a proxy contest for board control); and *Blasius Indus. v. Atlas Corp.*, 564 A.2d 551 (Del. Ch. 1988) (invalidating board action expanding the board by two directorships and then filling the two vacancies, thereby making it impossible for dissident slate in proxy contest to gain majority board control).

9 15 U.S.C. §§ 78mmm-78n, et. seq.

pre-Williams Act tender offer was the so-called “Saturday night special.” That is a short hand description of a surprise tender offer typically made over a weekend, in which little or no information was disclosed or adequate time provided to shareholders trying to decide, in an informed, unhurried manner, whether or not to tender their shares.¹⁰ These offers, usually made on a “first come, first served” basis, frightened shareholders to believe that if they did not tender quickly (or at all), they would be left holding illiquid stock or become vulnerable to a “squeeze out” merger at a lower price. The purpose and effect of this tactic was to stampede target company shareholders into tendering their shares to the hostile bidder even if the offering price was unfairly low. The shortness of time in which to respond also disabled target company boards from taking any meaningful defensive action.

The Williams Act eliminated these and other abuses associated with tender offers by adding subsections (d) and (3) to Section 13, and subsections (d) and (e) to Section 14, of the Securities Exchange Act of 1934. Those amendments imposed important disclosure and procedural requirements upon tender offers which are described in the margin.¹¹ As a result of that legislation and the implementing rules adopted by the SEC, both the substantive structure of, and the disclosures relating to, tender offers have been, and continue to be, regulated at the federal level.

But what the Williams Act legislation did not regulate was the conduct of target company boards in responding to hostile takeover bids. Indeed, at the federal level, there was no governmental interest in regulating anti-takeover defensive measures.¹² The important

10 Stephen M. Bainbridge, *Mergers and Acquisitions* (2d Ed.), Concepts and Insights Series (Foundation Press 2007) at 161-162, 179.

11 Section 13(d) requires public disclosure whenever any person or affiliated group acquires more than 10% (later reduced to 5%) of any class of equity security of a company registered under the Exchange Act. Section 13(3) regulates self-tender offers by issuers, by requiring extensive disclosure to shareholders of information material to the offer. Section 14(d) requires any person beginning a tender offer that would result in the bidder owning 5% or more of a class of equity securities of a registered company to file disclosures similar to those required by Section 13(d). Section 14(d), implemented by SEC Rule 14d-7, requires bidders to permit tendering shareholders to withdraw their shares during the entire period of the bid. Section 14(d)(6), implemented by SEC Rule 14d-8, provides that whenever a partial bid (for less than all outstanding securities of the class) is oversubscribed, all shares tendered during the tender offer period must be taken pro rata. Section 14(d)(7) requires that whenever the terms of a tender offer are improved, the improved consideration must also be paid to those who have already tendered their shares. And Section 14(e), implemented by SEC Rule 14e-1, prohibits fraud in connection with a tender offer and obligates the bidder to keep the tender offer for at least 20 business days. And under SEC Rule 14e-2, after a tender offer is made the target board must disclose to shareholders within 10 business days whether the board recommends acceptance or rejection of the offer or takes no position, and the reasons for their recommendation. See William J. Carney, *Mergers and Acquisitions, Cases and Materials*, (Second Ed), Foundation Press 2007 at 927-929; and Stephen M. Bainbridge, *Mergers and Acquisitions* (2d Ed.), Concepts and Insights Series (Foundation Press 2007) at 161-162, 179.

12 As Chancellor William B. Chandler stated at a Symposium held in Tokyo in June 2003:

With minor exceptions, the United States Congress had shown no interest in adopting a statutory framework to regulate corporate decision-making. The [SEC] also expressed no interest in

consequence of that abstention was to leave the regulation of board anti-takeover defensive conduct to the states, and more specifically, to state courts. Because Delaware was (and is) the state of incorporation of a majority of the large public corporations in the United States, the conduct of those corporations' directors became subject to regulation under Delaware law.¹³

But even at the state level several core issues had yet to be resolved. One fundamental question was who should decide whether an unsolicited takeover bid can go forward—the stockholders or the board? Another was: which governmental branch and institution—the executive, legislative or judicial—should decide the first question? The legislature was not a realistic option, because tender offers and target board responses thereto were not addressed in the Delaware General Corporation Law or any other statute. Moreover, the Delaware legislature had never expressed any interest in becoming a prime actor in this arena.¹⁴ Nor did the executive branch. Delaware had no administrative agency charged with regulating internal board conduct. Thus, by default, the regulation of board anti-takeover defensive conduct was left to the Delaware courts, whose basic tools were common law fiduciary duty concepts applied on a case by case basis. It is within that institutional framework that the anti-takeover law governing Delaware corporations has developed and continued to evolve over the last forty years.

regulating takeover defenses such as the poison pill. Moreover, the United States Supreme Court had essentially sidelined federal judges and state legislatures with respect [to] such corporate governance matters. Almost by default, state courts were left to fill this void and create dependable ground rules governing when corporate boards...might employ takeover defenses...to deter, thwart, slow down or even stifle an ever increasing wave of hostile acquisitions.... As the state of incorporation of a substantial majority of United States corporations, Delaware was thrust into the forefront to develop these ground rules.

William B. Chandler, III, *Hostile M&A and the Poison Pill in Japan: A Judicial Perspective*, 2004 COLUM. BUS. L. REV. 45, at 49-50.

13 That result was hardly anticipated, nor was it even intuitive, at the time the Williams Act was adopted. To the contrary, at that time it was widely predicted that internal corporate governance regulation would be enforced by the federal courts, applying Section 10 (b) of the Exchange Act and SEC Rule 10(b)(5), 15 U.S.C. §78j(b) and 17 C.F.R. §§ 240.10(b)-5. Indeed, much of traditional state corporate governance law in cases involving securities transactions had become de facto “federalized” in lawsuits brought in federal courts under Rule 10b-5. That trend was abruptly reversed in 1977 by the United States Supreme Court, which held in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) that breaches of fiduciary duty by corporate officials “without any deception, misrepresentation, or nondisclosure” are not remediable under Section 10(b) and Rule 10b-5. The result was to reallocate all transactional litigation involving traditional corporate governance issues—including mergers and acquisitions litigation—to the state courts. As a result, much of the takeover litigation involving Delaware-chartered public corporations took place in the Delaware courts.

14 The Delaware General Corporation Law (“DGCL”) was originally adopted in 1899 and since 1967 has been amended on an annual basis.

B. Delaware Court Regulation Of Anti-Takeover Board Conduct

Once it was settled (in Delaware at least) that the courts would be the governmental institution to determine how corporate boards should properly respond to a hostile takeover bid, other fundamental questions still remained for the Delaware courts to decide.

1. *Who Decides Whether A Bid Goes Forward?*

The first question was which body within the corporation—the stockholders or the board—should decide whether or not to entertain a hostile takeover bid? There was no clear answer to that question. If the acquisition took the form of a merger, the DGCL affirmatively empowered the board to decide whether the shareholders would be entitled to consider and vote on the transaction.¹⁵ But if the transactional form was a tender offer, no such statutory power or duty was vested in the board; indeed, the statute did not address tender offers at all. Moreover, a tender offer was in form a transaction between the bidder and the target shareholders. That suggested that the board should play no role and that the power to accept or reject the offer should reside in the shareholders alone. This issue was hotly debated within the American corporate community, with no consensus being reached.¹⁶ Not until 1985, in its *Unocal* decision¹⁷ did the Delaware Supreme Court resolve that debate. The Court did that by deciding, as a matter of fiduciary law and statutory interpretation, that where a target board has reason to regard a hostile bid as a threat to legitimate corporate policy and shareholder interests, the board has the power and the duty to interpose itself between the tender offeror and the target shareholders, and take defensive measures that are proportionate to the threat. This aspect of Delaware corporate jurisprudence became a foundational concept of Japan's 2005 Guidelines, although the Guidelines limit more strictly the ability of Japanese company boards to act unilaterally (*i.e.*, without shareholder approval), than does Delaware law.¹⁸

15 See 8 *Del. C.* §§ 252, 252 (requiring that the board recommend a merger or consolidation to shareholders before shareholders entitled to vote).

16 In an article written in 2006, (See Jacobs, *Lessons From Delaware*, 2 *NYU Journal of Law and Business* at 333, n. 28), the debate in the U.S. was driven by two interest groups having diametrically opposite views. Takeover defense lawyers (and some academics) argued that board decisions with respect to tender offers should be treated like any other board decision concerning an acquisition proposal and that the business judgment rule should locate the power to deploy defensive tactics with the board. See Martin Lipton, *Takeover Bids in the Target's Boardroom*, 33 *BUS. LWYR.* 101 (1979); see also Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 *STAN. L. REV.* 791 (2002). The plaintiff's bar, and many academics, took the position that shareholders should ultimately decide whether a hostile bid will succeed, and that the target board should take a passive role. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *HARV. L. REV.* 1161 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *STAN. L. REV.* 819 (1981).

17 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) ("*Unocal*").

18 Jacobs, *Lessons from Delaware*, 2 *NYU Journal of Law and Business* at 336-337, and Notes 35-38. The Guidelines require that where possible, shareholders should approve a poison pill rights plan in advance; if a poison pill is adopted by the board, there should be a mechanism that enables the defensive measure to

2. *Whose Interests May The Board Consider?*

A second fundamental issue that the Delaware courts were soon called upon to decide was whether in defending against a hostile bid, the target company directors had a duty to protect the interests of shareholders exclusively, or whether the interests of other constituencies, such as creditors, employees, and the community generally, could also be taken into account. In *Unocal* the Delaware Supreme Court held that in cases where the defensive measures were intended to keep the company independent (as a “stand-alone” company), the board, in fashioning a “proportionate” anti-takeover defense, may to some extent take non-shareholder interests into account.¹⁹ But, where the defensive goal is not to keep the target company independent but, rather, to sell the company to an acquirer other than the hostile bidder, the answer was quite different. In *Revlon*,²⁰ a case handed down the same year as *Unocal*, the Court held that in those circumstances, the only constituency the board may consider are the shareholders. The shareholders’ interest (the Court held) is to receive (and the board has a duty to obtain) the highest value reasonably available, even if as a result the hostile bidder becomes the successful acquirer.

3. *Under What Standards Will The Court Review Board Anti-Takeover Conduct?*

(a) Pre-1985 Review Standards

The third fundamental question was under what standard should Delaware courts review the legality of board anti-takeover conduct? Here again the answer was not easily arrived at, because until 1985 there existed only two standards for reviewing board conduct in American corporate law—business judgment and entire fairness. Neither standard was particularly well suited or responsive to the concerns presented by hostile takeovers.²¹ Under business judgment review, it is presumed that in making a business decision “the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company.”²² Unless the plaintiff stockholder can present evidence sufficient to overcome that presumption, the courts will uphold the board’s decision. Under entire fairness review, applied in cases where the board or management is accused of acting in a self-interested manner, the directors or managers had the burden to demonstrate that their decision was entirely fair to the corporation and its stockholders, in terms of both

be removed promptly by the board, and the shareholders’ ability to replace the board at the general shareholders meeting must be preserved; and the pill should contain terms that enable shareholders to respond to a tender offer based on their own judgment. *Id.*, at 339. The 2008 Supplemental Report reaffirms the principle that although the directors “must responsibly decide whether or not to adopt and implement takeover defense measures and then fulfill their responsibility of explaining their decision to shareholders” (2008 Supplemental Report at 5-6), “[t]he decision to accept or reject a takeover should in the end be made by shareholders.” (*Id.*) at 5.

19 *Unocal*, 493 A.2d at 955.

20 *Revlon, Inc. v. MacAndrews & Forbes*, 506 A.2d 173 (Del. 1986) (“*Revlon*”).

21 The reasons why the traditional business judgment and entire fairness review standards were a less than adequate “fit” for reviewing board responses to hostile takeovers, are more fully discussed in Jacobs, *Lessons from Delaware*, at 328-338.

22 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

process and price.²³

Neither standard was particularly well-suited or responsive to the concerns presented by hostile takeovers, because (1) board resistance to hostile takeovers, particularly tender offers, did not comfortably fit the paradigms envisioned by those two standards and (2) application of these standards to hostile takeovers created the risk of being either under or over-inclusive. Here is why.

The business judgment standard presupposes that the board has made a “business judgment” that involves the business or assets of the corporation. But, as earlier noted, a tender offer is (formally speaking) a transaction solely between the offeror and the target company stockholders. Under the DGCL a tender offer does not require the board’s approval, and arguably does not involve the corporation’s “business” at all. Nor was the entire fairness standard a good fit for the hostile takeover fact pattern. That standard was applied to transactions that involved self dealing by a majority stockholder or that was approved by a board having a financial conflict of interest. But, many corporate boards that approved defensive measures against hostile tender offers had a majority of independent directors whose livelihoods (unlike those of “inside” directors) would not be affected by the outcome of the hostile offer. In such cases, no self-dealing in the classic sense was involved at all.

Moreover, these two standards, if applied to review board anti-takeover defensive behavior, created a risk of either over or under inclusion. Reviewing a takeover defense under the entire fairness standard created a significant risk of over-inclusion, *i.e.*, that the defense would be invalidated simply because the defensive measure would deprive the shareholders of the ability to accept an offer at a premium above the market price of the target company stock. Thus, fairness review would create a high risk of depriving target boards of their ability to protect shareholders against coercive, two-tiered offers of the kind involved in *Unocal*. On the other hand, reviewing a takeover defense under the business judgment standard would virtually guarantee its validation, thereby creating the risk of under-inclusion. That is, business judgment review created a risk that courts would give undue deference to defensive decisions by a compliant board that, even though disinterested and acting in good faith, was servile to the views of senior managers who did have a career-based self-interest in opposing an offer that would benefit the shareholders.

Accordingly, for almost two decades the Delaware courts embarked on a quest for a review standard that would better address the complexities of hostile takeovers and the varied motives that drive a target board’s defensive responses. That quest eventually led the Delaware Supreme Court to formulate entirely new review standards. I refer, of course, to the so-called “intermediate” standards that the Supreme Court adopted and articulated in *Unocal* and *Revlon* in 1985, and that the Court of Chancery adopted in *Blasius* in 1988.²⁴

At this point I discuss the Delaware intermediate review standards, for two reasons. First, they are substantively relevant to Japan, if only because the CVSG and the Guidelines adopted some aspects of them in whole or in part. Second, those review standards may be

23 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

24 *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, (Del. Ch. 1988).

institutionally relevant to Japan, since the development of anti-takeover law through the common law adjudication process, once shown to have worked in my country, might work in Japan as well.

(b) Post-1985 Intermediate Review Standards

Unocal was the first conceptual breakthrough in developing standards for judicially reviewing board conduct specially tailored to hostile takeovers. That breakthrough was quite dramatic, because it was the first time that a court had squarely confronted the unique paradigm for which neither the business judgment nor the entire fairness standard was well suited. For the first time, a court expressly recognized the unique feature of the hostile takeover paradigm—that the “omnipresent specter that a board may be acting primarily in its own interests rather than those of the corporation and its shareholders.”²⁵ That is, hostile takeovers created a potential—even though not an actual or provable—conflict that was too elusive to warrant entire fairness review, yet was also too disquieting to bestow automatic business judgment deference. *Unocal* solved that problem by crafting an intermediate standard of *reasonableness*—intermediate in the sense that it falls between the highly deferential business judgment standard and the highly intrusive fairness review standard. The reasonableness standard solved the problem in two ways. First, it required the board to establish the reasonableness of its defensive actions for the defense to become entitled to business judgment review. Second, the standard lent itself to objective application, in that the board must prove that the hostile offer was reasonably perceived as a threat to corporate value and policy, and that the defense the board selected was reasonable, that is, not disproportionate to the threat.

As we know, the Corporate Value Report and the Guidelines endorsed *Unocal*'s principles that: (i) takeover defenses must be “reasonable,” (ii) that defenses are valid insofar as they are designed to enhance corporate value and not to entrenching corporate management, (iii) that defenses should “not be excessive but proportional to threats,” and (iv) that before adopting a defense target boards must make a diligent investigation of the hostile offer and the offeror.²⁶ The Guidelines did not, however, adopt the principle, which was upheld in *Unocal* and *Moran*,²⁷ that before a hostile bid is made, a board may adopt a defensive measure (and, more specifically, a rights plan) unilaterally and without the approval of shareholders.²⁸

25 493 A.2d at 954.

26 Jacobs, *Lessons From Delaware*, at 336, n. 35-337 (citing corporate value report at 25, 84; and guidelines, pt. IV (3) at 8, n. 6).

27 *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985) (“*Moran*”).

28 Even where a hostile bid is launched, any defense adopted by the target board directors must reflect “the reasonable will of the shareholders,” because “the decision to accept or reject a takeover should in the end be made by shareholders.” 2008 Supplemental Report at 5. But where an “abusive takeover” is “recognized to be clearly detrimental to the shareholder interests, the board of directors may implement takeover defense measures upon its own judgment from the perspective of protecting the shareholder interests.” *Id.* (citing the Tokyo High Court decision of March 23, 2005 in the Nippon Broadcasting System case). Even in that context, the board has a “responsibility to explain matters to shareholders in the

This same intermediate standard—reasonableness—was applied by the Supreme Court first in *Revlon*, and later in *Paramount v. QVC*,²⁹ to circumstances where the board's response to a hostile offer is to put the target company up for sale or to cause the company to engage in a change of control transaction. In those cases, the board's duty is to sell the company to the bidder offering the highest value reasonably available for the shareholders. The court will review the reasonableness of the board's choice of transaction both as to process and price, with the board having the burden to prove that its decision was reasonable in both respects. Reasonableness of process is a value also endorsed in the Corporate Value Report and the Guidelines, which contemplate that a Japanese court will assess the reasonableness of board-adopted defensive measures.³⁰

The third intermediate review standard was adopted in the 1988 Blasius decision. Although *Blasius* is an intermediate standard, it is not, strictly speaking, a standard of reasonableness. Rather, it is much more rigorous from the target directors' perspective. To understand why, some brief background is helpful.

Earlier in my remarks, I mentioned that after the Williams Act, the tender offer virtually replaced the proxy contest as the preferred hostile takeover vehicle. That remained true until the "poison pill" rights plan was developed, and the Delaware Supreme Court upheld its validity in *Moran v. Household International*. In *Moran*, the Supreme Court held that although a board could adopt a poison pill as a pre-planned defense, if the pill is used as a defense against an actual hostile takeover, the Delaware courts will review whether the board's decision to deploy the pill is reasonable under *Unocal*. Over the next several years, lawsuits were filed challenging the board's use of the pill as a defense against specific hostile offers. Those challenges proved largely unsuccessful from the bidder's standpoint. In most cases the Delaware courts refused to order the target boards to redeem the pill, because keeping the pill in place often resulted in higher bids, and ultimately transaction terms, superior to the hostile bidder's initial offer.

Because it proved unlikely that the courts would grant relief to hostile bidders by ordering the target board to redeem the poison pill, hostile bidders needed to adopt new strategies designed to counteract the pill defense. The strategy they developed was to bring back the proxy contest, and combine it with a hostile tender offer. That is, the bidder would commence

process of verifying their will" (*Id.* at 15). That responsibility includes "explain[ing] to shareholders matters such as the board's evaluation of the takeover proposal based as much as possible on facts so shareholders can decide whether to accept or reject the takeover." *Id.* at 7.

29 *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) ("*QVC*").

30 The Report observes that a reasonable takeover defense is one that gives shareholders "the opportunity to [compare]...the acquirer's takeover proposal and the existing management's proposal" (CORPORATE VALUE REPORT at 40). It also emphasizes the importance of the "due diligence and neutrality of the [board's] evaluation process." (*Id.*, at 55). Those same process concerns are reflected in *Revlon*, which requires the target board to adequately inform itself to compare, and then choose between, two competing acquisition bids. Delaware law also requires disclosure to shareholders all material facts relating to that choice so that the shareholders themselves can decide whether or not to approve the transaction being proposed by the board.

a tender offer, and simultaneously would also mount a proxy solicitation to remove the incumbent target directors and replace them with board candidates who, after assuming office, would redeem the poison pill.³¹ Because that strategy, if successful, would enable hostile bidders to circumvent the poison pill, target company boards were forced to develop counterstrategies. Those counter strategies included tactics designed to interfere with, and in some cases to obstruct altogether, the bidder's proxy solicitation.

For example, in one such case (*Aprahamian*), the target company board rescheduled the shareholders' meeting to a later date, to enable the board to solicit revocations of proxies in order to defeat the otherwise victorious dissident group. The Court of Chancery invalidated the board's obstructive action.³² In *Blasius*, which was decided one year later, the target company board amended the by-laws to expand the size of the board, and then filled the newly created board positions, so that the incumbents would retain control of the board irrespective of the outcome of the proxy contest. The Court of Chancery held that in cases where the board's defensive actions amount to an intentional interference with the shareholders' voting franchise (their right to elect a new board), those actions would be reviewed under a standard that requires the board to show a "compelling justification" for their actions. Because no compelling justification was shown, the *Blasius* Court invalidated the board's defensive actions.³³

The "compelling justification" standard, although labeled as "intermediate," is in fact much more rigorous than the "reasonableness" review standard mandated by *Unocal* and *Revlon*. The policy reason is that the shareholder vote that installed the board into office is what

31 Much of this post-*Moran* history related here is described in *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1186-87 (Del. Ch. 1996).

32 *Aprahamian v. HBO & Co.*, 531 A.2d 1204 (Del. Ch. 1987).

33 *Blasius, supra*, 564 A.2d 651. In *Blasius*, the proxy contest was not accompanied by a hostile tender offer, but in later cases that did involve a combined tender offer and proxy contest, the *Blasius* standard was invoked (unsuccessfully) by the hostile bidder challenging different board defensive conduct. See, e.g., *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115 (Del. Ch. 1990); *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 496-97 (Del. Ch. 1995), *aff'd.*, 670 A.2d 1338 (Del. 1995). The *Blasius* review standard has been upheld by the Delaware Supreme Court. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

Because *Blasius* restricted the ability of boards to interfere directly with a proxy contest seeking to oust them from their positions, target company boards developed other strategies to avoid ouster. One of those strategies was the development of novel forms of poison pill rights plans. Two of these innovations were (i) the so-called "dead hand" poison pill that could not be redeemed except by the incumbent directors or their designated successors, and (ii) the "slow hand" poison pill that could not be redeemed by any newly elected board for a lengthy period (e.g, six months) after taking office. If legally valid, the dead hand pill would stop a proxy contest before it began, because no hostile bidder would wage a proxy contest to replace an incumbent board if the bidder's newly elected nominees were powerless to redeem the pill. Similarly, the slow hand pill would operate as a deterrent. The dead hand pill was judicially invalidated in *Carmody v. Toll brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998); and the "slow hand" pill was invalidated in *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), affirming *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25 (Del. Ch. 1998).

underlies the legitimacy of all director exercise of power. It therefore is vital that the shareholder franchise be safeguarded against board interference. The rigor of the *Blasius* standard is intended to reinforce that principle as a matter of fundamental corporate law policy.

C. Shareholder Efforts To Reduce Board Control Over Anti-Takeover Defenses

The history I have related is illustrates that the institutional framework for regulating board anti-takeover defensive conduct is dynamic and interactive: one evolutionary development gives rise to another, which in turn generates a third. I next describe the most recent phase of that evolution: the current movement by the shareholder community to wrest control over the takeover process, which under *Unocal* resides in the target company board. This movement, which is being led by activist institutional shareholders such as labor union and public employee pension funds, involves efforts to amend portfolio company by-laws to limit the ability of boards to adopt poison pills, and/or to continue their deployment as a defense against a hostile takeover.

These efforts have taken different forms. Early iterations of these shareholder proposals sought to amend the by-laws to flatly prohibit the board from redeeming a rights plan without prior shareholder approval and also to require the board to redeem any existing rights plan.³⁴ A more nuanced version, proposed by Harvard Law School Professor Lucian Bebchuk, would require that a rights plan either be approved by the shareholders or renewed for only successive one-year terms by a supermajority vote of the board.³⁵ A third version involved proposals to amend the by-laws to require a so-called “chewable pill” which, if adopted, would require the board to redeem the pill if the unsolicited bid satisfied specified conditions, such as (for example), a premium exceeding a certain percentage over the pre-bid market price.³⁶

Another institutional shareholder effort to wrest control over the takeover process is less direct but equally potent. These efforts would increase shareholder influence over the process for electing (including replacing) directors. One such form are shareholder proposals to amend the corporation’s charter to require a “majority” voting system, in states (such as Delaware) where directors are elected (or re-elected) by a plurality vote.³⁷ This form of

34 See Frederick H. Alexander and James D. Honaker, POWER TO THE FRANCHISE OR THE FIDUCIARIES?: AN ANALYSIS OF THE LIMITS ON STOCKHOLDER ACTIVIST BY-LAWS, 33 Del. J. Corp. L. 749, 758-64 (2008); Charles F. Richards, Jr. and Robert J. Stearn, Jr., SHAREHOLDER BY-LAWS REQUIRING BOARDS OF DIRECTORS TO DISMANTLE RIGHTS PLANS ARE UNLIKELY TO SURVIVE SCRUTINY UNDER DELAWARE LAW, 54 Bus. Lwyt. 607 (Feb. 1999).

35 *Id.*, at 759; *Bebchuk v. CA, Inc.*, 902 A.2d 737, 739 (Del. Ch. 2006) (declining to rule on the validity of the by-law because the matter was not ripe for judicial determination).

36 A different version of a “chewable pill” allows a prospective bidder holding no more than 1% of the corporation’s stock to call a shareholder vote upon any financed all cash offer for all shares, accompanied by an investment banker’s opinion stating that the offer is fair. See Dennis J. Block, Nancy E. Barton, and Stephen A. Radin, THE BUSINESS JUDGMENT RULE (Fifth Ed., Aspen Law & Business), Vol. I, at 1089-90.

37 See, e.g., 8 Del. C. § 216 (3) (absent a contrary certificate or by-law provision, “[d]irectors shall be elected by a plurality of the votes present in person or represented by proxy at the meeting and entitled to vote on the election of directors.”).

proposal would change the corporation's governance system so that no director candidate would be elected or re-elected without receiving a majority of the votes represented in person or by proxy at the annual shareholders meeting. That would increase the influence of institutional shareholders, which often collectively control enough shares to constitute—or block—a majority vote. The institutional pressures to effect that change led many public corporations to agree voluntarily to amend their certificates to provide for majority voting. In 2006, in response to this movement, the Delaware legislature amended the DGCL to permit Delaware corporations to adopt majority voting either by certificate or by-law amendment.³⁸

Other forms of institutional investor by-law proposals would increase shareholder access to the corporate ballot by reducing the cost (to dissident shareholders) of waging a proxy contest. One variation would enable certain shareholders, under specified circumstances, to use the corporation's proxy materials to nominate an opposing slate of director candidates. A second variation would require the corporation to reimburse the dissidents' reasonable expenses of conducting a proxy contest where the dissident slate wins at least a minority of the board positions. Such a proposal was the subject of a recent decision by the Justices of the Delaware Supreme Court, who held that such a by-law could be adopted by shareholder vote without the board's consent.³⁹

Viewed from a broader perspective, these efforts by shareholders to “push back” the power of boards to control the takeover process are part of a more pervasive movement taking place in the European Union, the U.K., and Australia, to shift the focus of corporate law from protecting the interests of shareholders, affirmatively to grant shareholders greater participatory rights in the corporate governance process.⁴⁰ Although these developments do not affect Delaware's anti-takeover jurisprudence in any direct way, they will likely influence how that jurisprudence continues to evolve.

D. State Anti-Takeover Legislation

At the risk of complicating further an already-complex institutional tapestry, the story of how the anti-takeover institutional framework evolved in the United States would be incomplete without one final piece. I refer to the enactment, by several states, of different forms of anti-takeover legislation that vary markedly from the court-centered Delaware system I have described. That state anti-takeover legislation falls into two categories: (i) statutes designed to regulate the substance of corporate takeovers, or some aspect thereof, and (ii) statutes intended to afford target company directors greater latitude in blocking

38 8 *Del. C.* § 216.

39 *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (validating shareholder power to enact proposed by-law but holding that by-law could not be worded so as to preclude the board from exercising its fiduciary duty to deny reimbursement in an appropriate case).

40 See, Jennifer G. Hill, REGULATORY SHOW AND TELL; LESSONS FROM INTERNATIONAL STATUTORY REGIMES 33 *Del. J. Corp. L.* 819 (2008); 2007 EU directive on Shareholder Rights, Euro. Comm, MODERNISATION OF COMPANY LAW AND ENHANCEMENT OF CORPORATE GOVERNANCE, http://ec.europa.eu/internal_market/company/modern/index_en.htm.

hostile takeovers than what Delaware case law permits.

1. Substantive Takeover Legislation⁴¹

Simultaneous with Congress's adoption of the Williams Act, many states adopted so-called "first generation" state takeover laws. Like the Williams Act, the first generation state laws were mainly disclosure statutes, but some of them also imposed certain procedural and substantive requirements that created substantial obstacles for takeover bidders, which ultimately led to their invalidation.

Typical of these first generation statutes was the Illinois Business Takeover Act, which differed from the Williams Act in three critical ways. First, the Illinois Act required bidders to notify the target and the Illinois Secretary of State twenty days before the offer's effective date. Second, the statute permitted the Secretary of State to delay a tender offer by holding a hearing on the offer's fairness; and required the Secretary to hold such a hearing if shareholders owning ten percent of the class of securities subject to the offer requested it. Finally, the Secretary could enjoin an offer on various grounds, including substantive unfairness.

The Illinois statute, and others modeled after it, posed significant constitutional problems that ultimately led to its invalidation by the United States Supreme Court in *Edgar v. Mite Corp.*⁴² The fatal flaw in this statute was that it ignored the fact that tender offers are transactions in interstate commerce, meaning that tender offers were made to shareholders who were residents of states besides Illinois, and that the tender offerors were typically non-Illinois corporations. The U. S. Supreme Court held that Illinois had "no legitimate interest in protecting non-resident shareholders" or in "regulating the internal affairs of foreign corporations," offered only "speculative" protection for resident shareholders, and that the possible benefits of the protection afforded by the act were outweighed by the risk that the offer would fail due to defensive tactics by incumbent management. The Court concluded for these reasons that the Illinois statute was unconstitutional under the dormant Commerce Clause of the United States Constitution.

The *Mite* opinion left open a narrow window of opportunity for states to regulate takeovers—the internal affairs doctrine, under which a state's takeover law governs questions of internal governance of corporations organized under the law of that state. This led to the so-called "second generation" of state takeover statutes, which were made applicable only to target corporations chartered by that state, and which were otherwise crafted to fit within the internal governance loophole.

There were four principal variants of second generation statutes: The first were "control share acquisition" statutes, which provided that if a bidder acquires a specified controlling percentage of the target's voting power (*e.g.*, 20% to 33 1/3%, or 33 1/3% to 50% or over 50%), then the acquired shares will not have voting rights unless the shareholders approve

41 This history of state takeover legislation borrows liberally from Professor Bainbridge's treatise on Mergers and Acquisitions. See Stephen M. Bainbridge, *MERGERS AND ACQUISITIONS, CONCEPTS AND INSIGHTS SERIES* (Foundation Press, 2d Edition) at p. 252 et. seq.

42 457 U.S. 624 (1982).

granting voting rights to the acquirer's shares.⁴³ A second category were "fair price" statutes, which typically provide that certain specified transactions, sometimes called "Business Combinations," that involve an "interested shareholder" (typically a shareholder holding more than 10%), must be approved by a specified supermajority shareholder vote, unless certain minimum price and other conditions are met. The third category were the "Business Combination" statutes, which typically prohibit a target from engaging in any business combination with an interested shareholder for a specified period of time (often five years) following the date in which the interested shareholder achieved that status. After the initial statutory "freeze" period, a business combination with an interested shareholder is still prohibited, unless the business combination is either approved by a specified vote of the shares not owned by the interested shareholder, or meets specified price and other criteria.⁴⁴ The last category are the co-called "cash out" statutes, under which an acquirer of more than a threshold percentage of the target company's stock must offer to purchase the remaining shares of all the other stockholders at a price that reflects the highest premium the acquirer paid while accumulating its target stock. The approach taken by the cash out statutes most closely resembles that of the London City Code, which similarly requires the acquirer of a specified percentage of a UK target company's shares to offer to purchase all the remaining shares.

As occurred with the first generation of state takeover statutes, a constitutional challenge was mounted, this time against the Indiana statute. The Indiana statute required a shareholder vote to determine if the acquirer of the control shares would be permitted to acquire the balance of the target company shares, in a merger or otherwise. In *CTS Corp. v. Dynamics Corp.*,⁴⁵ the United States Supreme Court upheld the Indiana statute, concluding that it was neither preempted by the Williams Act nor violated the dormant Commerce Clause. As a consequence of *CTS*, hostile offers in the United States are now potentially subject to regulation under the "second generation" statutes, but only where the target corporation is incorporated under the laws of the particular state in question. Thus, if the target corporation is a Delaware corporation, the only applicable state anti-takeover statute would be the Delaware statute (8 *Del. C.* § 203), which is a "business combination" statute.

2. The "Nonshareholder Constituency" State Statutes

The second group of anti-takeover statutes operates quite differently from those I have

43 The stated purpose of control share statutes is affording shareholders the opportunity to vote on a proposed acquisition of large share blocks that may result in or lead to a change of control of the target, and to reject a potential inadequate or otherwise undesirable offer. The Indiana statute (Ind. Code Ann. § 23-1-42) falls into this category, except that the shareholders determine whether or not the proposed acquisition may be made, as distinguished from whether the acquired shares will be entitled to vote.

44 The New York statute (N.Y. Bus. Corp. Law § 912 (c)) falls into this category. The Delaware statute (8 *Del. C.* § 203) is similar to the original business combination statutes, except there is no requirement of shareholder approval after the freeze period expires. But, if at any time during the freeze period a proposed transaction is approved by the board of directors and by the two thirds of the outstanding shares not owned by the bidder, then the freeze period will be waived.

45 481 U.S. 69 (1987).

previously described. These so-called “non-shareholder constituency” statutes, which have been adopted by thirty-one states,⁴⁶ operate in two ways. First, they relieve the target company directors, in responding to any takeover bid, of any obligation to treat the interests of shareholders as either dominant or controlling. Second, they permit the directors to consider the effects of a takeover on other constituency groups, including employees, suppliers, customers, creditors and local communities in which the firm does business. Importantly, these statutes represent an explicit legislative rejection of *Unocal* and *Revlon*, insofar as those cases dictate that the interest of stockholders is paramount. The underlying purpose of those statutes is political: to protect the economy of the local communities in which the target company or any of its major facilities is located, by empowering target directors to block a takeover that could result in the closure or relocation of those facilities, with resulting disruption of the labor force and loss of revenues to the community.

Typical of this genre are the statutes adopted by Pennsylvania, Rhode Island and Virginia. The Pennsylvania statute provides that directors are allowed to take account of the interests not only of shareholders but also of “employees, suppliers, customers and creditors, and... communities in which offices or other establishments of the corporation are located.” The statute also relieves the directors of any obligation to redeem any rights under a poison pill rights plan “solely because of the effect such action might have on a potential or proposed acquisition of control of a corporation.” And it “protects the actions of a majority board of disinterested directors in resisting unsolicited takeovers by retaining the ordinary business judgment rule with respect to the adoption of defensive measures.”⁴⁷

The Rhode Island statute provides that a board of directors which determines to reject a business combination “shall have no obligation to facilitate, to remove any barriers to, or to refrain from impeding, the business combination.”⁴⁸ The Virginia statute provides that the statutory standard governing conduct by Virginia directors, that “[a] director shall discharge his duties...in accordance with his good faith business judgment of the best interests of the corporation,” applies “with respect to any potential changes in control” to “any action taken or not taken by directors.”⁴⁹ Those provisions have been judicially construed as “the appropriate standard by which to assess director conduct related to the issuance or redemption of a Poison Pill.”⁵⁰

As noted, statutes of this kind are legislative rejections of the intermediate review standard adopted by Delaware case law, specifically *Unocal* and *Revlon*.⁵¹ I mention them because

46 Stephen M. Bainbridge, *CORPORATION LAW AND ECONOMICS* (Foundation Press 2002), at 741.

47 Pa Bus. Corp. Law §§ 1715 (c), (d); *AMP Inc. v. Allied Signal Inc.*, 1998 U.S. Dist. LEXIS 15617, at *14; 1998 WL 778348, at *5 (E.D. Pa. Oct. 8, 1998).

48 R.I. Bus. Comb. Act § 7-5.2-8(b).

49 Va. Stock Corp. Act § 13.1-690; §13.1-728.9.

50 *WLR Foods, Inc. v. Tyson Foods, Inc.*, 869 F.Supp. 419, 421 n.2 (W.D.Va. 1994), *aff'd*, 65 F.3d 1172 (4th Cir. 1995), *cert. denied*, 516 U.S. 1117 (1996).

51 The Indiana statute made this point explicitly:

Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to

while Delaware may be the most influential jurisdiction in the takeover area, in the American federal system, it is not the only jurisdiction.

III. CONCLUSION

To return to my beginning point, the issue of importance is not so much the institutional framework that prevails in the United States generally, or in Delaware specifically, but what framework is most suitable for Japan. That must be for you and other Japanese policymakers to decide. I hope that my observations about the Delaware experience will be of assistance to you in this important endeavor.

for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article.

Ind. Code Ann. § 23-1-35-1(f) (West 1990).

Comment:
Developing Takeover Policy in the United States and Japan

Curtis J. MILHAUPT*

Introduction

I am honored to have the opportunity to comment on the keynote speeches of Prof. Kanda and Justice Jacobs, two people who have been centrally involved in the development of takeover law and policy in their respective countries. Five years ago, the Center for Japanese Legal Studies at Columbia Law School co-sponsored a symposium in Tokyo on the poison pill. The lead speakers were Prof. Kanda, Chancellor William Chandler of the Delaware Chancery Court, and my Columbia colleague Ronald Gilson. The discussion at that conference was almost completely hypothetical. As readers are well aware, in the early 2000s Japan had not yet experienced much hostile takeover activity. Needless to say, no Japanese corporation had actually adopted a shareholder rights plan. And the courts had issued only a small number of decisions on takeover defenses. In the five years since that symposium, as Prof. Kanda has just explained in his keynote speech, there have been dramatic developments in the Japanese takeover market. I am extremely pleased that Columbia Law School is once again involved in a major symposium on Japanese takeover law and policy at a key moment in its institutional development.

I would like to approach the speeches of Prof. Kanda and Justice Jacobs from the perspective of institutional design and the process of institutional change. As the starting point for the analysis, note the diversity of takeover policies around the world, as reflected in these two speeches. Although many scholars have argued for years that we are witnessing “convergence” in corporate law and governance due to globalization and the homogenizing force of the capital markets, national laws on hostile takeovers and defenses vary greatly among highly developed countries.

Why do we see such diversity in this key area of economic regulation? Because takeover policy,¹ perhaps to a greater extent than any other area of corporate law, is deeply connected to a country’s institutional structures, and these structures have proven to be quite resilient in the face of globalization.

The question at the center of any country’s takeover policy is “who decides”? Who decides

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1 As I will explain below, I use the term “takeover policy” to mean both legal rules and surrounding institutions and organizations used to interpret and enforce the rules.

whether control over a firm will be sold and at what price? This question is integrally related to the question “for whose benefit is a corporation to be run?” The answers to these questions are bound up in each country’s legal culture, business culture, and market culture. I have created a matrix below to illustrate very simply how takeover policy interacts with and complements other legal and market institutions, taking the United States, Japan, and the UK as examples. Just as I have located Japan in the middle of this matrix, I will argue that the existing institutional features of Japan relevant to takeovers lie between those of the U.S. and the UK, and that this observation may provide some insights into the future direction of institutional development for Japanese takeover policy.

Takeover Law and Policy Matrix

	US	JAPAN	UK
Decision-maker			
Legislave Guidance on Defenses			
Common Defensive/ Protective Measures			
Ultimate Authority			
Legal Culture			
Enforcement Culture			
Corporate Culture			
Market Forces/ Philosophy			

I. Takeover Policy and Institutional Design

There are several possible answers to the “who decides” question: the shareholders, the board of directors, or a third party, such as a government agency. In the UK, the shareholders decide. The City Code of London provides that the board cannot take measures to frustrate a bid in the absence of shareholder approval.² In the United States (or at least under Delaware law, the most influential source of corporate law in the United States), as Justice Jacobs discusses in his speech, the Unocal case endorses the board of directors as the ultimate decision maker. Indeed, in the Unocal case, the Delaware Supreme Court explicitly rejected the notion that the board should be neutral in the face of a takeover bid.³ In Japan, I would argue that so far, the answer to the “who decides” question is not entirely clear. Certainly

2 City Code on Takeovers and Mergers, General Principle 7.

3 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 496, fn 10 (Del. 1985).

Japan's existing takeover policy places greater emphasis on shareholder approval than does Delaware law. The METI/MOJ Guidelines indicate that the "will of shareholders" should be a central consideration in adopting takeover defenses. However, other elements of Japanese takeover law, including some judicial decisions, appear to indicate that the board of directors has, at least under certain circumstances, the authority to unilaterally erect defenses to a bid that the board deems to be harmful to the corporation. The opinions of the Supreme Court of Japan and the Tokyo High Court in the Bull-Dog Sauce case nicely capture the contrasting emphases of existing Japanese takeover policy. The Supreme Court's ruling focuses on the fact that the shareholders approved the defensive measure that the board had devised to fend off Steel Partners, while the High Court's "abusive acquirer" rationale seems to emphasize the board's determination that the private equity fund's investment motives were harmful to the firm.

Naturally, how a given country answers this key question has major implications for institutional design. Even a cursory examination of the main features of takeover institutions in our three sample jurisdictions illustrates this point.⁴ The U.S. institutional landscape features a shareholder rights plan ("poison pill") adopted unilaterally by the board of directors, policed by courts applying broad principles of fiduciary duty. Virtually all of Delaware takeover law fits into this simple design,⁵ although application of the fiduciary duty doctrine in a given case may be quite nuanced and complex. In the UK, board neutrality is coupled with a mandatory bid rule for protection of shareholders, plus a Takeover Panel to provide guidance to market players, interpret the Takeover Code, resolve disputes, and provide modest sanctions for violation of the Code. (Notice how different even the two "Anglo-American" common law countries are in their takeover institutions.) The Japanese institutional environment thus far contains features resembling some elements of both the US and the UK institutions—shareholder rights plans and judicial review from the U.S., and Takeover Guidelines and version of a mandatory bid rule from the UK. But also note how relatively complex the Japanese landscape is in comparison to the other two jurisdictions: some defensive measures are based on "hard law" (e.g. the trust-type rights plan), others are based on "soft law" (e.g. the pre-warning type rights plan) and still others are based on non-law (e.g. cross shareholding). In addition, golden shares are permitted, and rights plans are coupled with a mandatory bid rule, yet judicial review of takeover defenses is common, and an institution without direct parallel in either the U.S. or the UK—the Corporate Value Study Group—has also played an important role in the formation of Japanese takeover policy.

4 I am engaged in an empirical research project that attempts to document takeover defenses and their effects in roughly 30 countries around the world. While I do not yet have statistical results, the summary statistics indicate that there is tremendous variation around the world in the types of defenses in use, the main enforcement agency for takeover disputes, and the effectiveness of enforcement by the enforcement agency.

5 To be sure, there are added complications in the United States from the use of staggered boards as well as by-law amendments which seek to give shareholders greater input with respect to the poison pill, as well as takeover defenses that interfere with the shareholder voting process.

II. Explaining Developments in Delaware and Japan

The development of new standards of judicial review for hostile takeover defenses that Justice Jacobs recounts in his speech are a dramatic illustration of the common law system at work. As he explains, the gap in U.S. statutory law was exposed by the emergence of unsolicited tender offers for shares of publicly held corporations in the 1980s. Prior to that time, proxy contests were the principal means of obtaining control in the face of resistance by the target corporation's board of directors. By default as much as by design, it fell to the Delaware courts to develop standards to govern these novel market transactions, because no other actor in the legal system was prepared to do so. Using the only tools at their disposal—fiduciary principles applied to board conduct in the face of an unsolicited bid—the Delaware courts responded by fashioning new standards of judicial review. As Justice Jacobs explains, the “enhanced scrutiny” that emerged out of the Delaware cases requires that the board act reasonably in relation to an unsolicited bid. This new standards lies between the very deferential business judgment rule applied to ordinary business decisions of the board and the very exacting “fairness” test applied when the board has a conflict of interest or the transaction involves self-dealing. Enhanced scrutiny fashioned in the Unocal and other subsequent cases is a judicial recognition that while takeover defenses generally do not raise the same problems as pure conflict of interest transactions, there is nonetheless an “omnipresent specter of conflict of interest”⁶ when the board takes defensive measures against an unsolicited bid for control. While Delaware takeover doctrine certainly has its critics,⁷ one has to admire the sophistication and flexibility of the Delaware courts in responding to this new development, completely in the absence of legislative guidance on the key questions of “who decides?” and “for whose benefit should the corporation be run?”

Thus, the key features of Delaware approach are a court-centered system relying heavily on general standards of fiduciary duty to judge the actions of the board in erecting defenses to unsolicited bids for corporate control. The doctrine as it has developed in Delaware gives considerable discretion to managers. Ronald Gilson, for example, has argued that Delaware legal doctrine giving managers wide scope of authority with respect to the shareholder rights plan could have posed a serious obstacle to the efficient transfer of assets in the U.S. economy. This negative result was avoided only because the legal doctrine was complemented by robust capital market institutions in the form of independent directors and active institutional investors. Gilson argues, “Without this institutional infrastructure, it is a fair assessment that the poison pill would have materially interfered with the ... process [of

6 Unocal.

7 Three major lines of criticism against Delaware takeover doctrine are (1) that the standards are too vague and indeterminate (see Ehud Kamar); (2) that the doctrine is based on political influence of powerful players (see Macey and Miller); and (3) that it gives too much discretion to the board and strips shareholders of the opportunity to decide.

economic transition] that the U.S. experienced in the 1980s and early 1990s.”⁸

The key point is that in the United States, the overriding focus of the entire corporate system on shareholder wealth maximization (the property model of the firm), the relatively robust nature of complementary market institutions, and the decentralized, formalistic and aggressive enforcement environment in the United States⁹ all work together to constrain the degree to which managers can use the agency slack created by the poison pill to their benefit.¹⁰

Perhaps a foreign system always appears more complicated to a distant observer, but my principal impression of the Japanese institutional setup for takeovers so far is its multi-layered and complex nature. Courts have the ultimate authority on takeover-related disputes, but the judicial decisions are influenced by the METI/MOJ Takeover Guidelines. Indeed, the Guidelines were drafted specifically to lend guidance to courts and market participants. The Guidelines contain both standards (defensive measures should be “necessary and proper”) and rules (“details of defensive measures must be disclosed in advance). The Guidelines were promulgated by two ministries (only one of which has unambiguous jurisdiction over the Company Law), but the policy of the ministries, in turn, was heavily influenced by the thorough work of the Corporate Value Study Group. The Corporate Value Study Group is itself a mixed body of experts, containing representatives of both corporate managers and investors. The Corporate Value Study Group continues to be influential. It provided a detailed supplemental commentary on takeover defense policy in the wake of the highly controversial Bull-Dog Sauce ruling, which correctly or not was interpreted by the foreign investor community as another sign that Japan is closed to foreign investment and out of step with global corporate governance standards. After the Guidelines were promulgated, revisions to Japan’s securities laws added a partial mandatory bid rule. Until then, we did not see a shareholder rights plan and a mandatory bid rule in the same jurisdiction.

But the complexity (some might say ambiguity) of Japan’s current takeover policy is not surprising. Japan is undergoing dramatic economic, social and legal changes. Major questions are under debate: Should Japanese firms be more “American” (market oriented)?¹¹ Should the Japanese legal system be more transparent and participatory (court centered)? What

8 Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 *Colum. Bus. L. Rev.* 21, 39 (2004).

9 On the different types of enforcement culture around the world, see Curtis J. Milhaupt and Katharina Pistor, *Law and Capitalism* (University of Chicago Press, 2008).

10 To be sure, the entire market system of the United States is under reconsideration following the sub-prime lending and financial crises. It is too early to say whether the market-oriented U.S. corporate governance system will be materially altered by the crisis.

11 As an example of the disagreement about this question, compare the remarks of famous Japanologist Ronald Dore (“After less than two decades of missionary activity, the conversion of Japan to the theology of shareholder sovereignty seems complete,”) *Japan’s Conversion to Investor Capitalism* (working paper)) with those of former METI Vice-Minister Takao Kitabata (“Excellent American companies are different from what are called ‘American-style’ in Japan. Rather, I have discovered that they are similar to Japanese enterprises.”). *Kaisha wa, kabunushi no mono dake ka?*

kind of institutions should Japan create to fill the governance gaps that have opened up in the post-bubble era, and should those institutions be modeled on the U.S. or some other country? How thoroughly should Japan embrace the freedom of contract/disclosure model of economic regulation? Until at least a rough consensus is reached on these huge questions, we should not expect to see a straightforward, unambiguous takeover policy in Japan.

III. Future Developments in Japanese Takeover Policy

Now let's turn to the future. I will make use of the same simple focus on institutional design choices to provide guidance on three questions about the future of Japanese takeover policy: 1. Can we expect to see legislation on takeover defenses in Japan? 2. Will the Corporate Value Study Group come to play in Japan the role the Delaware courts play in takeover policy in the United States? 3. What would a takeover policy with "Japanese characteristics" look like?

Legislative Guidance?

The U.S. experience suggests that the Japanese Diet will not adopt legislation on takeover defenses. Other than the Williams Act, which is a procedural statute in the tender offer context, there is no national legislation in the United States regarding takeovers, and specifically there is no federal legislation addressing takeover defenses. The reason is almost certainly due to political economy considerations. Namely, it is impossible for politicians to reach a consensus on the "who decides" and "in whose interests" questions. Investors are diversified, and managers and workers are dispersed throughout the country. It is instructive to note, however, as Justice Jacobs discusses in his speech, that we do observe anti-takeover legislation at the state level. Again, political economy considerations are helpful in understanding why. Workers (and unions) are a more concentrated and sympathetic interest group than corporate managers, and states are not global economic actors, so they have less to fear about backlash from other countries in enacting protectionist legislation.

The CVSG as the Delaware Court?

As an outside observer, the CVSG appears to be playing a role somewhat similar to the role played by the Delaware courts in educating and instructing market participants, particularly in the early stages of development of the takeover market. Its thoroughly researched and well-reasoned reports provide a solid analytical basis for Japanese takeover policy and provide guidance to market actors seeking to follow best practices. Some commentators have argued that this is a key role of the Delaware courts.¹² In other words, if "soft law" guidance provided by the Delaware courts is an important feature of the U.S. system, is it possible that the CVSG could play this role in Japan?

One question that may arise with respect to this role is whether the CVSG is institutionally

¹² See, e.g. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 *UCLA L. Rev.* 1009 (1997).

equipped to be actively engaged with the market in real time. The following quote by Justice Jacobs when he was Vice Chancellor deciding a famous “dead hand” poison pill case is instructive.

Since the 1980s, [takeover] law, largely judge-made, has been racing to keep abreast of the ever-evolving and novel tactical and strategic developments so characteristic of this important area of economic endeavor that is swiftly becoming a permanent part of our national (and international) economic landscape.¹³

Delaware takeover law in the 1980s and early 1990s was assembled through a race between market innovators and the courts. Although the pace of market activity is slower in Japan, we have already seen that the market has a tendency to race ahead of policymakers. (For example, the METI/MOJ Guidelines do not contemplate the type of shareholder rights plan used in the Bull-Dog Sauce Case). The U.S. (and as I will argue below, the UK) both have institutions that are well suited to providing rapid, sophisticated guidance in response to ongoing market developments in the takeover field. Japan needs such an institution too.

Takeover Policy with Japanese Characteristics?

Let’s return to our simple matrix. The discussion thus far has filled in some of the boxes on this matrix. Although this is not the place to elaborate, I would argue that in some important areas of enforcement culture, Japan shares traits with the UK.

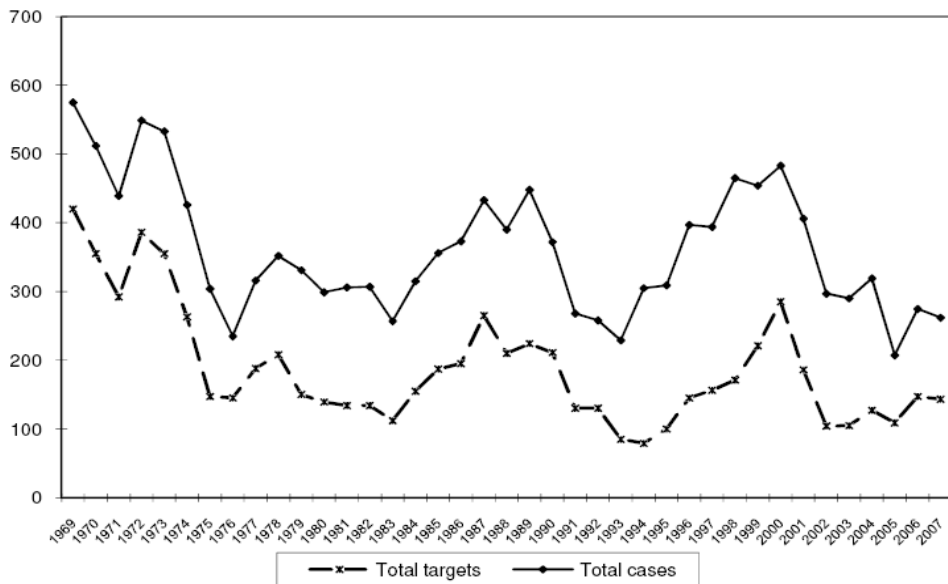
Takeover Law and Policy Matrix

	US	JAPAN	UK
Decision-maker	BOD	?	SH
Legislative Guidance on Defenses	No	No, but Guidelines	No, but Takeover Code
Common Defensive/Protective Measures	Rights Plan Staggered Board	Rights Plan Mandatory Bid Cross Shareholding	Mandatory Bid
Ultimate Authority	Courts	Courts [METI-MOJ/CVSG]	Takeover Panel
Legal Culture	Hard Law	Soft Law	Soft Law
Enforcement Culture	Formal Decentralized	Informal Centralized	Informal Centralized
Corporate Culture	Property	Community	Property
Market Forces/Philosophy	Strong	Weak, but Changing	Strong

¹³ Jack Jacobs, Vice Chancellor, Delaware Court of Chancery, in *Carmody v. Toll Brothers, Inc.* 723 A.2d 1180, 1185 (Del. Ch. 1998).

Recall the key institutional features of UK takeover policy: board neutrality, plus a mandatory bid rule and a Takeover Panel composed of experts to issue interpretations and resolve disputes under the Code. The Takeover Panel was a completely private body until just a few years ago. As Table 1 shows, the Takeover Panel consults with market participants in about 50% more cases than there are bids. This suggests that the Takeover Panel plays a direct, ongoing role in consulting with market participants to influence behavior in relation to actual and potential takeover bids.

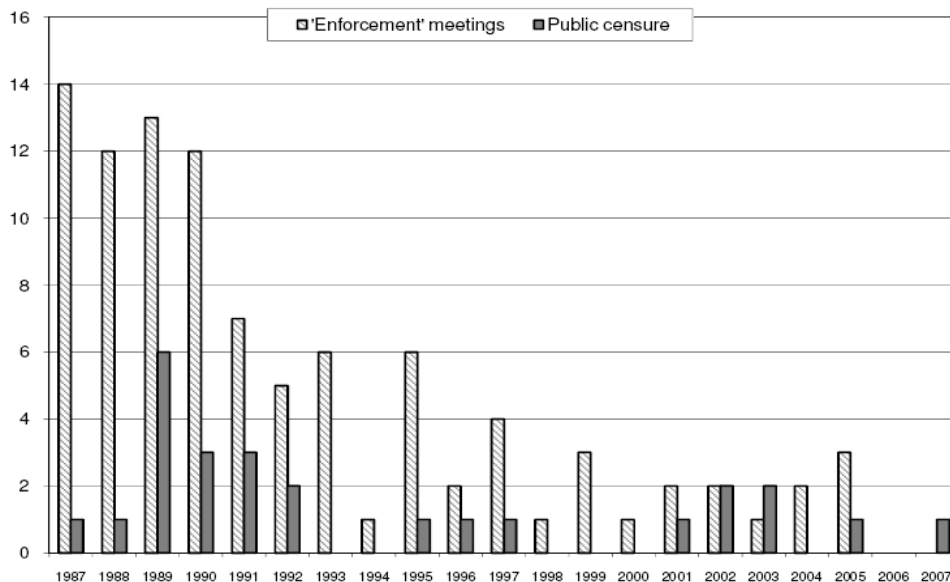
Table 1
Ex Ante engagements by Takeover Panel, 1969-2007¹⁴



The Takeover Panel also plays an enforcement role. As Table 2 shows, it sanctions market players for their conduct in relation to takeover activity. These sanctions include a simple private reprimand as well as a more formal public censure. Interestingly, there is virtually no litigation regarding takeovers in the UK courts.

14 Source: John Armour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment*, ECGI Law Working Paper No.106/2008.

Table 2
Takeover Panel, Ex post enforcement 1987-2006¹⁵



The Takeover Panel seems like a body worthy of study by Japanese policymakers. Its use of informal consultations and norm-based sanctions seems possibly more consistent with Japanese legal and business cultures than the court-centered approach of Delaware. Most interesting from my perspective is the ongoing, real-time engagement of the Takeover Panel with market participants and its use of informal sanctions to shape their behavior.

Conclusion

The speeches by Prof. Kanda and Justice Jacobs give us a unique perspective on the development of takeover policy in Japan and the United States, by two people who have been centrally involved in this task in their home countries. In this brief comment, I have tried to highlight a central lesson that I take from their speeches--the institutional complementarities at work in any country's takeover policy. The "best" takeover policy for any country, of course, is one that encourages beneficial transfers of corporate control while discouraging harmful or inefficient transfers. But achieving that policy within a country's existing and shifting institutional frameworks is a huge challenge.

At the symposium, I was asked whether adoption of the UK system would be too drastic for Japan. My point is not to recommend that Japan adopt UK takeover policy. That is a decision for Japanese policy makers, and more importantly, a direct transplant of the UK system into Japan would not make any more sense than a direct transplant of the US system.

¹⁵ Source: John Armour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment*, ECGI Law Working Paper No.106/2008.

The challenge of regulating hostile takeovers in Japan is substantial because so many of the surrounding institutions are undergoing change. History shows very clearly, however, that the “drastic” nature of change is no barrier to reform in Japan. In any event, the changes that have taken place to date are already “drastic” in comparison to the postwar system of corporate governance. Japan is finding its own way to regulate hostile takeovers, adapting its own institutions with insights from foreign examples.

I made reference to the UK system as a simple reminder that the U.S. policy was developed on a foundation of legal, corporate, and market activity that looks quite different from Japan’s starting point. Perhaps some elements of the UK system bear a closer resemblance to those of Japan. But of course every country’s starting point is unique. The challenge for Japan is to develop a viable takeover policy for today while maintain innovation capacity in its institutional design. For this purpose, an institution with a sophisticated and flexible understanding of the economic and legal significance of hostile takeovers and defenses is essential. I do not know whether the courts, the Corporate Value Study Group, or a newly formed Takeover Panel is the most suitable institution for this purpose, but in my opinion, the existence of such a body in Japan is essential to the success of Japanese takeover policy.

Panel Discussion

Japanese Legal Structure for Corporate Acquisition: Analyses and Prospects

Gaku ISHIWATA (Partner, Mori Hamada & Matsumoto)

Hideki KANDA (Professor, University of Tokyo, Graduate Schools for Law and Politics)

Jack B. JACOBS (Justice, Delaware Supreme Court)

Wataru TANAKA (Associate professor, University of Tokyo, Institute of Social Science)

Tomotaka FUJITA (Professor, University of Tokyo, Graduate Schools for Law and Politics)

<Moderator>

Curtis J. MILHAUPT (Professor, Columbia University School of Law)

Tsuyoshi YAMADA (Associate professor, Niigata University, Niigata Law School)

Kanda: We would like to start the second part. It is a panel discussion and entitled “Japanese Legal Structure for Corporate Acquisitions: Analyses and Prospects.” Taking the current situation of Japanese law and practice on hostile takeovers into consideration, the panelists will discuss major issues and future prospects. The profiles of the panelists are found in the booklet before you. From left on the stage, they are Professor Fujita from University of Tokyo, Associate Professor Yamada from Niigata University, Associate Professor Tanaka from University of Tokyo and Mr. Ishiwata from Mori Hamada & Matsumoto. Justice Jacobs, Professor Milhaupt and I, Kanda, who made presentations during the first part, are seated in the front row so that we can answer questions from the panelists. Professor Fujita will act as moderator of the panel discussion. Professor Fujita, please.

I Current situation of hostile takeovers in Japan

Fujita: Thank you. Now, shall we start the panel discussion? First, let us overview the current situation of hostile takeovers in Japan. Traditionally, hostile takeovers have been very rare in this country, but what do you think is the reason? On the other hand, after the Nippon Broadcasting System Case in 2005, hostile takeovers started gaining major attention. In fact, although the successful hostile takeovers are still few, it seems that the number of takeover attempts is increasing. Mr. Ishiwata, you have expertise in takeover practices, so can you tell us what you feel? Do you think the situation surrounding corporate acquisitions in Japan has actually been changing?

Ishiwata: Just as Professor Fujita mentioned, in the past 20 years, the situation around

hostile takeovers in Japan has greatly changed.

First, early in the 1990s, there were not many cases of corporate acquisitions including friendly takeovers, there were not many people who were capable of conducting corporate acquisitions, and the understanding about corporate acquisitions was not sufficient. The Japanese TOB regulation was significantly amended in 1990 to create the framework of the current structure. Prior to this amendment, there were only three TOB cases and even after the amendment the TOB was not used for four to five years. After that, the number of TOB cases started increasing dramatically. Also, during the bubble economy in the 1980's, the term "acquisition" sometimes conveyed a negative impression, such as greenmailers, or "takeovers" by stock speculators; therefore, many business managers hesitated to use it, and society itself had some hesitation to accept it as well. Moreover, prior to the collapse of Japan's bubble economy in early 1990, cross-shareholdings were significantly more common than now, which made hostile takeovers difficult to conclude.

However, after collapse of bubble economy, efficient corporate acquisitions started to be positively considered as a measure to get out of the economic slump. As the legal system to promote corporate acquisitions was streamlined and implemented, corporate acquisitions became widely recognized as a management option. Also, many corporations, mainly banks, stopped cross-shareholdings, and, consequently, stocks became increasingly liquid.

As a result of such movement, an easy environment to conduct hostile takeovers was gradually established, while participants of hostile takeover, such as activist funds, emerged with the globalization of the market. Consequently, hostile takeover cases started to be seen. While some of the current hostile takeovers still have the characteristics of a greenmailer, others are to increase the corporate value. If such hostile takeovers with the "right" purpose start to become successful, other acquirers of hostile takeovers will follow, and hostile takeovers will take root in Japan.

Fujita: Thank you.

II Current situation of the hedge against acquisition: laws and practices

Recent Decisions on Takeover Defense

Fujita: Next, let us overview the current situation of legal rules surrounding takeover defense in Japan. Recently, the validity of a takeover defense has been brought to courts, and various rulings have been issued. Many of you might already know, but we would like to have Professor Yamada to introduce major precedents.

Yamada: Hello everyone, my name is Yamada. Today, I would like to introduce recent five judicial precedents briefly. As you know, Nippon Broadcasting System Case(Tokyo high court judgment of March 23, 2005, Hanrei-jiho No. 1899, p. 56:), Japan Engineering Consultants

(Tokyo district court judgment of July 29, 2005, Hanrei-jiho 1909, p.87:) and Bull-Dog Source Case (Supreme court judgment of August 7, 2007, Supreme Court Reports (civil cases) vol.61 no.5, p.2215), in particular, not only had significant impacts on the future practices, but also were mentioned in the report of “Corporate Value Study Group,” which will be discussed later. So, it is worth taking a look at these cases here. However, assuming that researchers and practitioners are very familiar with these cases, we will not go into details and just review the main points. First, let’s look at the two cases regarding the issuance of new shares to a third party. The first case is Bell System 24 Case (Tokyo high court judgment of August 4, 2004, Finance and commerce judicial precedent No.1201 p.4:). Corporation Y is the biggest telemarketing company in the industry with 10 billion JPY of capital and 4.89 million shares, which is listed on Tokyo Stock Exchange 1st section. Corporation X is the corporation Y’s largest shareholder, holding approximately 2.04 million shares (approx. 41.7%) of corporation Y’s stock including its subsidiaries’. Corporation Y is corporation X’s consolidated subsidiary.

There has been a feud between corporations X and Y over the management of the corporation Y since 2002. On July 20, 2004, corporation Y held a board meeting and discussed the possible business collaboration with corporation SB, and decided to issue new shares to a third party to NPI at 20,050JPY/stock to raise the necessary capital of 100 billion JPY, which was resolved with three votes in favor and two votes against it. After the new shares were issued, corporation X’s shareholding of corporation Y would decrease from 39.2 % to 19%, while NPI’s shareholding would be 51.5%.

On July 20, 2004, corporation Y and corporation SB signed the 20-page Letter of Intent (in Japanese) regarding the comprehensive business collaboration in call center business.

In this case, the court stated that the temporary restraining order was ultimately dismissed, because the finance through issuance of new shares was necessary for the business plan that is deemed to be reasonable, thus the maintaining its own control over the business by decreasing the X corporation’s shareholding is not necessarily only one motivation of the issuance of new stocks, even if it is so intended, plus such intension is hard to be deemed to override the genuine purpose of expanding and improving the company.

Next, let’s look at a relatively recent case, Quants Case (Tokyo district court judgment of June 23, 2008, Finance and commerce judicial precedent No.1296 p.10). On June 9, 2008, the board of Quants Inc., a corporation listed on JASDAQ, decided to issue total 44,444 thousands shares (approx. 16% of issued shares) for subscription to Ichiya Co., Ltd. and Chronicle Corporation. On June 27, 2008, Quants Inc. was submitted a motion for the dismissal of three directors as an agenda to the ordinary shareholders meeting. Ichiya and Chronicle had signified their approval of the motion. Quants Inc. also planned to grant the voting rights to the shares at this meeting, which Ichiya and Chronicle would obtain based on the Companies Act article 124 (4).

Open Loop Inc., listed on Nippon New Market Hercules, is Quants’ shareholder with its 3.9 million shares (1.71%). Open Loop filed for a temporary restraining order against issuance of new shares by Quants Inc., stating that the issuance of new shares is “made through significantly unfair measure.” There is a difference in two judgments between Bell System 24

and Quants Case; Unless there is a special situation to justify, issuance of new shares to a third party is believed to be made mainly to decrease the shareholding of existing shareholders so that current management could maintain control over the business. The current management claimed the collected capital was to be used for redemption of corporate bonds, but, while funding is deemed to be generally needed, it is not enough to be considered as a special situation to justify this issuance of new shares. Therefore, after 40 million JPY was deposited as security, this issuance of new shares was withheld by the court.

The next case is very famous Nippon Broadcasting System Case's restraining order against issuance of new stock option. I will not go into the details because everybody knows about this case very well. In the high court decision regarding this Nippon Broadcasting System Case, four types, or four categories, are frequently quoted: (1) greenmail, (2) "scorched earth" management, (3) aiming to use the target company's assets as the company's collateral etc., and (4) aiming to sell off assets to produce a large one-time dividend. Basically, I believe the former part is as important as the rest above mentioned four categories. The reason why the issuance of new stock option with the purpose of maintaining/securing the control over the business is that the directors are based on the trust of the owner of the company, or shareholders. If there is a special situation to justify the issuance of new stock option to protect the overall interest of the shareholders, the allotment of stock options to a third party for the main purpose of maintaining/securing corporate control should be exceptionally regarded as legitimate. The above mentioned four categories, such as greenmail, are shown as examples of the special situations. However, as everybody knows, finally in this case, the issuance was suspended because there was no prima-facie evidence or proof.

Next, let's look at Japan Engineering Consultants Case. As for this ruling, the latter part is especially important. "When the takeover battle of a corporation exists, the shareholders should choose between current management and hostile acquirer to entrust the management, and the board of directors is entitled to adopt a suitable measure for the purpose of providing suitable information and time for shareholders to deliberate upon the proposal." and "The board of directors is entitled to request the hostile acquirer to provide a business plan and enough time to consider it in order to provide the shareholders with appropriate information and time to deliberate it, but also to file a suit against the acquirer who does not respond to reasonable requests for not being provided the enough information and time to consider the proposal, within the concept of the Securities and Exchange Act and application of "the doctrine of balance of power distribution" by the Commercial Code."

Now, it seems that our time is limited, let's move to Bull-Dog Source Case, which has been repeatedly quoted. I am sure that everybody is familiar with this case, so let's jump to the court ruling. Unlike other cases where defense measure was implemented by the board of directors, in this case, it was implemented by the approval of shareholders' meeting. The supreme court supported the original ruling (Tokyo High Court judgment of July 9, 2007, Finance and commerce judicial precedent No.1271 p.17:) for the following reason: According to the principle of shareholder equal treatment, to protect the interests of individual shareholders, the company is obligated to treat shareholders fairly and equally based on the

type and number of shares they hold, but since individual shareholders' interests are normally inconceivable without an ongoing and thriving company, if there is a risk that the acquisition of management control by a particular shareholder would damage the company's corporate value, such as by interfering with the company's survival or growth, or would harm the company's interests or the common interests of shareholders, discriminatory treatment of said shareholder aimed at preventing such acquisition cannot be immediately construed as a violation of the intent of said principal unless said treatment is unreasonable and contrary to the shareholder equal treatment principle. Further, the question of whether the acquisition of management control by a particular shareholder damages the company's corporate value and harms the corporate interest or the common interests of shareholders should be decided by the shareholder themselves, to whom the company's interests ultimately would inure, and that decision should be respected unless the shareholders' meeting was procedurally unfair, the facts upon which the decision was predicated prove to be nonexistent or false, or are there is some other important fault that renders the decision unjustified. This concludes my brief presentation.

The Current Practices: Especially "prior warning type" Defense

Fujita: Thank you very much. Now, with the information on these judicial precedents presented, what was made clear about legal restrictions on takeover defense measures in current judicial precedents in Japan? Also, is there any important issue which is not made clear yet? We would like your brief comment, Professor Tanaka.

Tanaka: The past judicial precedents emphasize on respecting the shareholders' will, and, as a result, they clearly separate the defense measure implemented by the board of directors' own decision from the defense measure implemented by the shareholders' approval. In the Nippon Broadcasting System Case, the board of directors made a substantial decision that the hostile takeover in question would damage the corporate value and implemented the defense measure (issued a large amount of new stock option) to stop the acquisition itself. In this case, as Professor Yamada explained, the defense measure is regarded as legitimate only in extremely exceptional cases. Even when the board of directors implement the defense measure by its own decision, however, if the board of directors does not decide on the merit of the takeover by itself, such as saying "this acquisition will damage the corporate value, so we must stop it," but instead, it implements the defense measure only for the purpose of providing necessary information or appropriate time for shareholders to make the decision, leaving the final decision whether or not to accept the acquisition offer up to shareholders, then the board of directors is allowed to implement the defense measure within a suitable degree. This is the ruling of Japan Engineering Consultants Case.

What about the defense measure implemented by the approval of the shareholders' meeting? The Bull-Dog Source Case falls into this category, and in this case, at least if most of the shareholders except the acquirer are in favor for the defense measure, even the defense

measure to frustrate the acquisition itself, such as, in the Bull-Dog Source Case, the allotment of discriminative share options which would significantly reduce the existing shareholding of the acquirer, is allowed to be implemented based on the substantial decision that the hostile takeover in question would damage the corporate value. Moreover, regarding the decision that the takeover would damage the corporate value, the court basically respected the shareholders' own decision unless the decision-making procedure suffered from material defects (such as, misrepresentation)

Next, the following two points are still not clear from the judicial precedents: the first is what happens if the *defense plan* has been adopted by the approval of the shareholders' meeting in advance, but, when the acquirer actually approaches the company, a particular *defense measure* is implemented by the board of directors' decision in accordance with the general instruction provided by the defense plan? This is important because, as I will explain later, the common defense practice in our country, the "prior warning type" defense plan exactly falls into this case. On its adoption, the shareholders' meeting typically approves it, but implementation of the particular defense measure only requires the board of directors' decision, according to the defense plan. However, because there has been no lawsuit in this case, the court's position is still not clear. This means that it is not clear to what extent any defense measures implemented in accordance with the defense plan are allowed, or under what standards the court scrutinizes the defense measures. The second issue is, as Professor Kanda mentioned in his keynote lecture, whether a defense measure, which will not provide the acquirer with the financial compensation, is regarded as legitimate or not. In the Bull-Dog Source Case, the acquirer was provided with the financial compensation, and the Supreme Court explicitly pointed out this fact as one of the reasons to rule the defense measure in question as legitimate. Thus, whether the defense measure, which does not provide the acquirer with the compensation, is regarded as legitimate or not has yet to be made clear by the judicial precedents.

Fujita: Thank you. Professors Yamada and Tanaka clearly pointed out the current issues of the recent cases regarding takeover defense measures. We would like to discuss the "unclear points" that Professor Tanaka mentioned later. Now that we have the information on the legal rules, let's go over the current practices of takeover defense. The "takeover defense plan" was first adopted after the Nippon Broadcasting System Case in 2005. To be sure, it does not mean that no defensive action was taken by the target company before the case. The board of the target companies sometimes decided to issue new shares to a friendly third party after a hostile acquirer purchased substantial portion of the target's shares. However, after that case, the number of companies that adopted a defense plan even before a hostile acquirer actually appears suddenly increased, and 570 or so companies currently adopt a defense measure. Why has the number of takeover defense measures suddenly increased since 2005? How should we interpret the number 570? What is the difference between the companies that adopt a defense measure and those do not? What is the motivation to adopt or not to adopt a defense measure? Mr. Ishiwata, can you share your information regarding these points with

us?

Ishiwata: First, we should consider why takeover defense plans have been adopted since 2005. One of the reasons is the hostile takeover case of Nippon Broadcasting System by Livedoor in 2005. This case made people realize that hostile takeover could actually happen in Japan. Then, in 2005, the guidelines regarding takeover defense were issued by the Ministry of Economy, Trade and Industry and Ministry of Justice so that the requirements for a company to adopt takeover defense plans legally were clarified. We can point out that this expanded the people's awareness that they can adopt takeover defense plans legally. Also, Japanese TOB regulations basically allow an acquisition through accumulation in the stock market and basically permits partial acquisitions with very limited coverage of the obligation to purchase all shares (i.e. the mandatory purchase rule); therefore, it can be pointed out that our legal system offers an environment where a takeover can be easily concluded.

Next, as for the question of how to interpret the number 570, I believe that this is within my expectations. The number of domestic listed companies in Japan is said to be about 3,870, and 14.7% of them have adopted defense plans. Although this figure is small compared to that of the U.S., most Japanese companies who adopt takeover defense plans obtain approval at the shareholders' meeting in advance, so it requires more procedures than in the U.S. It is also well known even in Japan that, recently, increasing numbers of companies have abandoned takeover defense plans in the U.S. Therefore, it can be said that the number of defense plans in Japan will not drastically increase to the American level. Also, some people say that, when evaluating the adoption percentage of takeover defense plans, the cross-shareholdings and the fact that parent/subsidiary companies are also allowed to go public should be taken into consideration. I agree with them, but it is a difficult question how to take those factors into consideration because there are companies which have cross-shareholdings as well as defense plans. On the other hand, in the U.S., even where a poison pill is not adopted, instead, a so-called "shadow pill" can be implemented only by the resolution of the board meeting, so it is almost the same as adopting the poison pill. Therefore, it may not be good enough to simply compare the companies that have adopted defense plans. In any event, I think it difficult to simply compare Japan and the U.S.

The situation that has influence on a company to decide whether or not to adopt a defense plan is the possibility of hostile takeover. To be specific, the following could influence the possibility of hostile takeovers: 1) whether or not the shareholder structure is liquid, 2) whether or not the stock price is discounted, 3) whether or not the company has large amount of cash and cash equivalents, 4) the existence of potential hostile takeover party, and 5) the size. I believe that management's character and opinion about hostile takeovers, whether the company or other companies in the same industry have been targeted to hostile takeover, and whether the competitors have adopted defense plans could also have an effect.

The next issue is the motivation of the adoption of defence plans. According to interview surveys, many companies adopt defense plans so that they can set procedures and rules in advance to apply when a hostile takeover actually happens. Personally, I also think that there

are many business managers who would like to have the opportunity to convey their own thoughts clearly to the shareholders when their company is targeted to hostile takeover. Other motivations include the concern about abusive takeover, the concern about the acquisition at very low price when the stock price is discounted, values regarding employees' interests and corporate culture, and simple dislike of hostile takeover.

Fujita: Thank you. Next let's look into the details of takeover defenses. Various defense plans such as a "trust-type rights plan" had been tried for a while, but, currently, the overwhelming majority is so-called "prior warning type" defense plan. Professor Tanaka, can you introduce the characteristics of recent defense measures to us?

Tanaka: The "prior warning type" defense plan works like this (we will sometimes call it "the defense plan," or "the plan"). A company (hereinafter *the adopter*) adopts the defense plan and announces it in public. The plan demands, among others, any person trying to acquire the adopter to take several steps. In particular, any person, who wants to buy the adopter's shares beyond a certain threshold (typically 15% or 20% of its outstanding shares) or wants to launch a tender offer bid (TOB) for the adopter's shares, is required by the plan to provide the board of directors of the adopter with certain information (identity of the acquirer, the purpose and conditions of the acquisition, etc.). The defense plan also requests certain time for the board to deliberate the acquisition offer, including the time to consider and offer to its shareholders an alternative (e.g., some restructuring plan). The defense plan also warns that, if the acquirer buys the adopter's shares beyond the threshold or launches the TOB without complying with these requests, then the adopter will counteract by the implementation of some defense measures allowed by law, including, but not restricted to, the allotment of discriminative share options to all its shareholders without contribution. Here, "discriminative" means that, even though the share options are allotted to the acquirer as long as it is a shareholder of the adopter, the acquirer does not have any rights to execute the share options, while other shareholders can execute these options at the very low exercise price to have new shares issued. Such issuance of new shares, of course, decreases the size of shareholding of the acquirer in the adopter. The acquirer could still be economically fine if they can transfer their share options to a third party at the fair price, but the transfer of share options requires the approval of the board of directors of the adopter, according to the defense plan. Therefore, if it is not approved and other shareholders execute their share options, the acquirer will suffer from financial loss as well as decrease in the shareholding.

According to the statement of the "prior warning type" defense plan the primary purpose of the plan is not to frustrate the hostile acquisition itself, but to require the acquirer to provide information and time necessary for the adopter's shareholders to deliberate the merits of the acquisition offer. Thus, as long as the acquirer complies with the rules provided by the defense plan, then, the plan says, as a general rule, the board of directors of the adopter will not implement any defense measures and let its shareholders to decide whether or not to accept the acquisition offer. Most "prior warning type" defense plans state, however, that even

when the acquirer complies with the rules, the board of directors still can implement defense measures in certain circumstances, and the “circumstances” are, in my opinion, fairly broad. For example, typical defense plans provide that the board can implement defense measures if the terms and conditions of the acquisition offer are very insufficient compared to the company’s “intrinsic value,” which means, in short, that the acquisition price is too low, and if the acquisition would damage the stakeholders’ interests and, as a result, damage the corporate value or common interests of shareholders. In those circumstances, the board of directors is allowed to decide to implement the defense measures, according to the defense plan.

Let me compare the “prior warning type” defense plan with typical defense practices employed in the U.S. First, the “prior warning type” defense plan is similar to the “rights plan” (or “poison pill”) common in the U.S., in that the allotment of discriminative share options is used (or supposed to be used) as a defense measure in both plans. However, in the U.S., share options are allotted to all the shareholders when the rights plan is adopted, and, if the shareholders transfer their shares thereafter, share options allotted to these shareholders will accompany the shares. In Japan, however, it is difficult under the Companies Act for a company to issue such share options that transfer along with the shares. As a result, in the practice of the “prior warning type” defense plan – “Japanese rights plan,” so to speak—, share options are not allotted when the defense plan is adopted. Instead, the adopter just warns potential acquirers that the share options will be allotted if any acquirer tries to acquire the adopter without complying the requirements of the plan (e.g., if the acquirer does not provide the board with sufficient information, as I explained before). Therefore, our defense plan is called the “prior warning type” defense plan.

Finally, let’s see how the defense plan is adopted, and how the particular defense measures are supposed to be implemented according to the plan. These days, most defense plans have been adopted by the approval of the shareholders’ meeting. The approval procedures vary among companies. Some companies get the approval through the resolution of modification of the article of incorporation, which requires special resolution (two-thirds majority vote) of the shareholders’ meeting. Others get only “precatory resolution,” thus ordinary resolution, of the shareholders’ meeting. But anyway, most of the companies somehow get the approval of the shareholders’ meeting. On the other hand, when the defense measure is to be implemented, such as when the adopter decides to allot discriminative share options against the acquirer who does not comply with the requirements of the defense plan, it can be done by the board of directors’ decision, -- or at least, it is so stated in the typical defense plan. (Remember that, as I stated before, there has been no judicial precedent concerning to what extent any defense measure is permitted by law if such a measure itself is implemented by the board’s decision only, but still in accordance with the general instruction of the defense plan which was adopted with approval of the shareholders’ meeting in advance.) However, because the percentage of independent outside directors is very small in typical Japanese companies compared with American companies, if a defense measure is implemented by the board of directors’ decision only, the neutrality of this decision will be questionable. To handle

the issue, the “independent committee” (also called the “special committee” or the “third-party committee”) that consists of outside directors (if any), outside auditors, and outside intellectuals is formed to advise the board of directors whether or not to implement the defense measure, and the board, taking the advise into consideration, make the final decision whether or not to implement the defense measure.

Corporate Value Study Group's New Report (June 2008)

Fujita: Thank you. The judicial precedents and the practice surrounding takeover defense have evolved just like you said. The Corporate Value Study Group's New Report, “Takeover Defense Measures in Light of Recent Environment Changes,” discussing how takeover defense measures should be implemented, has lately attracted attention. Corporate Value Study Group is a private group that belong to Ministry of Economy, Trade and Industry, but it can be said that the group has a certain role in forming the rules for takeover defense. For example, after the Nippon Broadcasting System Case, Ministry of Economy, Trade and Industry and Ministry of Justice jointly released the guideline (“Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate value and shareholders' common interests” (May 27, 2005, Ministry of Economy, Trade and Industry/Ministry of Justice)), following the group's report (Corporate Value Study Group “Corporate Value Report: Toward the Firm Establishment of Fair Rules in the Corporate Community” (May 27, 2005)). Professor Yamada, could you introduce the contents of the group's new report?

Yamada: Well, I am not sure if I am the best person to introduce the Corporate Value Study Group's New Report (June 2008) because there are several members of the group, including the chair person, but I guess I am in the most neutral position, so let me introduce the Corporate Value Study Group's New Report (June 2008) itself briefly. The main purpose of the Corporate Value Study Group's New Report (June 2008) is to outline the relationship with the past legal principle and precedents to suggest a reasonable takeover defense that the shareholders and the investors would ultimately understand and agree with.

Now, the practical issue of takeover defense is that “(1) Granting cash or other financial benefits to the acquirer would trigger the implementation of takeover defense, and, as a result, while time, information and the negotiation opportunity required to appropriately decide whether or not to support the takeover are ensured, the opportunity to sell the stock to the acquirer would be lost, which could prevent the formation of an efficient capital market. Therefore, financial benefits should not be granted to the acquirer. (2) The argument that takeover defense are always justified in so far as they are approved by a majority of shareholders in the shareholders meeting, even though directors avoid making a decision on their own and pass on the decision to the formality of the shareholders' meeting, might send a wrong message to concerned parties that a concrete defense system can be established with the shareholder structure, which would guarantee the approval of a resolution of the

shareholders meeting”

The Corporate Value Study Group’s New Report (June 2008) outlines the past judicial precedents, especially concentrating on the point whether takeover defense would improve the common interest of the shareholders. The summary is as follows:

Whether or not takeover defense will enhance the shareholders’ interests will differ in each case, depending on their objectives and contents and on the characteristics of the takeovers. Bearing this in mind, in order to deal with the issue of legality of takeover defense, it would be necessary to examine judicial decisions on the past cases, by focusing on the objectives of takeover defense and how they are operated. As a result of such examination, takeover defense can be broadly categorized as follows:

- (1) Cases where adequate time and information is necessary for shareholders to appropriately decide whether or not to support the takeover, and opportunities for negotiation between the acquirers and the target companies are ensured by takeover defense : Japan Engineering Consultants, Co., Ltd. Case (Tokyo High Court, July 29, 2005)
- (2) Cases where takeover defense are implemented to stop the takeover based on the substantive judgment in view of the contents of the takeover’s proposal.

Generally deterring takeovers by implementing takeover defense deprives shareholders in favor of the takeover of the opportunities to sell their shares to the acquirers. Therefore, the implementation of takeover defense based on the substantive judgment in view of the contents of the takeover proposals should, in principle, be limited. Based on the examination of past judicial decisions, cases where such implementation would be permitted would be categorized into the following two typical cases in accordance with the characteristics of the acquirers and their behavior:

- (a) Cases where takeover defense are implemented against abusive takeovers, which are clearly detrimental to the shareholders’ interest;
Nippon Broadcasting System Inc. Case (Tokyo High Court, March 23, 2005)
- (b) Cases where takeover defense are implemented based on the substantive judgment that the takeover proposals are detrimental to the shareholders’ interest.

Bull-Dog Source Case (Supreme Court, August 7, 2007)

The group’s report evaluates each case in detail to see what procedure was taken to implement the defense measure, or if the financial benefits is necessary or not. For detailed information, please see the Corporate Value Study Group’s New Report (June 2008).

That’s all from me.

Fujita: Thank you for your precise and concise summary. We will discuss the categories of takeover defense measures in more detail later.

Now, why this kind of report was released in this timing? Professor Kanda, can you give us your comment as the chairperson of the Corporate Value Study Group, if you do not mind?

Kanda: All right. In short, as takeover defenses began to be employed by listed companies in Japan, Japanese people began to discuss only the technical details or specifics of such defense plans. We wondered if it is right. The detailed discussion is like, which kind of the shareholders' meeting resolution should be required, special resolution or ordinary resolution? Does an ordinary resolution have any legal meaning? Or, is it just de facto evidence of what shareholders think? Is it desirable to set up a special committee, and does it legally have any meaning? Does a special committee's opinion have a binding force on the board of directors? Should financial compensations to the hostile bidder be made for a defense measure to be lawful, or is it appropriate? Of course, it is important to discuss these specific issues, but these issues should not be separated from a more basic issue, that is, whether defenses are appropriate and how defenses affect shareholders and investors. However, today, the discussion in Japan tends to focus on technical specifics, and, as a result, both investor and management communities seem to be misguided by losing the fundamental point of the issue. Consequently, it seems that defense plans, which can harm shareholders' interest, are put in place sometimes. So, at the METI Study Group we thought it is important to go back to the basics at this point and have policy discussion as to the proper purpose of defense plans and how such plans should be employed.

Other Trend: Amendment of the Financial Instruments and Exchange Law (TOB Regulation)

Fujita: Thank you. Because I personally like to discuss technical details, I take this opportunity for self-reflection.

We have reviewed (1) the trend in the judicial precedents, (2) current practices of takeover defense, and (3) the Corporate Value Study Group's new report that can be regarded as a soft law. I realize how many things have happened in only a few years. Let me add one more trend just in case. While these judicial precedents and soft laws are important, we should keep it in mind that the TOB regulation under the Financial Instruments and Exchange Law has been also amended. The Japanese TOB regulation was originally the regulation on disclosure similar to the Williams Act in the United States, but, since the amendment in 1990 that implemented the mandatory TOB system where the control shares has to be obtained through TOB if not market purchase, its characteristics has significantly differed from the American law. I am not sure how clearly it was intended at the amendment in 1990, but, looking back now, this was the turning point where the rules were greatly changed.

Since the Nippon Broadcasting System Case, the difference from the U.S. has become greater. For example, the amendment in 2006 provided the target company's right to question the acquirer, extended the TOB period, relaxed the requirements to withdraw/change the TOB, added "speed limit" (the limit of the number of stocks allowed to be purchased in a certain period through the combination of TOB and other methods), and introduced "mandatory offer of all shares" (acquirer of more than two thirds of a company's stock should

place TOB for entire stocks. While how much influence they have on acquisition practices is a different issue, at least, the TOB regulation under the Financial Instruments and Exchange Law is not just to regulate the disclosure. Currently, the regulation has very clear characteristic as a regulation to properly control hostile takeover, and it seems to clearly differentiate itself from the simple regulation on the securities market.

To look at it from wider perspectives, in Japan, while the Finance Service Agency issued this TOB regulation, the court has formed the laws independently. In addition, there are soft laws, such as the Ministry of Economy, Trade and Industry's report. It seems that there are different rules by different entities without coordination. As a result, the existence of each rule has a certain reason, but when looked as a whole, it is not certain if the performance as one legal system on hostile takeover in the country is really efficient.

III Discussion points regarding takeover defense measures: What is the purpose of defense measures?

Fujita: We reviewed the current situation regarding hostile takeover in Japan in three points: acquisition itself, legal rules and takeover defense measure. Next, let's ask panelists for their opinion about the basic issues and arguments regarding defense measures.

Let's start with the purpose of takeover defense measures. What should it be, and whose and what kind of interests should be protected? Actually each person has very different opinion regarding this issue. For example, the report of the Corporate Value Study Group, states that "takeover defense measures are ultimately for protecting shareholders' interests" and emphasizes the shareholders' interest. This is the one extreme. On the other extreme, there are people who think not only shareholders' but also other stakeholders' interests should be protected; for example, employees' interests and even corporate culture. Looking at the actually adopted "prior warning type" defense as Professor Tanaka presented, in many cases, it states that the defense measure can be implemented if the acquisition is "deem to damage the relationship with stakeholders." I would like to ask Mr. Ishiwata about the purpose of takeover defense measures in this regard. Mr. Ishiwata, what is your view from the practitioner's perspective?

Ishiwata: The word "practitioner" has different nuance depending on what it refers to: lawyers, company's legal department staff, IR staff or business managers.

Presumably, many lawyers and managers who are familiar with capital markets would think that the purpose of takeover defenses is ultimately for protecting shareholders' interests.

On the other hand, other managers put priority on the company's interests including the stakeholders' interests. Particularly, quite a few Japanese managers seem to put high priority on the employees' interests.

Based on such a context, many takeover defense plans provide the requirements for implementation such as "in case where there is any threat to cause a harm to corporate value

or common interests of the shareholders by destroying the relationship with the stakeholders such as employees, the defense measure can be implemented within a reasonable range.” However, such defense measure is not intended to be implemented if only stakeholders’ interests are harmed but shareholders’ interests are not affected. Rather, this is an issue of when the harm to the stakeholders leads to harm to the shareholders’ interest. Particularly, requirements to implement takeover defense measure in Japan are stipulated without any variations depending on whether the hostile takeover is through tender offer to all the shares or partial tender offer. Therefore, at least in the case of partial tender offer, there is a likelihood that destroying the relationship with the employees could cause the harm to the shareholders’ interests.

On the other hand, it is true that management in our country often puts great importance on the employees’ interests. During the economic growth phase in Japan, companies were supported by so-called “breakneck employees” (hard workers) who work more than what they are paid for to make a lot of contribution to the company. The driving factors for those employees to work much harder than what they are paid for was attributed to the lifetime employment system in addition to the low liquidity of employment. They vaguely expected or trusted that somebody in the organization would remember their hard work in the future to compensate them in the form of promotion or the like. Or, maybe they felt a strong attachment and loyalty to the company or its culture. If a hostile takeover causes uncertainty in the long-term trust and corporate culture, employees would lose their incentives and loyalty to work harder than what they are paid for, and short-term minded employees who would work only to the extent equivalent to what they are paid for will increase. Because this could be a problem, the concept that it is necessary to keep the high loyalty or contribution of the employees to reinforce the company’s competitiveness by maintaining this system of building the trust of the hard workers, who work more than what they are paid for, would arise.

However, it seems to me that such management more or less understands that the destruction of the employment relationship or the corporate culture itself is hard to offer as the reason for the “implementation” of a defense measure, which would dilute the acquirer’s equity stake. In this regard, Japanese “prior warning type” takeover defense plan provides the opportunity for the directors to provide the information to the shareholders, so, when there is a risk of destroying the employment relationship or corporate culture, the management can take advantage of the opportunity to convey its thoughts to the shareholders. Quite a few managers expect such purpose/role out of takeover defense plans. In such cases, the purpose of a takeover defense is not the purpose secured by the “implementation” of the takeover defense measure, but the purpose softly secured by “the social sanction such as reputation risk,” which may not be enough to implement the takeover defense measure.

Also, many Japanese shareholders are interested not only in financial information but also relatively sentimental information, such as the acquiror’s intention.

Fujita: Thank you for your insightful comments on these difficult questions. Indeed, there

are different “practitioners” depending on their positions. Professor Tanaka, do you have any comment on the views that Mr. Ishiwata just mentioned, especially from the theoretical perspective as a researcher of corporate laws.

Tanaka: Mr. Ishiwata’s comments all make sense, and I have nothing against them. Still, I would like to say what I feel about current “prior warning type” defense plans. As Mr. Ishiwata said, implementing the defense measure when the stakeholders’ interests are to be damaged does not mean that it can be implemented for sure if the employees’ interests are at stake. It states that, only when the damage caused to stakeholders’ interests leads to the damage to the “corporate value” or ultimately the damage to “common interests of the shareholders” (expressions can vary among defense plans), the defense measure can be implemented for this reason. With such an expression aside, we should note that, according to the statement of the defense plan, the company adopting the “prior warning type” defense plan could implement the defense measure even against the all-or-nothing-type 100% cash takeover. “All-or-nothing-type 100% cash takeover” here means a takeover that all shares of the target company are acquired with cash, typically by a cash tender offer to all the shares, followed by some type of “cash out” transaction (e.g., merger or share exchange with cash as a consideration) at the same price as the tender offer bid. This type of acquisition does not intend the partial acquisition from the beginning, and so the tender offer bid is based on the condition that the acquirer will not buy any share unless enough number of shares to implement the second-step cash out transaction have been tendered. As Mr. Ishiwata mentioned, current “prior warning type” defense plan basically does not differentiate all-or-nothing type 100% cash takeover and other types of acquisitions. Now suppose all-or-nothing type 100% cash takeover is offered, and the board of the target company tries to implement some defense measure against it in accordance with the defence plan having been adopted. In this case, if the board tries to implement the defense measure based on the judgement that the takeover will cause the damage to the stakeholders’ interest and to the “corporate value,” such judgment cannot be based on the shareholders’ interest – at least on the interest of shareholders at the time when the takeover is offered. For they sell out all their shares when the acquisition is successful, so they should have no interest what the acquirer plan to do with the company and its stakeholder. Instead, implementing the defense measure in such a case would be based solely on the damage to the stakeholders’ interest. However, as Mr. Ishiwata mentioned, if the possibility of the acquisition for the purpose of exploiting the company and its employees exists, employees may lose confidence in the future of the company and so may refuse to work harder than what they are paid for, which means shareholders may suffer damage ex ante (i.e., before any takeover attempts take place). Thus, maybe Japanese companies adopt the above mentioned defense plan based on the careful consideration on the shareholders’ interest ex ante, even though such measure may not advance shareholders’ interest ex post (i.e., when a particular takeover attempt takes place).

Let me compare the defense plan in Japan with the defense measures permitted in Delaware state law. According to the judgment in Unocal, the board of directors is certainly

allowed to consider the interests of other stakeholders to the extent such consideration promotes the shareholders' long-term interest. However, when the company is "on sale," the matter whether the stakeholders' interest is sufficiently protected or not after the acquisition has no relationship with the interest – even the long-term interest – of shareholders, for the shareholders sell out their shares. In this case, Revlon duty applies in the Delaware law and the board of the target company is prohibited from considering the stakeholders' interest. (Even in this case, protecting stakeholders' interests may still promote the shareholders' interest if we view shareholders' interest *ex ante* [e.g., by inducing employees' to work hard]. But judging from the reasoning in Revlon, Delaware courts seem to refuse such an *ex ante* view of shareholders' interest.)

In this regard, I see that, in Japan, the justifiable purpose of the takeover defense is interpreted wider than that of Delaware law, whether it is good or bad.

Fujita: Thank you. The conversation seemed to have unexpectedly revealed the fact that not only the argument over what it should be, but also the basic understandings of current situation are not completely the same, even among the Japanese lawyers. Now that Professor Tanaka mentioned the Delaware law, I would like to ask Justice Jacobs about the American point of view. We understand that, under the American law – Delaware case law at least – what justifies the implementation of takeover defense measures is basically protection of shareholders' interest, including not only short-term interest but also long-term interest, of course. In this regard, maybe it is too much in detail, though, what do you think about the issue that Professor Tanaka mentioned? When an acquirer offers the acquisition in a way that the shareholders of the target company will not be left as a minor shareholder – for example, by attempting to purchase all the stocks in cash, in which case acquisition will be canceled if it is not successful – it seems that the acquirer's business plan after acquisition has nothing to do with the interest of the target company's shareholders. If so, as long as the proper acquisition price is offered and the amount is guaranteed to be paid, it seems unnecessary to require the disclosure as to how the company would be operated after the acquisition. According to the new report of the Corporate Value Study Group (June 2008), "In particular, in the case of an all-or-nothing offer with no minority shareholders left after the takeover, (where a cash tender offer for all shares is made on condition that two-thirds or more of voting shares of the target company are tendered and where the acquirer is committed to, when he acquires two-thirds or more of voting shares, immediately conduct a cash-out merger or other organizational restructuring to pay the remaining shareholders the same amount as the purchase price in the preceding tender offer), it is reasonable to think that the acquirer does not need to disclose detailed management plans, management outlooks, or profit forecasts for the post-takeover period." (footnote 17). However, in the practice of takeover defense in Japan, quite a few people think that, even in this case, the acquirer should disclose the information regarding the post-acquisition business plan; otherwise, defense measures can be justified. What about Delaware law? When the acquirer attempts to takeover by 100% cash acquisition, if the acquirer does not disclose the post-acquisition business plan, would

that be the “threat” to justify the defense measure under the so-called *Unocal* standard, under the Delaware case law? Is it regarded as non-threat? It sounds a little too particular, but could it influence how to treat the interests that should be protected for justifying the defense measures. Can you tell us if possible?

Jacobs: Some all-cash-all-shares offers might well constitute a “threat” that is cognizable under *Unocal*. Even where the offering price is at a premium over market price, there may be a question of whether that price is fair; that is, whether an investment banker would opine that that price was fair in relation to the intrinsic value of the company. If a banker would conclude that the offer is under-priced, then that is a cognizable threat against which a board could defend and also use as a tool to negotiate a higher price.

On the other hand, if the offering price is fair, there may be other reasons why such a bid could constitute a threat against which the board could defend. For example, suppose that the offer is subject to obtaining financing, and is being made in the current economy where financing is very difficult, if not impossible, to obtain. If there is a substantial risk that the financing will not be available and that the offer will not close, then no matter how high the offering price may be, the board might reasonably regard the offer as a “threat.” The same would be true if a transaction with the bidder would result in an antitrust violation or a violation of some different provision of law.

If you sweep all of this to one side and assume no obstacles, that is, no legal problem, no fairness problem, no closing problem, then the question becomes whether a target board can legitimately say that an all-shares offer that is fair and that will be consummated constitutes a “threat” under *Unocal*. The answer could be yes, but under a very odd theory of Delaware law that was adopted by the Supreme Court before I joined it. That theory is called “substantive coercion,” which is: where management has a business plan that it believes will generate value that is greater than the amount of the offer and has reason to believe that the shareholders might not understand their plan, this possibility of shareholder confusion might, in some circumstances, validly constitute a threat.

The case that creates the greatest doctrinal and theoretical issues is where the bid is a “perfect,” flawless bid—that is, a bid that clearly would exceed whatever value management could generate internally, will be financed, and will pose no antitrust or other legal obstacle. In those circumstances can the board defend against that type of bid? The only argument that the board would have would be what I call the ultimate, “Just Say No” scenario. That is, the board would argue that it intends to keep the defense in place, not because the board needs time to develop a better transaction, or to bring in a “white knight competing bidder,” and not because the board can generate more value internally. The only justification would be that “the board is the board,” and in its wisdom believes that the best policy for the corporation is to remain independent.

No matter how fair the offer may be, the question under Delaware law is: Can a board “just say no” in these circumstances? That question has thus far never been answered. The reason, I think, is that when offers get to a high enough level, such pressure is being exerted on the

board by institutional investors to accept the offer, that no board has had the courage to actually take that extreme position.

Fujita: Thank you very much. Your answer was more detailed and complicated than I expected. Actually, I had similar impression to Professor Tanaka's, but now I understand that, when comparing the rules of Delaware and those of Japan, it is not simple to say which rules recognize wider "legitimate" purpose for takeover defenses.

Who makes decisions regarding acquisition (takeover battle) and how?

Fujita: Next, as the second basic issue regarding hostile takeover, let's discuss whether shareholders should decide the properness of an acquisition, or the board of directors should have a certain role, which means that the board of directors should be granted a certain discretion to decide the properness of an acquisition. According to the new report of the Corporate Value Study Group that Professor Tanaka referred to, considering the judicial precedent set in a lower court can be summarized as follows: (1) When implementing the defense measure with the intension to stop the takeover by deciding that "this takeover is abusive" based on careful review of the proposal, the board of directors, in principle, is not allowed to make such decision. To be accurate, the board is allowed to do so only in the very limited exceptions recognized in the *obiter dictum* of Nippon Broadcasting System Case. (2) If the defense measure is for providing time and information to shareholders to deliberate upon the proposal or obtaining the proper negotiation opportunity between the acquirer and the target company, like Japan Engineering Consultants Case, the board of directors is allowed to implement the defense measure to a certain degree. Of course, it is limited to the proper measure in relation to the purpose, but I understand that it is basically different from the standard like the case of Nippon Broadcasting, which prohibits in almost all cases. I would like to ask the panelists if they support this as logically or practically appropriate or reasonable. First, I would like to ask Professor Yamada, as he introduced the report of the Corporate Value Study Group.

Yamada: I would like to state my opinion from the neutral point of view. I will talk about what I thought when I was considering the Corporate Value Study Group's New Report (June 2008). This report discusses especially three cases: Nippon Broadcasting System Case, Japan Engineering Consultants Case and Bull-Dog Source Case. What especially drew my attention was the case, in which the board of directors could implement the defense to cease the acquisition without consulting the shareholders meeting. It limited the invocation of the defense plan only when the other party, in this case hostile acquirer, is clearly going to damage the corporate value, as a sort of self defense measure. On the other hand, when implementing the defense measure based on the practical decision whether the takeover proposal damages the common interest of the shareholders, basically, the Corporate Value Study Group's New Report (June 2008) insisted, should depend on the shareholders' rational

will. The report also states that it should be decided considering the acquirer's attribute, the acquisition proposal and the shareholder structure of the target company. The explanation was persuasive and helped me to get things straight. This is my personal opinion, however, according to this concept, is it possible that the takeover defense can be adopted by the board as self defense measures, including the issuance of new shares to a third party, only the case where the acquirer will damage clearly the corporate value? Especially, when discriminative allotment of share options without contribution as well as of the issuance of new shares to a third party are used as takeover defense, as I mentioned before, compared to the trend of the judicial precedents up to Bell System 24 Case, the opinion that the management's power should be "limited to the self defense" seems to make the allowance range very narrow.

Especially, in the case of temporary restraining order, the procedure called court hearing is taken place intensively two to three times in one or two weeks. In this case, the board of directors has to prove that the other party will clearly destroy the corporate value, in a few weeks or so. I think this is practically very difficult. Although this is only my inspiration, in general, "the other party will damage the corporate value" and "the abusive acquirer" often have the same meaning, but they would not be always the same. For example, when the acquirer intends to obtain the control over the target company through the abusive method, to obtain the target company's control premium and to use the corporate asset for own benefit, the acquirer would not carry out the acquisition that would damage the corporate value. It might be too particular, but that was what I thought about "self-defense."

Fujita: Thank you very much. The report only refers to the "takeover defense measures" and not to the general legitimacy of the issuance of new stocks to a third party, so, once it is determined that the main purpose is not for maintaining control power, like Bell System 24 Case, it goes beyond the report's scope. If the purpose of issuing new stock is determined such, the board of directors has the right to manage with its managerial decision – I thought that was the position of this report, but maybe it can be interpreted differently. Mr. Ishiwata, what do you think about this report? Regarding this categorization or classification?

Ishiwata: As described before, the report states that "If a takeover defense measure is used for ensuring time, information and negotiation opportunity, there is a possibility that the board of directors is allowed to implement the defense measure by its decision only. On the other hand, to stop the acquisition by making a substantial decision with respect to the acquisition proposal, it basically requires the decision of the shareholders with a limited exception in which the board of directors is allowed to implement the defense measures by its decision only." It is true that this classification is mostly consistent with the judicial precedent (although partially different in terms of negotiation opportunity etc.), easy to understand and good reference for practitioners.

However, it is important that, even if you say that the board of directors alone can implement the defense measure based on the lack of time and information, practically, the requirement to implement the defense measure is further limited by the requirements of

reasonableness (or proportionality). As for the category of providing time, information and negotiation opportunity, when the board of directors is allowed to implement the defense measure by its own decision, it is difficult to predict the threat of lack of time and information, which would satisfy the requirement of reasonableness in relation to the effect of the takeover defense measure that would dilute the acquiror's equity stake.

Shareholders' decision making method

Fujita: Thank you very much. Now, there is another issue: if shareholders should decide the desirability of acquisition, what is the best method for shareholders' decision? There are two different methods. One is to decide whether or not to approve the takeover defense measure by majority voting such as the general meeting of shareholders. This is like the collective decision making just like to decide whether or not change all the directors by the general meeting of shareholder. Another method is the sellout of the stocks by individual stockholder. The individual stockholders accept takeover bid or sell their stock to the person who is buying the stocks in the market. This can be regarded as a stockholder's consent to the acquisition in a wider sense. What is the merit and demerit of each of these two different shareholders' decision making methods? Is one method better than the other? Which one should be considered as a general rule? Professor Tanaka, what should we think about these issues?

Tanaka: As for the problem with the TOB, it may have a characteristic which can be called "coerciveness." By "coerciveness" I mean that the TOB may give some pressure on the shareholders of the target company to sell their shares. One example is, if the acquirer takes control of the target company by the TOB, the acquirer might cash out all the remaining shares at the much lower price than the TOB price. Also, when the partial tender offer that would leave minority shareholders afterwards is placed, the value of the minority shares may decrease after acquisition for several reasons. For example, the acquirer who then becomes the controlling shareholder might exploit the acquired company, by way of making transactions with the acquired company with the conditions very disadvantageous for the latter. In these cases, even if the shareholders are not satisfied with the conditions of the takeover bid, they might be pressured to sell their shares. To deal with this problem, there could be some merit in the shareholders' meeting because usually there is no such coerciveness in the case of the shareholders' meeting. In the TOB, shareholders' decision on whether or not to sell their shares is "asymmetric" in the following sense. Only those who applied to the tender offer bid can sell their shares, and those who didn't apply cannot sell theirs. As a result, even shareholders who oppose to the takeover may decide to apply to the TOBs because they fear to become the minority shareholders and be exploited by the acquirer in case the TOB is successful by the tender of shares of other shareholders. The resolution of the shareholders' meeting, in contrast, has the effect on all the shareholders. For example, if implementation of some defense measure is approved by the shareholders' meeting, then the

measure will be implemented, and give an effect (positive or negative) on the interest of all the shareholders. Thus, if some shareholders are against the takeover attempt, they can simply vote against the takeover (or vote for the defense measure) in the shareholders' meeting. They do not have to worry that, if they vote against the takeover, they may be treated less favorably than those who voted for it.

Turning to the disadvantage of the shareholders' meeting, if the resolution of the shareholders' meeting is required on top of the tender offer bid, it could be the double burden for the acquirer. Especially, when the tender offer bid is the "all-or-nothing-type 100% cash takeover," as I defined before, the TOB is generally not coercive because the bidder promises in the announcement of the TOB that they will pay the same price as the TOB price in the follow-up, cash-out transaction. If the shareholders' meeting is required in this case as well, we could say it is just a waste of time – at least if assuring the shareholders to decide the merit of the takeover without suffering from coerciveness is our main concern. Another demerit of the shareholders' meeting is that, especially in Japan, there is a gap between the record date of the meeting and actual date of the resolution. In particular, in the case of the ordinary shareholders' meeting, the gap could be up to three months (typically, the record date is set at the end of the March for the shareholders' meeting held late in June). Therefore, while many people who sold their shares before the shareholders' meeting (but after the record date) can participate in the resolution of the shareholders' meeting, many shareholders who bought shares after the record date cannot participate. Another demerit is current shareholders' meetings have not guarantee the anonymity of the vote; therefore, some shareholders might be reluctant to vote against current management, fearing its retaliation.

My discussion so far is concerned on *how* shareholders decide, that is, whether shareholders decide by voting at the shareholders' meeting, or decides by applying or not applying to the TOB. What I am more interested in recently, however, is that the resolution of the shareholders' meeting can be greatly different from the decision whether or not to apply to the TOB concerning *what* to decide. There are two possibilities what to decide at the shareholders' meeting. One is, as in the Bull-Dog Source Case, to let the shareholders' meeting to decide whether or not some defense measure should be implemented. Another possibility is that the law could, as the Delaware law does, allow the board of directors to implement a defense measure by its own decision, but also allow the acquirer to stop implementation of the defense measure by replacing the current directors by proxy contest. In the latter case, shareholders still make the ultimate decision. The difference is that the second method not only addresses the problem of possible coerciveness of the TOB (as I explained before) but also sends out the message of the court or the law to potential acquirers that, in order to take over the company in a hostile way, one has to replace the directors, and thus take responsibility and obligation of the director (or the acquirer has to find persons who are willing to take such responsibility and obligation of the directors in the company in which the acquirer takes control). Behind the Delaware case law that allows the board of directors to decide to implement the rights plan while giving the acquirer the opportunity to replace the directors by proxy contest may lay such a policy: You cannot take over the company without

taking responsibility of directors. Therefore, the evaluation of the rule that requires the decision of the shareholders' meeting, especially the second method, depends on whether or not to support such a policy.

Fujita: Thank you. Professor Yamada, do you have anything to add?

Yamada: We had a discussion "which is the better method to ask for shareholders' opinion, TOB or shareholders' meeting?" Professor Tanaka said both methods had their own problems. I think he is right, but, regarding asking for shareholders' opinion at the shareholders' meeting, the Corporate Value Study Group's New Report (June 2008) clearly states that "passing on the decision to the formality of the shareholders' meeting might cause a problem that the board of directors would avoid their responsibility and make effort to revive the stable shareholder, which we will discuss later, or cross-shareholding." However, there is a formality issue with the shareholders' meeting, especially the standard date issue. I doubt if formally called "precatory resolution" that passes on the decision to the formality of the shareholders' meeting is enough to claim that the shareholders' opinion to be referred. Especially, as for the, for example, as I have seen it several times, if the hostile acquirer says "then we will raise the employee's salary" at the shareholders' meeting, it is hard for the employee shareholders who attend the meeting to say "no" to that offer. I feel there is a kind of "coerciveness" in there. I do not think the resolution of the shareholders' meeting reflects the shareholders' opinion 100%.

Fujita: Thank you. Now, I would like to ask a question to Professor Milhaupt. It might be my misunderstanding, but, when there is a takeover battle, in the context of asking for shareholders' will, in the U.S., the coercive nature of the TOB, i.e., the possibility of the decision making of the shareholders being biased during the TOB process, seems to be considered as problematic and many issues are pointed out. However, it seems that the decision making at the shareholders' meeting has been considered less problematic. Am I correct? As Professor Tanaka and Professor Yamada just said, nobody says that takeover bid has no "coerciveness" in Japan as well, but quite a few people think that the decision making at the shareholders' meeting also has issues and it is not necessarily better than the TOB. If the shareholders' decision making methods and their problems in the U.S. are different, can you share your opinion with us? If they focus on different issue in the U.S., what are they? Is it because the agenda is different, or the shareholders are different, or there is a completely different issue? Any opinion is appreciated.

Milhaupt: It is true that we think of tender offers as potentially coercive and thus potentially more problematic than shareholder voting. But I think there are some problems with the shareholders' decision-making process in the United States. In the proxy area, there is always the possibility that not enough information or inaccurate information is provided to the shareholders. We have many 14a-9 claims in the United States (14a-9 is the Antifraud

Provision of the proxy rules). And not surprisingly, most 14a-9 cases relate to mergers--the plaintiff's claim is that inaccurate information about the transaction tainted the shareholder vote.

Another potential problem with shareholder voting that has been discussed recently - I do not know how big a problem it actually is—is so called “empty voting.” “Empty voting” is the term used for voting shares when the person or institution doing the voting does not have an economic interest in the firm. Through the use of derivatives and other sophisticated financial instruments, it is now possible to separate voting rights from economic interest. And so it is possible to have votes which are unconnected to an economic interest in the firm. Some scholars in the United States, particularly Professors Bernard Black and Henry Hu, have written about this. I would be interested to hear Justice Jacob's view on how big the problem actually is and whether Delaware Law is equipped to handle this problem.

Secondly, I think it is important to point out that the context for the shareholder vote is different in the United States and Japan. Basically, the poison pill in United States transforms a shareholder's decision whether or not to sell his shares in a tender offer into a voting decision about management, because the bidder is blocked from proceeding with a tender offer until the pill is dealt with in some way (either removed by a new board majority or waived in a negotiation between the bidder and the incumbent target management). Shareholders in the United States are almost never voting on the pill itself; they are voting on whether to replace management so that the pill can be removed. In the United States, it is extremely rare to have shareholders actually voting on a defensive measure—typically there is not sufficient time to do that, and in any event, that is simply not the structure of the poison pill in the United States--the poison pill can be implemented unilaterally by the board. The context is very different in Japan, where shareholders actually can vote on the defensive measure being considered by target management. I think that is an important distinction between the two contexts for shareholder voting in the U.S. and Japan.

Finally, we all speak of “the shareholders,” but of course, increasingly this is a very misleading generalization. There are many different types of shareholders in all countries now, and they may not all have the same interests with respect to a particular vote. It is important to be very precise about which type of shareholder we are talking about and how the interests of, for example, an activist institutional investor may differ from those of a public pension fund or an individual. Certainly in the controversial contest between Steel Partners and Bull-Dog Sauce, it is important to understand the distinctive nature of “the shareholders” when considering shareholder approval of the rights plan used in that transaction.

Therefore, since both the context for the shareholder vote and the makeup of the shareholders is different in the U.S. and Japan, I think it is difficult to make general statements about whether the U.S. experience in this area is relevant for Japan.

Fujita: Thank you very much. Every time I hear the answers to the questions about the situation in the United States, I realize how difficult it is to simply compare the two countries. Each country has different context that lies beneath the problem, and we cannot simply say,

“Japan is different from the U.S. in such and such way” when there is apparent difference in opinions about various argument between Japan and the U.S.

Different Acquisition Methods and Allowance of the Defense Measure

Fujita: Now, due to the limited time, we need to move on to the next topic. Next topic is the relationship between acquisition methods and allowance of the defense measure. The judicial precedents in our country have not paid attention to the method of defense measures when considering their properness. However, the acquisition should be greatly different depending on the methods. For example, the argument over the “coerciveness” of TOB could be different between the case of the tender offer to buy all the stocks in cash and the case of partial tender offer. If so, depending on the situation, the scope or degree of the allowance of defense measures could be affected. Like this case, can the allowance of defense measures be set by the relative relations with the method used for acquisition? Mr. Ishiwata, Professor Tanaka, what do you think?

Ishiwata: Basically, I agree with you. The Japanese courts have the tendency of focusing on the acquiror’s attributes or the existence of the approval of the shareholders of the target company, rather than the acquiror’s acquisition method or structure itself. However, as you mentioned, the type or degree of the threat against the shareholders’ interest would be different depending on the acquisition method, so the scope/degree of the defense measure to be allowed should be different depending on these factors. However, in Japan, because a TOB is often carried out by the relatively limited number of specific law firms in practice, manners or structures of TOBs do not vary much so it is hard for the court to notice the difference. Still, I hope that in the future more discussion will be made looking at more on the difference in acquisition methods such as coerciveness.

Fujita: Professor Tanaka, do you have anything to add?

Takana: I think that the all-or-nothing-type 100% cash acquisition and other acquisitions, especially partial acquisitions, are significantly different. Partial acquisitions include partial tender offer and market purchase of the shares. Such a partial acquisition and all-or-nothing-type 100% cash acquisition are totally different. One difference is the coerciveness. Take the example of the acquirer accumulating the shares of the target company in the stock market. If any shareholder of the target company thinks takeover of the target company by this acquirer would significantly decrease the corporate value, that shareholder would rather sell his or her share in the market than oppose the acquisition. Therefore, if the court really thinks that the decision over the takeover battle should be made by the shareholders, as the Tokyo High Court stressed in the Nippon Broadcast System Case, then, in the case of the market purchase of shares, it should not be assumed that a shareholder made the affirmative decision on the acquisition just because the shareholder

sold his or her shares in the market. Moreover, many of abusive actions which could be taken by the acquirer, such as, to exploit the acquired company or its minority shareholders after acquisition by unfair transactions, to execute the greenmail, or to sell out the shares at the high margin while the stock price sky-rockets due to the speculative factor of accumulation of the shares regardless of the corporate value, etc... these could happen only in the case of partial acquisitions. If the acquirer buys all the shares with cash, these things I just mentioned cannot happen. Therefore, the degree of "threat" to the company is very different. Taking these things into consideration, though past judicial precedents are not necessarily clear, the scope and degree of permissible defense measures should depend on the acquisition method. With regard to this point, Delaware case law in *Unocal* should be referred to. That is, the "reasonableness" of any defense measure should be determined according to the degree of "threat" caused by the hostile acquisition. The stronger the threat is, the wider range of defense measures should be permitted.

Hostile acquirer's damage and its compensation

Fujita: Thank you. Let's move on to the next point. As Professor Tanaka pointed out at the introduction to recent judicial precedents, one of the current issues which are unclear in Japan is whether the implementation of a defense measure that would cause the acquirer financial damage such as defense measure to reduce its shareholding without any compensation is legitimate or not. In Bull-Dog Source Case, the Supreme Court ruled the defense measure in question as legitimate, clearly taking into account of the fact that the acquirer was provided the cash consideration instead of the stocks. However, it may not necessarily mean that the financial benefits must always be granted. As for the decision making method, Bull-Dog source obtained the special resolution of the general meeting of the shareholders, but is it really necessary all the time? How do the practitioners think about this court decision on the case of Bull-Dog Source with regards to financial benefits? Mr. Ishiwata, can you give us your comment?

Ishiwata: As for the financial benefits, I do not think it is necessary as long as the requirement of reasonableness (proportionality) is satisfied. However, it is also true that the financial benefits could reinforce the reasonableness (proportionality).

However, considering the various movements in the market after the Bull-Dog Sauce Case, recent general opinion is that financial benefits are not acceptable as a policy issue apart from legal arguments.

Therefore, current practitioners do not consider providing financial benefits in the face of hostile acquisitions. I understand that they are currently seeking alternatives to satisfy the requirements for reasonableness (proportionality). Also, it is sometimes argued that a supermajority vote by the shareholders is required to justify the third party's loss by analogy to the statutory provision that preferential issuance of new shares to a third party requires a supermajority vote of the shareholders. However, the case where a hostile acquirer will suffer

damage and the case of preferential issuance are not quite the same because the situations between the shareholders who would receive the financial benefits and the shareholders who would suffer the damage would be different. Therefore, we need to examine this issue carefully.

Fujita: Thank you. Mr. Ishiwata's last point is very important. If the shareholders' meeting approves the issuance of stocks to a third party at a preferable price ("preferential issuance"), there should be no problem because the existing shareholders who would suffer the financial damage agree with it. The person who receives the preferential issuance is the party of special interest, so if the person executes the voting right and the resolution was fixed even if the stockholders who suffers the damage, that will be the grounds for the revocation (Companies Act article 831(1)(iii)). On the contrary, in the case like Bull-Dog Source, the existing stockholders who will suffer the financial damage (acquirer) were against it and the rest were in favor for it. According to the analogy of preferential issuance, that means only the majority of stockholders who would receive the preferential issuance are in favor of it. So even if they are both special resolutions, the two cases have completely different meanings. It is surely misleading to use the rough comparison to make an argument.

The new report of the Corporate Value Study Group also emphasizes the appropriateness of defense measures without financial benefits and is struggling to justify it. It argued that if the defense measure without financial benefits, thus to damage the acquirer, is allowed to be implemented, there should be the possibility for the acquirer to avoid such damage by withdrawing the offer. The question is what kind of possibility should be granted to the acquirer, or how much relief is necessary. Professor Tanaka, what do you think?

Tanaka: In Japan, when a "prior warning type" defense plan is adopted, there is only a warning. Only when the acquirer triggers the implementation of the defense measure by, for example, purchasing more than 15% of the shares, the adopter takes some action, such as allotment of discriminative share options, which can be the target of the lawsuit. Therefore, even if the acquirer wishes to initiate the lawsuit over the legitimacy of the defense plan, there is no target for the lawsuit when the defense plan has been adopted but there has not been any triggering event yet. Here is a possible lawsuit example. The "prior warning type" defense plan states that the board of directors of the adopter generally does not implement the defense measure if the acquirer gives the board enough information and time to deliberate. However, what can the acquirer do if the board refuses to negotiate the offer, claiming that the information is insufficient, no matter how much information the acquirer provides? The acquirer can trigger the implementation of the defense measure, such as allotment of discriminative share options without giving financial compensation to the acquirer, and then makes a petition to the court for injunction, claiming that the board's decision to allot discriminative share options in such circumstances is unreasonable and thus illegal. However, if the acquirer loses the case, the share options will be irreversibly allotted and the acquirer ends up suffering not only decrease in its shareholding but also the financial

damage. That means the lawsuit is a gamble for the acquirer. Even if we regard the purpose of the defense plan, that is, obtaining enough information, as legitimate, I think it is implausible for the court in Japan to permit the defense measure which will give the acquirer such damage just because the acquirer failed to provide enough information. If so, it could be difficult to implement the defense measure without financial compensation, even for the purpose of obtaining the information.

Now let me give one possible solution to this problem. Suppose the acquirer triggers the implementation of the defense measure by buying the adopter's shares beyond a certain threshold or initiating TOBs without providing the information the board of the adopter required, since the acquirer believes that the board's requirement is unreasonable. Then the board will make a resolution to allot discriminative share options as a defense measure. The board can, however, make this resolution not final and binding but *conditional*, promising that, if the acquirer initiates the lawsuit to challenge its resolution, then the board will postpone the allotment of share options as long as the suit is pending, and moreover, the board will rescind its resolution if the acquirer "withdraws" immediately after the suit is over. For example, suppose the acquirer initiates the suit for injunction, but the court decides the allotment of share options is legitimate, probably because the board's requirement to provide additional information was reasonable in the circumstances. Then the acquirer can "withdraw." "Withdraw" here means to withdraw the tender offer bid or, if the acquirer triggered the implementation of the defense measure by acquiring the adopter's shares beyond a certain threshold (15% or 20%, as provided in the defense plan), it means for the acquirer to sell the shares within a certain period of time to reduce its shareholding below the threshold. If the acquirer "withdraws" by either way, then the board of directors of the adopter will rescind the allotment of share options in accordance with the condition it made in the original resolution. In this scenario, the acquirer is given an opportunity to challenge the defense measure in court without taking a risk of suffering the loss by the allotment of discriminative share options. In my opinion, giving the acquirer such an opportunity is an important factor (perhaps necessary condition) for the court to rule the allotment of discriminative share options without financial compensation as legitimate. If the board's resolution to allot the discriminative share options without financial compensation is final and binding, then the allotment will cause a significant harm to the acquirer. As I said before, it is implausible for the courts in Japan to permit such a defense measure. In contrast, if the board makes the resolution conditional in a sense I explained so far, then, I suppose, the probability for the court to rule the defense measure as legitimate will fairly increase. In the latter case, the court may well feel that its decision that the defense measure is legitimate will not cause the acquirer inevitable damage, but just put the acquirer back to the original position and prohibit the acquirer from carrying out the acquisition.

The fundamental problem here is that the Japanese system is not like American system which allows the acquirer to file for the order to cancel the existing share options. But putting this aside, there should be a way for the defense measure to be regarded as legitimate even when the financial compensation is not provided to the acquirer. Otherwise, takeover

attempts not for the purpose of acquiring the control of the target company, but for the purpose of simply acquiring benefits from the target company in a way of financial compensation, -- in other words, greenmail,- will certainly increase.

Fujita: Thank you. Now I would like to ask Justice Jacobs about the U.S. again. The question is, is there similar discussion in the U.S., too? If the rights plan is implemented, the shareholders except the acquirer can execute the stock option at the discounted price, and the acquirer is not allowed to execute its option stock. Of course the voting right of the acquirer will be decreased, but at the same time it causes the acquirer financial loss as well. In this case, is causing the acquirer financial loss legal issue in the U.S.? For example, if the rights plan is implemented and the acquirer suffers financial loss as a result, will the directors of the target company who decided to implement the measure be held responsible for the acquirer's loss, for example will they be held responsible to compensate the loss? Only the liability I can think of is torts, but either way, will they legally be held responsible for the acquirer's loss to a certain degree?

Jacobs: Before I answer that question, I must disclaim that anything that I say is not a formal opinion on behalf of my Court or any of my colleagues. I am responding only as a commentator, not a judge.

The direct answer to your question is that we have not ever had a case involving a set of facts that raises the question that you have asked. The only cases involving compensating bidders or potential bidders have been in the so-called "greenmail" area. Those cases involve different facts; that is, greenmail involves a potential bidder acquiring a "toehold" of shares in the open market, in a quantity that is less than the percentage required to trigger a poison pill. Under the classic "greenmail" fact pattern, the board decides to have the company acquire the bidder's shares, which will represent a minority interest, and causes the company to pay a premium over market price for those shares. In those circumstances, unless it is shown that the board was intentionally acting to entrench itself in office, there is no liability risk for the board, because its decision will normally be entitled to business judgment protection.

But in the greenmail situation, the board is causing the shares to be repurchased by the company. Any "compensation" to the bidder is not compensation for dilution, but rather is compensation to the bidder for selling its shares together and foregoing any opportunity to acquire control.

The case that you are talking about, however, is one where there is an American-style poison pill in place, the bidder "breaks through" the pill (that is, the bidder acquires enough stock to trigger the pill), and the operation of the pill results in diluting the bidder's shares. The issue becomes: does the bidder have a cause of action, a claim for compensation that would be recognized by an American court?

My answer as a commentator is that I would have a great difficulty envisioning that type of recovery being allowed in the United States, because that result would be alien to the thrust

of the Delaware decisional law, which is that it is a valid defense for a target company board to create and keep in effect a rights plan whose very purpose is to dilute the shares of anyone who “breaks through” it. If that premise is correct, then there is no legal wrongdoing by the board, because any dilution that occurs results solely from an avoidable decision by the bidder. That is, if the bidder breaks through the pill and suffers dilution, whatever harm results is harm that the bidder has brought upon itself.

I would be interested to hear what Professor Milhaupt says on this issue. He may have a different view about it. But I think in the United States that concept just would not have much traction, so that if we had a case like *Bull-Dog Sauce*, there would be no compensation payable to the bidder.

Fujita: Thank you. The answer was expected in a way, but it is worth to mention as one aspect that a scenario that is intensively discussed in Japan, where it is said to utilize the American rules on defense measures, is something that a Delaware Supreme Court judge has not heard or thought of.

IV The possibility of an alternative legal system on acquisitions

Fujita: Finally, since the theme of the discussion says projection, let’s briefly look at the future direction. For the future, we could project that the “prior warning type” defense plan will remain as a takeover defense measure in Japan – even though some judicial precedents have already shown the limit of its implementation – and it may gradually grow with more judicial precedent in the future. On the other hand, as an alternative scenario, the decision to drastically change the system itself might be purposely and intentionally made at some point. In fact some people claims that British system is one of the options. While requiring the tender offer to all the shares to obtain control, the implementation of defense measures against such a reasonable takeover attempt that compiles the rule is prohibited. And this rule is governed by a special organization called takeover panel. Such system could be introduced in Japan too. If we introduce a system like this, that will significantly change the traditional so-called American system in a wider sense. Well, considering the panel discussion we had, I am reluctant to use the word “American Style,” though. How should we think about such options? Or, should we continue the current framework? Professor Milhaupt, what do you think? If possible, Professor Kanda, can you comment on it as well?

Milhaupt: First, just to clarify, I certainly was not advocating that Japan adopt the UK system. That is certainly not my role; it is a question for Japanese policymakers to decide. I think there are some elements of the UK model that are worth considering from the Japanese standpoint. In particular, I think the ongoing and direct interaction of the Takeover Panel with market participants is interesting and potentially worthy of study by the Japanese.

So far, developments in Japan’s takeover market to some degree resemble the process of change in the United States, particularly in the late 1980s; that is, the way the legal system

was mobilized to respond to a new type of economic activity. In Japan (so far) as in the United States, the courts have taken on—or been forced to play—the role of the ultimate decider in contests for corporate control. In both countries, the courts had to create new legal standards to resolve the cases. But you are absolutely right, your last comment was that the Delaware system is quite different from that which is been adopted so far in Japan.

I would like to make two general points about the process of creating new takeover policy in Japan. First, throughout its history Japan has made major institutional changes when necessary, so I am not very concerned about the fact that moving to the UK system (or the US system) would be a drastic change. The drastic nature of change in and of itself has never been much of barrier to institutional change in Japan. It is remarkable the degree of study and the depth of analysis of foreign systems that Japanese people undertake before making a change. This conference is a good example of that process. The end result may be based on a foreign model, but Japanese are masterful at adapting foreign models to fit their own needs. I expect that the same will be true of Japanese takeover policy.

My final comment, or caution, on the process of creating a new takeover policy is an insight from comparative corporate governance scholarship: institutions are complimentary, that is, they fit together in ways that increase their overall utility. It is very difficult to change just one piece of an institutional structure, and the system as a whole may be worse off because of piecemeal change. Newly added elements need to fit together with pre-existing elements. So I think the main point, as Japan goes through this process of developing a new set of institutions for hostile takeover, is that whatever foreign model you adopt, or if you create completely novel institutions, is to be conscious of how the pieces fit together with Japan's existing institutions and culture.

Fujita: Thank you.

Kanda: Let me point out a few things. First, I would like to explore a new scheme, if an experiment is allowed. For example, I would definitely like to try something like the British system for four to five years, for instance. However, such experiment may be difficult to try. Second, as you realized from the discussion on whether the bidder should be financially compensated, common sense in Japan is often not acceptable in the rest of the world, whether it is good or bad. Therefore, in this unique country, Japan, even if a British-like system is introduced, it will follow its own path. Specifically, for example, in the U.K., it is very rare to go to court challenging a Takeover Panel's decision. However, in Japan, even if something like the panel is established, people would still go to court, I think. Also, in the U.K., the existence of the panel makes the board of directors to be neutral and indeed prohibits it from employing takeover defenses. However, in the U.K. a decision of the shareholders' meeting is respected even after the hostile bid is initiated. In Japan, even if the panel is implemented, probably the shareholders' meeting would often decide and trigger defense measures. And finally, how should the panel be structured in Japan? In Japan, it would probably be a special group of some kind of a government council. Taking these into

consideration, if our country tries to copy the British system, it will follow its own path. Yet, as I already said, if an experiment is permitted, I would definitely like to try it.

Fujita: Thank you very much. This panel discussion addressed wide range of issues from the current situation of laws and practices on takeover defense measures to logical points, to the new framework including alternative system with the current rules. It may be a little too much information, and we are running out of time, so we would like to end the discussion here. Thank you for your participation.

Materials

Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests

May 27, 2005

Ministry of Economy, Trade and Industry

Ministry of Justice

Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests

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* This translation is for convenience purposes only of the Japanese language original and in the event of any discrepancy, the Japanese language original shall prevail.

Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests

May 27, 2005

**Ministry of Economy, Trade and Industry
Ministry of Justice**

(Introduction)

The Ministry of Economy, Trade and Industry (METI) and the Ministry of Justice (MOJ) have formulated “Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders’ Common Interests” (hereinafter referred to as the “Guidelines”) which set forth principles that must be satisfied for defensive measures adopted in anticipation of takeovers which are detrimental to corporate value and shareholders’ common interests to be considered reasonable, with the goal of preventing excessive defensive measures, enhancing the reasonableness of takeover defense measures and thereby promoting the establishment of fair rules governing corporate takeovers in the business community.

The Guidelines set forth the meaning of terms used (I. Definitions), the background (II. Background), principles concerning takeover defense measures (III. Principles), their purposes (IV. Purposes) and specific examples (V. Specific Examples).

Since the environment surrounding corporate takeovers is expected to change dramatically, METI and MOJ intend to review and revise the Guidelines based on the application thereof on an ongoing basis.

I. Definitions

The terms set forth in the following subparagraphs shall have the meanings prescribed in the respective subparagraphs.

1. Takeover: The acquisition of shares of a corporation in a quantity sufficient to exert influence over the corporation
2. Takeover defense measures: Measures adopted by a joint-stock corporation prior to the making of an unsolicited takeover proposal, such as the issuance of shares or stock acquisition rights (*Shinkabu Yoyakuken*) for purposes other than business purposes

such as fundraising, which are intended to make it difficult to accomplish a takeover that is not approved by the board of directors

3. Adoption: Approving specific takeover defense measures, such as a plan to issue new shares or stock acquisition rights as a takeover defense measure
4. Implementation: Implementing the takeover defense measures which have previously been adopted to make it difficult to accomplish a takeover
5. Termination: Canceling adopted defensive measures, for example, by redeeming the new shares or stock acquisition rights that were issued as a takeover defense measure
6. Corporate value: Attributes of a corporation, such as assets, earnings power, financial soundness, effectiveness, and growth potential, etc., that contribute to the interests of the shareholders
7. Shareholder interests: The interests of the shareholders as a whole

II. Background

The structure of the Japanese business community has been undergoing dramatic changes. With the continuing unwinding of cross-shareholdings, the idea that corporations belong to their shareholders is taking hold and corporate managements are paying greater attention to their shareholders. At the same time, people now have a more favorable image of M&A transactions and foreign capital. Against this background, the conventional wisdom, that a corporate acquisition is a friendly takeover agreed to by the management of both companies, no longer holds, creating an environment where hostile takeovers can take place.

However, here in Japan, there is no common code of conduct in the business community with regard to what constitutes a non-abusive takeover and what constitutes a reasonable defensive measure, partly because Japan has had less experience with hostile takeovers unlike the United States and EU. Defensive measures against hostile takeovers, if they are used properly, can help enhance corporate value and shareholders' common interests. But at the same time, there is a risk that defensive measures, if they are improperly structured, may be used to entrench corporate management, preserving intact inefficient management. Therefore, if left as is, this absence of rules could encourage repeated surprise attacks and excessive defensive tactics, making it difficult for takeovers to fully demonstrate their effectiveness as a mechanism to enhance corporate value.

The purpose of the Guidelines is to promote the establishment of fair rules concerning takeovers by proposing legitimate, reasonable takeover defense measures modeled after typi-

cal defensive measures that have been developed elsewhere, based on legal precedents, doctrines concerning takeover defense measures, as well as on the Corporate Value Report (May 27, 2005) of the Corporate Value Study Group (Chairperson: Professor Hideki Kanda, The University of Tokyo).

The Guidelines are not legally binding and should not be read to require that all legitimate takeover measures must conform to the Guidelines. But, if the Guidelines are shared and respected by interested parties including corporate managers, shareholders, investors, stock exchanges, lawyers, financial advisors, etc., ^{Supplement 1} they will facilitate a major change in the Japanese business community and lead to the enhancement of corporate value. More specifically, they will lead to the establishment of corporate management focused on the interests of shareholders, active use and independence of external board members, establishment of procedures to reasonably investigate takeover proposals, improved procedures governing shareholders meetings, ^{Supplement 2} exercise of responsibility by institutional investors, and consensus-building between corporate managers and investors about the long-term enhancement of corporate values.

The mission of the Guidelines is to change the business community from one without rules concerning takeovers to one governed by fair rules applicable to all. To prepare for the upcoming era of M&A activity, we expect the Guidelines to become the code of conduct for the business community in Japan by being respected and, as the need arises, revised.

III. Principles

Takeover defense measures should conform to the following principles in order to protect and enhance corporate value and shareholders' common interests.

1. Principle of protecting and enhancing corporate value and shareholders' common interests

The adoption, implementation and termination of takeover defense measures should be undertaken with the goal of protecting and enhancing corporate values and, by extension, shareholders' common interests. ^{Supplement 3}

2. Principle of prior disclosure and shareholders' will

When takeover defense measures are adopted, their purpose and terms should be specifically disclosed and such measures should reflect the reasonable will of the shareholders.

3. Principle of ensuring the necessity and reasonableness

Takeover defense measures that are adopted in response to a possible takeover threat must be necessary and reasonable in relation to the threat posed.

IV. Purposes

1. Principle of protecting and enhancing corporate value and shareholders' common interests

The adoption, implementation and termination of takeover defense measures should be undertaken with the goal of ensuring and enhancing corporate values and shareholders' common interests (hereinafter referred to as "shareholder interests"). ^(Note 1) ^(Note 2)

A joint-stock corporation aims to enhance its corporate value and ultimately shareholder interests by respecting its relationship with various stakeholders, such as its employees, suppliers and customers.

If an acquiring person becomes a majority shareholder and abuses its power by running the corporation for its own interests, it will impair the corporate value and damage shareholder interests. Moreover, depending on the manner of the takeover, shareholders may be coerced into selling, including at unfair prices not reflecting the real value of the corporation. This would harm the financial interests of the shareholders.

Therefore, it is legitimate and reasonable for a joint-stock corporation to adopt defensive measures designed to protect and enhance shareholder interests by preventing certain shareholders from acquiring a controlling stake in the corporation.

(Note 1) The following can be cited as typical defensive measures to protect and enhance shareholder interests.

(i) Takeover defense measures to prevent takeovers that would cause an apparent damage to shareholder interests through any of the acts listed in (a) through (d).

Supplement 4

- (a) Accumulating shares with the intent of requiring the corporation to buy them back at a higher price
- (b) Temporarily taking control of the corporation and running the corporation in the interests of the acquirer at the expense of the corporation, such as acquiring the corporation's important assets at low prices
- (c) Pledging assets of the company as collateral for debts of the acquirer or its group companies or using the company's funds to repay such debts
- (d) Temporarily taking control of management of the company and selling valuable assets that are currently not related to the company's businesses and declaring temporarily high dividends with profits from the disposition, or selling the shares at a higher price after the share price rose due to tempo-

rarily high dividends

- (ii) Defensive measures to prevent coercive, two-tiered takeovers (takeovers which coerce shareholders into accepting a higher priced front-end tender offer by setting unfavorable terms or not specifically indicating terms for the back end of the transaction, without offering to buy all shares at the front end).
- (iii) Defensive measures to ensure the time and negotiating power required for the target to (i) obtain information from the acquirer in the case where it is difficult for shareholders to evaluate the takeover proposal, for example, where shareholders do not have sufficient information in order to decide whether to sell or keep their shares notwithstanding the fact that the takeover proposal would impair shareholder interests, or to (ii) present a superior alternative to shareholders.

(Note 2) With regard to the first principle, if a competing, unsolicited proposal is received after the board has already agreed to a friendly takeover, the directors have a fiduciary duty to evaluate the competing proposal in good faith. It is not appropriate for a corporation to implement takeover defense measures that deprive shareholders of the opportunity to consider competing proposals unless there are reasonable grounds.

2. Principle of prior disclosure and shareholders' will

In order to ensure the legal validity and reasonableness of takeover defense measures, the purpose, terms, etc. of the defensive measure shall be disclosed in advance in specific terms to allow shareholders to make appropriate investment decisions (principle of prior disclosure) and shall reflect the reasonable will of the shareholders (principle of shareholders' will).

(1) Prior disclosure

In order to enable shareholders, the investment community, acquirers and others to take into account the effect of defensive measures and to make appropriate investment decisions, when adopting takeover defense measures, companies should clearly disclose in detail the purpose, specific terms, and effects (both positive and negative, including impacts on the restriction or modification of voting rights and property rights) of the defensive measures. ^(Note 3)

(Note 3) In order to enhance the legitimacy of takeover defense measures and promote acceptance by shareholders and market participants, it is extremely important for companies adopting defensive measures not only to comply with the minimum rules of disclosure set forth by laws and regulations, such as Commercial Code, the Securities Exchange Law, and rules of stock exchanges but also to disclose takeover defense measures voluntarily by utilizing operating reports (*Eigyō Hokokusho*) and annual reports (*Yukashoken Hokokusho*), etc.

When adopting defensive measures, companies should proactively notify shareholders,

the investment community, employees and other stakeholders, addressing “what is this measure intended to defend against?” and “what defensive measures are being adopted in order to accomplish that objective?” Through investor relations activities, companies should discuss the factors contributing to corporate value and specific management strategies under consideration to enhance corporate value, such as increasing dividends and implementing effective business strategies. Most institutional investors are interested in the long-term enhancement of corporate value. In the process of adopting defensive measures in advance of an unsolicited takeover proposal, companies should spare no effort to win the understanding and confidence of shareholders and the investment community about long-term management strategies.

(2) Principle of shareholders’ will

(i) Adoption of defensive measures upon receipt of approval at a general meeting of shareholders

As the ultimate decision making body, the shareholders, who are the real owners of a corporation, may use the general meeting of shareholders to adopt takeover defense measures involving amendments to the articles of incorporation or other methods for the purpose of protecting shareholder interests. Restricting the transfer of shares in the articles of incorporation is the most obvious example. Issuance of new shares or stock acquisition rights to a third party under particularly favorable conditions would also be deemed legitimate if approved by a special resolution of a general meeting of shareholders. Moreover, with regard to matters whose impact on shareholders is less significant than those matters requiring a special resolution (which requires a super-majority vote under the law), the adoption of defensive measures by an ordinary resolution of a general meeting of shareholders is permitted as a legitimate exercise of self-governance by shareholders.

(ii) Adoption of defensive measures by a resolution of the board of directors

While it is not consistent with the division of corporate authority envisioned by the laws of Japan for directors, who are elected at a general meeting of shareholders, to change the composition of shareholders by adopting a takeover defense measure, since it is difficult to convene a general meeting of shareholders in a timely manner, it is not appropriate to reject outright the adoption of defensive measures by the board of directors when such measures enhance shareholder interests.

Even in the case where a takeover defense measure has been adopted by a resolution of the board of directors, if there is a mechanism that allows the shareholders to terminate the defensive measure (and their failure to do so indicates passive approval), it does not run counter to the principle of shareholders’ will.

3. Principle of ensuring the necessity and reasonableness of defensive measures

Although takeover defense measures should be designed to protect and enhance shareholder interests, if defensive measures create inequality between shareholders, they could pose a serious threat to the principles of shareholder equality and protection of property rights. Moreover, there is a risk that defensive measures may be used not to enhance shareholder interests but to entrench corporate management.

In order to ensure the legitimacy and reasonableness of takeover defense measures, it is necessary to prevent these undesirable effects. Therefore, takeover defense measures should, by necessary and appropriate means, give due consideration to the principles of shareholder equality,^(Note 4) protection of property rights,^(Note 5) and prevention of the abuse of defensive measures for entrenchment purposes.^(Note 6)

(Note 4) The principle of shareholder equality is a principle that shareholders should be given proportionate treatment regarding shareholders' rights based on the numbers of shares held. Takeover defense measures that do not treat all shareholders equally can be introduced without running counter to the principle of shareholder equality by utilizing any of the following methods (i) through (iii) specified in the Commercial Code.

- (i) Issuance of stock acquisition rights on the condition that those who are able to exercise the rights are shareholders not holding shares in excess of a specified percentage (shareholders other than the acquiring person)

Since the privilege of exercising stock acquisition rights is not included in the rights of shareholders, it does not run counter to the principle of shareholder equality to attach a condition that those who can exercise the right are shareholders other than the acquiring person.

- (ii) Issuance of new shares or stock acquisition rights to shareholders other than the acquiring person

Since shareholders of a public corporation do not have a right to subscribe for new shares or stock acquisition rights and the allocation of new shares or stock acquisition rights is not a matter over which shareholders have any say, it does not run counter to the principle of shareholder equality to allot new shares or stock acquisition rights only to shareholders other than the acquiring person.

- (iii) Issuance of different class of shares

Since issuing different classes of shares, such as shares with certain veto powers (Article 222, Paragraph 9 of the Commercial Code), to certain persons is an exception to the principle of shareholder equality expressly set forth in the Commercial Code, it is legitimate to issue such shares as long as it is done after going through the necessary procedures, such as amendment of the articles of incorporation.

(Note 5) Property rights are constitutional rights and the Commercial Code gives due consideration to the protection of shareholders' property rights through the principle of the free trans-

ferability of stock, the designation system for the purchasers of stock with transfer limitations, and the system allowing shareholders to request the company to buy back their shareholdings. Therefore, when adopting a takeover defense measure that may be detrimental to the financial interests of specific shareholders, such as the acquiring person, the company is required to take the following appropriate steps.

- (i) Since issuing new shares or stock acquisition rights to persons other than shareholders under particularly favorable conditions significantly reduces the value of existing stock, it requires a special resolution by a general meeting of shareholders (Article 280-2 Paragraph 2, Article 280-21 Paragraph 1 of the Commercial Code).
- (ii) It is possible to issue to shareholders stock acquisition rights that can be exercised only by shareholders other than an acquiring person if approved by a resolution of the board of directors. However, if the terms of the stock acquisition rights are likely to cause excessive damage to the financial interests of the acquiring person, there is a risk that such issuance may be determined to be illegal under the provision of Article 280-21, Paragraph 1 of the Commercial Code. Therefore, it is necessary to adopt measures to enhance the legal validity of the stock acquisition rights (see V2 (1) below).

(Note 6) When implementing takeover defense measures, the board of directors must reasonably determine that a threat to shareholder interests exists. In addition, the board of directors must reasonably ensure that the defensive measures implemented are reasonable in relation to the threat posed and not excessive to the threat posed. The reasonable decision-making process the board of directors must engage in exercising sound judgment requires a serious review to avoid any material and careless misunderstandings of the underlying facts, etc. including, for example, consultation with external experts such as lawyers and financial advisors. Such careful deliberations are necessary to prevent the board from making arbitrary decisions and to enhance the fairness of takeover defense measures.

V. Specific Examples: Focusing on the Interpretation of the Grossly Unfair Issuance Standard and the Standard for Reasonableness

There are a variety of takeover defense measures, and the most typical ones in use are stock acquisition rights and different classes of stock. It should be expected that criteria will be established on the legality (see 1 (1) and 2 (1) below) and the reasonableness (see 1 (2) and 2 (2) below) of these types of takeover defense measures for the business community.

Some specific examples of takeover defenses which utilize stock acquisition rights and different classes of stock (hereafter called “stock acquisition rights, etc.”) are presented below, along with steps, referring to the three principles of the Guidelines, that should be taken to promote the acceptance of such measures by interested parties (such as stockholders and the market) while ensuring reasonableness and eliminating the risk of injunction ^(Note 7).

(Note 7) It is important to discuss the possibility of an injunction being granted with respect to the

issuance of stock acquisition rights, etc. (Articles 280-10 and 280-39 of the Commercial Code) because: (i) practically, the legal introduction of takeover defense measures is of the utmost importance and (ii) while the issue of whether there have been violations of legal ordinances or the articles of incorporation which might give rise to an injunction is relatively straightforward, the question of whether such an issuance might constitute a grossly unfair method is far more difficult. Therefore, the presence of certain objective criteria based on the three principles of the Guidelines is very important.

1. When stock acquisition rights, etc. are issued based on approval at a general meeting of stockholders

(1) Methods for avoiding an injunction on the issuance of stock acquisition rights, etc.

Under the Commercial Code, the issuance of stock acquisition rights, etc., is, in principle, subject to a board resolution (Article 280-20, Paragraph 2, Article 280-2, Paragraph 1), and for joint stock companies, except where transfer of their shares is restricted, approval at a general meeting of stockholders on the issuance of stock acquisition rights, etc. is only required if:

- 1) The issuance is to someone other than a stockholder on especially favorable terms (Article 280-2, Paragraph 2, Article 280-21, Paragraph 1); or
- 2) The articles of incorporation specify that the issuance of stock acquisition rights, etc. requires approval at the general meeting of stockholders (Article 280-2, Paragraph 1, Article 280-20, Paragraph 2)

With respect to the use of different classes of stock, a prerequisite for the issuance of such stock is that the terms of such shares must be fully set out in the articles of incorporation (Article 222, Paragraph 2). When stock acquisition rights, etc. are issued as a takeover defense measure based on approval at the general meeting of stockholders, it is generally assumed that (i) shareholder interests will be protected and enhanced, (ii) the will of the shareholders has been followed, and (iii) the defensive measures will be used according to necessary and reasonable methods without a risk of abuse of power by the board of directors. Therefore, there is a high probability that such measures will be considered in compliance with the three principles of the Guidelines, and thus constitute a fair issuance.

(2) Methods to ensure the reasonableness of takeover defense measures and promote the acceptance by shareholders, investors and other interested parties

In order to promote the acceptance of shareholders, the investment community and other interested parties, it is also necessary to increase the reasonableness of takeover defense measures in accordance with the three principles indicated in the Guidelines.

Taking into account the principle of protection and enhancement of corporate value and

shareholder interests, even if the issuance of stock acquisition rights, etc. as a takeover defense measure is approved at the general meeting of stockholders, in the event of a takeover bid that is in the shareholders' best interests, it is necessary to have a mechanism that makes it possible to remove the takeover defense measure, such as stock acquisition rights, etc. Accordingly, to improve reasonableness, shareholders should be able to terminate the stock acquisition rights, etc. by replacing the board at one general shareholders meeting. ^{Supplement 5, 6}

Taking into account the principle of prior disclosure and shareholders' will, reasonableness is increased by establishing measures to ensure regular opportunities to verify the shareholders' will as a whole, for example, a provision to require the periodic approval of the stock acquisition rights, etc. at general shareholders meetings after the issuance. ^{Supplement 7}

Taking into account the principle of ensuring necessity and reasonableness, it is necessary to consider fair treatment of shareholders, especially since the introduction of different classes of stock, such as shares with veto power, may discriminate against shareholders other than the acquiring person. In particular, a publicly traded company should be cautious about issuing non-redeemable shares with veto power.

2. When stock acquisition rights, etc. are issued based on a resolution of the board of directors

(1) Method for avoiding an injunction on the issuance of stock acquisition rights, etc.

Any issuance of stock acquisition rights, etc., except in the instances mentioned in 1 (1) above, does not require approval of the general shareholders meeting. ^{Supplement 8}

Accordingly, in such cases, the issuance of stock acquisition rights, etc. based solely on a resolution of the board of directors is not a violation of law or articles of incorporation. However, there is a possibility that such issuance will be considered an issuance by a grossly unfair method and thus will be enjoined.

The question of whether the issuance of stock acquisition rights, etc. as a takeover defense is a grossly unfair method is ultimately for the courts to decide. Clarifying the details based on legislative intent and judicial precedents, however, would be helpful in establishing the standards as to whether the method conforms to (i) the principle of protecting and enhancing corporate value and stockholder interests, (ii) the principle of prior disclosure and shareholders' will, and (iii) the principle of necessity and reasonableness.

1) Principle of protecting and enhancing corporate value and shareholder interests

If the issuance of stock acquisition rights, etc. is solely for the purpose of entrenching the board, it is likely that it will be regarded as a grossly unfair method. On the other hand, if the

issuance is intended to protect or enhance shareholder interests (see Note 1), there is little risk that it will be considered a grossly unfair method, even if there is no business purpose, such as the procurement of capital.

2) Principle of prior disclosure and shareholders' will

The fairness of an issuance of stock acquisition rights is enhanced if (1) there is specific disclosure of the purpose and terms, etc. prior to the issuance of the stock acquisition rights, etc., and (2) the issuance reflects the reasonable will of the shareholders.

(The purpose of the issuance of stock acquisition rights, etc. must be disclosed)

Since the issuance of stock acquisition rights, etc. as a takeover defense measure will affect shareholders with respect to future changes in the control of the company and it is possible that the issuance will be judged to be a grossly unfair method, the company is required to provide the necessary information to shareholders so that they can decide whether to seek an injunction or act to cause the termination of the stock acquisition rights, etc. based on the general consensus of the shareholders after being informed of the purpose.

Accordingly, the fairness of the issuance of stock acquisition rights, etc. as a takeover defense can be increased by disclosing to shareholders that the main purpose of the rights is as a takeover defense method, along with disclosure of the potential disadvantages to the shareholders.

(Must reflect the reasonable will of the shareholders)

An issuance of stock acquisition rights, etc. cannot be considered to be based on the reasonable will of the shareholders if there is no mechanism whereby the shareholders can cause the termination of the stock acquisition rights, etc. (where there is such a mechanism their failure to do so would constitute passive approval). In such a case, it is likely that such issuance will be considered an unfair issuance and thus will be enjoined. ^{Supplement 9}

Accordingly, for stock acquisition rights to be used as a takeover defense, it is necessary to provide a mechanism to allow shareholders to cause the termination of such rights based on the general consensus of the shareholders.

3) Principle of necessity and reasonableness

The fairness of the issuance of stock acquisition rights, etc. can be enhanced by providing measures like those described below and using the necessary and appropriate methods to prevent a takeover.

(Ensuring no discrimination among shareholders other than the acquiring person)

Unfavorable treatment of shareholders other than the acquiring person or the failure to grant advantages to all shareholders other than the acquiring person in order to prevent a takeover is generally not reasonable. Therefore, unless there is a reasonable basis for the issuance, it is likely that stock acquisition rights, etc. will be considered to have been issued by a “grossly unfair method,” if their terms include a provision which allows discriminatory treatment among shareholders (other than the acquiring person),^{Supplement 10} or if such rights have been issued on favorable terms only to certain shareholders (other than the acquiring person).^{(Note 8) (Note 9)}

Accordingly, the fairness of the issue of new stock acquisition rights, etc. as a takeover defense can be enhanced by designing the measure so that there is no unreasonably unequal treatment of shareholders other than the acquiring person.

(Note 8) In the case of stock acquisition rights, etc. being issued to a specified third party for the purpose of procuring capital or establishing a business tie-up, the prohibition on discrimination discussed above will not apply, since such issuance is not a takeover defense measure.

(Note 9) Unlike the stock acquisition rights, etc., the details of different classes of stock are defined in the articles of incorporation, and thus, shareholder approval is obtained for the differential treatment of the shareholders of the different classes of stock. Therefore, this is generally considered to be legal, even when the different classes of stock are only issued to certain shareholders.

(There should be no excessive financial loss to shareholders as a result of the issuance)

If takeover defense measures are implemented after a takeover is initiated and the takeover is thereby prevented, the purpose is achieved. In the event of an issuance of stock acquisition rights, etc. in the absence of an actual takeover threat, if such issuance results in an excessive financial loss to shareholders at the time of the issuance,^(Note 10) there is a high probability that the issuance will be considered as a grossly unfair method.

Accordingly, the fairness of the issuance of stock acquisition rights, etc. as a takeover defense can be enhanced by designing the measure so that this type of excessive financial loss created for shareholders at the time of the issuance does not occur.

(Note 10) This means, for example, a case where stock acquisition rights, etc. with the exercise conditioned on the initiation of a takeover are actually allocated to all shareholders before the start of a takeover, with a specific day prior to the start of the takeover as the record date for allocation (except where resolved or disclosed prior to the commencement of a takeover that stock acquisition rights will be allotted on condition that a takeover is com-

menced). In such cases, it is likely that all shareholders acquiring stock after the record date, including those who are not the acquiring person, will incur unexpected losses. In addition, the value of the stock owned by shareholders as of the record date may also drop significantly. If the stock acquisition rights are subject to transfer restrictions, it is also possible that the shareholders cannot recover the portion of their investments corresponding to such drop in value. In this way the takeover causes unforeseen losses for shareholders who are not acquiring persons.

(There should be measures to prevent the abuse of power by the board of directors)

There are also cases in which it is necessary for the board of directors to be given the discretion to redeem or terminate the stock acquisition rights, etc. in order to enable them to negotiate with the acquiring person regarding the terms of the acquisition. Therefore, granting the board of directors this discretion cannot solely be considered to constitute a grossly unfair method.

However, if the structure of the stock acquisition rights, etc. issued as a takeover defense is such that such rights cannot be redeemed and the discretion granted to the board of directors is overbroad, allowing the board of directors to entrench themselves in office Supplement 9 despite the fact that the takeover proposal better serves the shareholders' best interests than the business plan of the board of directors, it is possible that they will be considered to be grossly unfair methods.

Accordingly, the fairness of the issuance of stock acquisition rights, etc. as a takeover defense can be enhanced by providing a mechanism to prevent the abuse of power by the board of directors.

(2) Methods to ensure the reasonableness of takeover defense measures and promote acceptance by shareholders, investors and other interested parties

In order to promote acceptance by shareholders, the investment community and other interested parties, it is crucial to increase the reasonableness of takeover defense measures in accordance with the three principles presented in the Guidelines. In particular, in the case of a takeover bid that would protect and increase corporate value and shareholder interests, there should be a mechanism in place that enables the board of directors to act as promptly as possible to terminate defensive measures, without waiting for the judgment of the shareholders.

To achieve this, in order to prevent the abuse of discretion by the board of directors, there must be a mechanism whereby shareholders can express their own will regarding the takeover defense measures at the annual general meeting of stockholders, ^{Supplement 5, 6} defensive measures should include provisions establishing objective criteria for the conditions on which the defensive measures would be terminated by the board of directors, or, importance should

be placed on the judgments of independent outsiders.

(Establishment of objective criteria to permit the eventual implementation of a takeover bid, etc.)

Ensuring opportunities for an acquiring person to make a takeover bid (TOB) is an effective means of reflecting shareholder opinions by allowing them to respond to the TOB based on their own decisions.

Therefore, if the defensive measures are designed so that the stock acquisition rights, etc. are terminated ^(Note 11) if the evaluation period and negotiation periods have run and the details of the offer and related matters satisfy certain objective criteria, it will be easier to promote the acceptance of shareholders, the investment community and other interested parties. ^{Supplement 11}

In addition, if inside directors alone are allowed to decide whether to implement defensive measures without obtaining the consent of the independent outsiders, it is necessary to establish these objective criteria that preclude arbitrary judgments by inside directors. An example would be the automatic termination of stock acquisition rights, etc. in the event that the predetermined objective criteria, such as but not limited to, the provision of certain information, and the passage of specific evaluation and negotiation periods, are fulfilled.

(Note 11) In the event that stock acquisition rights, etc. have not yet been issued, this would mean stopping the issuance.

(Consideration of the judgments of independent outsiders)

The decision on whether to eliminate stock acquisition rights, etc. as a takeover defense after a takeover bid has been initiated may require consideration of complicated business issues, but the decision also can be influenced by the entrenchment behavior of inside directors. Therefore, it is reasonable for an outsider who can understand the operations of the company to evaluate a takeover bid after receiving confidential company information that is difficult for shareholders to obtain. If provisions are included that give weight to the judgments of independent outside directors and auditors (independent outsiders) who are capable of closely monitoring any entrenchment behavior of inside directors, this should be effective in creating confidence among shareholders and the investment community that the decisions of the board of directors are fair. ^{Supplement 12} The greater the degree of independence that the company outsiders have from the company, the greater this effect. ^{Supplement 13}

Therefore, takeover defense measures require careful thought and planning to correlate the objective termination provisions with the independence and power of the independent outsiders.

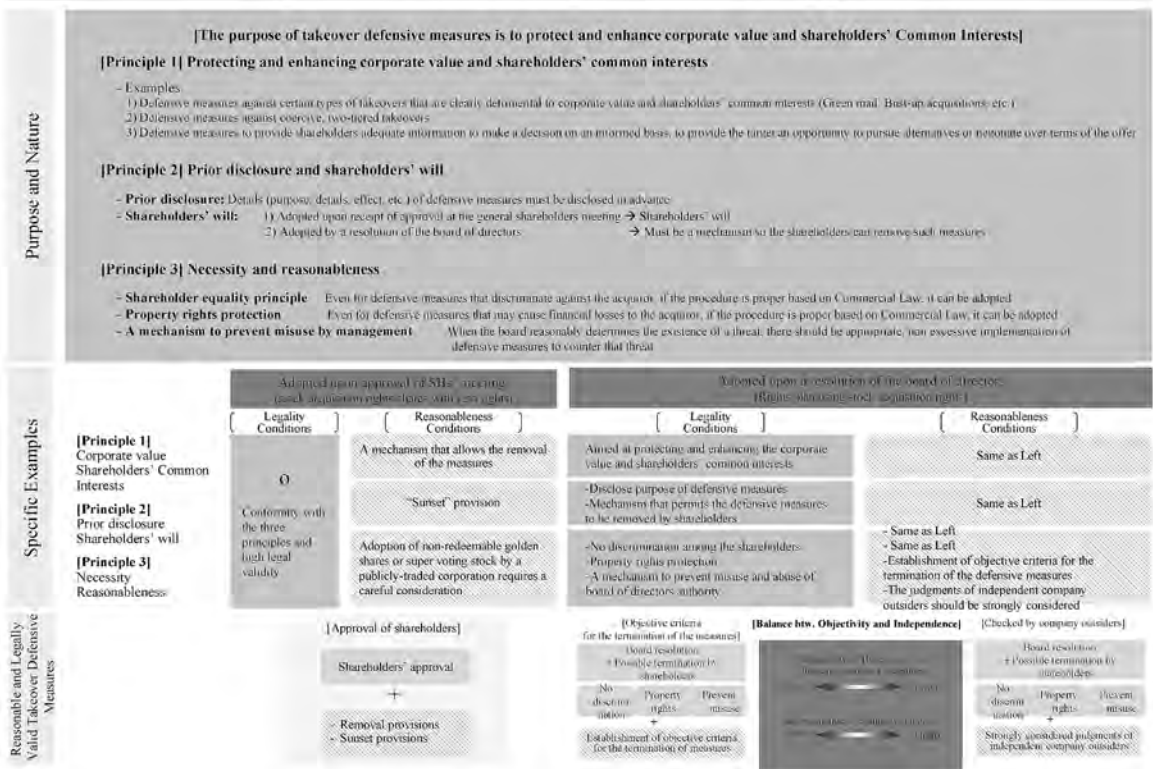
In particular, if there are no objective termination criteria, in principle, some means is necessary to seriously consider the judgments of independent outsiders in order to eliminate arbitrary decisions by the board of directors.

VI. Commentary

1. Diagram

The appended diagram provides an overview of the concepts of the guidelines.

Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests – Concept of takeover defensive measures to be adopted before an unsolicited takeover proposal is made –



2. Supplemental Explanation

- (1) (Page 2) The Tokyo Stock Exchange has announced that it will develop listing standards and a disclosure system based on the Guidelines. The Pension Fund Association has published guidelines for exercising voting rights concerning takeover defense measures, which is based on the Summary Outline of Discussion Points released by the Corporate Value Study Group. Many Japanese corporations have stated that they will refer to the Guidelines in considering adopting takeover defense measures.
- (2) (Page 3) With regard to general meetings of shareholders in Japan, institutional investors have pointed out the need to address issues raised by the fact that shareholder meetings of most companies are held at the same time, the lack of adequate disclosure, and insufficient IR

- activities. If companies want to introduce reasonable defensive measures corresponding to their own situations, it will become necessary for them to make efforts to solve these problems related to general shareholder meetings.
- (3) (Page 3) In the cases where directors exercise their authority granted in accordance with corporate law for a primary purpose other than maintaining and securing the control of the company (for instance, issuing shares to a third party for the purpose of raising funds, buying back shares as part of the legitimate capital policy, or taking actions as part of business activities that had been determined before a contest for control of the company arises), these actions are outside the scope of the principle of protecting shareholder interests, even if their purpose is not that of protecting shareholders' interests and such actions result in changes to the ownership structure.
- (4) (Page 4) The Tokyo High Court in its ruling on the Nippon Broadcasting System case on March 23, 2005 pointed out that the following four types of takeovers are "cases of exploiting a company":
- (i) The case where the acquirer accumulates the target shares for the purpose of making the concerned parties of the company buy back the shares at a higher price by driving up share prices, though there exists no true intention of participating in management of the company (the case of the so-called greenmailer);
 - (ii) The case where the acquirer accumulates the target shares for the purpose of an abusive acquisition, such as temporarily taking control of management of the company and transferring assets necessary for business operations of the target, such as intellectual property, know-how, confidential business information, and information as for major clients and customers, to the said acquirer or its group companies;
 - (iii) The case where the acquirer accumulates the target shares in order to pledge the target's assets as collateral for debts of the acquirer or its group companies or as funds for repaying such debts, after taking control of the company; or
 - (iv) The case where the acquirer accumulates the target shares for the purpose of temporarily taking control of management of the company so as to dispose of high-value assets, etc. such as real estate and negotiable securities that are currently not related to the company's businesses and pay temporarily high dividends out of proceeds from the disposition, or sell the shares at a higher price because share prices have risen rapidly due to temporarily high dividends
- (5) (Page 9 and page 12) A proxy contest, i.e., a mechanism to allow shareholders to decide whether to terminate takeover defense measures through the exercise of voting rights in the election of directors will be used more efficiently if combined with a takeover bid (TOB). The acquirer tries to appeal to shareholders with the price offered by means of the TOB, and with a new management team by means of the proxy contest. In addition, the additional expense needed for a proxy contest can be effectively limited if it is combined with a TOB. With regard to this point, it has been pointed out that it is difficult to conduct a TOB in parallel with a proxy battle at companies that have introduced takeover defense measures, since the conditions of withdrawal of TOBs are inflexible under TOB regulations in Japan.

- (6) (Page 9 and page 12) An example of a scheme in which shareholders are able to terminate the defensive measures at one general shareholders meeting by replacing directors is a scheme in which the defensive measure is terminable by the board of directors and the term of office for directors is set at one year.
- (7) (Page 9) This is the so-called sunset provision.
- (8) (Page 9) For example, the board may, upon its resolution, issue and allot to all shareholders stock acquisition rights, etc. with discriminatory exercise conditions, for example, rights which are not exercisable by shareholders who own more than a certain percentage of the stock or may make a board resolution to issue such stock acquisition rights, etc. as an allocation to shareholders.
- (9) (Page 10 and page 12) A defensive measure would be considered unfair, if, for example, it (i) becomes non-terminable in the event that any of the directors in office at the time of adoption is replaced, (ii) is non-terminable if a majority of the directors in office at the time of adoption are replaced, or (iii) is non-terminable for a certain period of time after a majority of the directors are replaced. In contrast, for example, if stock acquisition rights, etc. have a redemption provision under which the term of the rights will be periodically extended with approval at shareholders' meetings or consent of a certain percentage of shareholders but will be redeemed if such approval or consent is not obtained, such rights will be viewed as more fair, since it shows that such defensive measure reflects shareholders' will.
- (10) (Page 11) If there are shareholders who already own more than the specified percentage of stock, such as 20%, at the time that takeover defense measures are introduced, excluding such ownership from causing the defensive measure to be triggered does not constitute "differential treatment among shareholders other than the acquiring person".
- (11) (Page 13) For example, this is a mechanism through which the board of directors will terminate defensive measures and move toward the TOB if the acquiring person presents definitive information on the acquisition offer, the time necessary for the board of directors to negotiate with the acquiring person and pursue alternatives is ensured, and shareholders are provided with adequate information. It is reasonable to specify the conditions according to the situation. For example, in the case of a cash offer for all shares, since this is not inherently coercive, it is reasonable to limit the negotiation period to between one and several months, after which the takeover defense measures are removed and a transition is made to the TOB. In the case of a proposed partial acquisition, or where securities, etc. are proposed to be used for the consideration, a longer negotiation period is reasonable. These kinds of objective termination criteria are superior in ensuring the path of TOB in all acquisitions, in principle. Unlike other takeover defense measures, these are sufficiently reasonable, even if it is only the inside directors who make the decisions about the takeover defense measures.
- (12) (Page 13) In the case where termination provisions provide that the takeover defenses will not be terminated in the event of a partial offer, but will be terminated and a TOB will be commenced only in the event of all cash for all shares offer, an outsider's participation is presumably necessary, such as an analysis by outside experts (lawyers and financial advisors for example) on the appropriateness of the acquisition price and other terms, and consent of out-

side directors and outside auditors.

- (13) (Page 13) “Independence” is a concept required in order for outside directors and outside auditors who review the takeover defense measures to be able to strictly check the entrenchment behavior of inside directors, and means substantial independence from the company. To be fair and proper as an “independent outsider” who is overseeing takeover defense measures demands that the actual situation be closely examined, and that acceptance of the shareholders be obtained depending on the details of the defensive measures. If there is a low percentage of independent outside directors and outside auditors, it is necessary to come up with ways to overcome this, such as making efforts to increase their numbers, organizing an corporate governance committee composed of independent outside directors and independent outside auditors, and the board of directors obtaining advice from such committee on the implementation of takeover defenses when the need arises.

Takeover Defense Measures in Light of Recent Environmental Changes

June 30, 2008

Corporate Value Study Group

1. Objectives and the essence of Takeover Defense Measures

The premise of takeover defense measures¹ is that they should be ultimately for the protection of the interests of shareholders. Rights plans in the United States, which presuppose that shareholders finally decide to support or oppose takeovers through appointment or dismissal of directors at the general meeting of shareholders, are viewed as a mechanism that makes it possible to draw out from the acquirers and the incumbent management of the target companies better takeover terms and management proposals for shareholders. In other words, rights plans are understood as measures for protecting the interests of shareholders.

Furthermore, in examining the essence of takeover defense measures, it should be recognized that hostile takeovers have positive effects (such as the disciplinary effect of their threat on management and possibility of enhancing the shareholder interests).

Also, it should be borne in mind that deterring takeovers by implementation of takeover defense measures deprives shareholders supporting the takeovers of the opportunities of selling their shares to the acquirers.

“Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders’ Common Interests” (hereinafter “Guidelines”) published by the Ministry of Economy, Trade and Industry and the Ministry of Justice on May 27, 2005, assumes, as takeover defense measures that protect and enhance the shareholder interests², (1) defensive measures with the objective of ensuring adequate time and information necessary for shareholders to appropriately decide whether to support or oppose takeovers and opportunities to negotiate between the acquirers and the target companies and (2)

1 In this report, as “takeover defense measures,” defensive measures which utilize the gratis issue of stock acquisition rights with differential conditions for exercise and call option clauses are assumed. The basic ideas of the report, however, would also apply to other takeover defense situations.

2 In the “Guidelines,” “corporate value and the shareholders’ common interests” is referred to as “shareholder interests” in page 3 and subsequent pages, and this report will follow this usage of the term. In relation to this, “corporate value” appearing in the “Guidelines” and in this report is conceptually assumed to be “the discounted present value of future cash flow of the company”. This concept should not be arbitrarily stretched in the interpretation of the “Guidelines” or this report.

defensive measures with the objective of preventing takeovers which are clearly detrimental to the shareholder interests.

Takeover defense measures that are, contrary to these desired objectives, exploited for the purpose of managerial entrenchment should not be allowed, and the Corporate Value Study Group cannot support such takeover defense measures.

In light of the situation where more than 500 Japanese companies have adopted takeover defense measures since the establishment of the Guidelines, this report presents the essence of reasonable takeover defense measures able to gain the understanding and consent of today's shareholders and investors and examines the relationship between such reasonable takeover defense measures and past judicial precedents.

2. Takeover Defense Measures in Recognition of Current Environment

Following the establishment of the Guidelines, a variety of takeover defense measures were adopted in Japan. As a result, cases where disputes over takeover defense measures led to judicial decisions have also appeared. Given this context, the essence of takeover defense measures in recognition of the current environment can be described as follows.

- (1) Granting cash or other financial benefits³ to the acquirers in implementing takeover defense measures invites the actual implementation.⁴ As a result, it deprives

3 The granting of stock acquisition rights with differential conditions for exercise and call option clauses to the acquirers, as takeover defense measures modeling rights plans that are assumed in this report, is naturally not included in "cash or other financial benefits" referred to here.

4 Rights plans in the United States are arrangements where the target companies issue stock acquisition rights to shareholders in advance, and on the occurrence of takeover that are detrimental to the shareholder interests, a large number of shares are issued to shareholders other than the acquirers to substantially reduce the acquirers' shareholding ratio. The objective of rights plans, however, is not to ultimately deter takeovers through their actual implementation but is to temporarily halt them and to create pressure for discussions between the acquirers and the target companies. Specifically, in the structure where their implementation would be disadvantageous to the acquirers, the acquirers, in order to avoid this disadvantage, will need to temporarily halt before commencing takeovers and will need to negotiate with the board of directors and shareholders of the target companies for the removal of the stock acquisition rights. As a result, it enables the board of directors of the target companies to ensure adequate time and information necessary for shareholders to appropriately decide whether to support or oppose the takeovers or opportunities for the board of directors of the target companies to negotiate with the acquirers to improve and enhance takeover terms. Therefore, as long as the acquirers act rationally, rights plans will not be implemented.

Given the above, the granting of cash or other financial benefits to the acquirers will remove the disadvantage for them resulting from the implementation of takeover defense measures, and therefore will eliminate the incentive for the acquirers to temporarily halt before commencing takeovers. As a result, it will trigger the implementation of takeover defense measures.

Also, it might invite the board of directors of the target companies to easily implement takeover defense measures without ensuring adequate information and time or opportunities for negotiation or without substantively considering the takeover proposals, based on the understanding that the granting of cash or

shareholders of the opportunities of selling their shares to the acquirers after adequate time and information necessary for them to appropriately decide whether to support or oppose the takeovers or the opportunities for negotiation are ensured. Therefore it could prevent the formation of an efficient capital market. Thus, cash or other financial benefits should not be granted to the acquirers.

Furthermore, the granting of cash or other financial benefits might harm the interests of the shareholders of the target company because it would involve transfer of funds to the acquirer that would have been paid out to shareholders in the form of dividends or that would have, through being directed toward investments, contributed to the shareholder interests of the target company.

To begin with, takeover defense measures should not be implemented unless the directors of the target companies can responsibly explain that they are able to implement such measures without granting cash or other financial benefits since the takeovers would be detrimental to the shareholder interests.

- (2) The argument that takeover defense measures are always justified in so far as they are approved by a majority of shareholders in the general meeting of shareholders, even though directors avoid making a decision on their own and pass on the decision to the formality of the general meeting of shareholders, might send the erroneous message to related parties that firm defense system can be established with the shareholder structure which would guarantee the approval of a resolution of the general meeting of shareholders.⁵

It can even be argued that it would be evasion of responsibility if directors of the target company, who are obliged to carry out the duty of care for the company, avoid making an initial judgment on whether the takeover proposal is in the shareholder interests and justify themselves by passing on the decision of supporting or opposing the takeover to the formality of the general meeting of shareholders.

Hence, the directors of the target company must behave with responsibility and discipline in the face of takeovers.

These situations might invoke uses of takeover defense measures for the purpose of managerial entrenchment or not for the original objective of protecting the shareholder interests. To restrain the possibility of such misguided uses, it will be necessary at the present

other financial benefits would strengthen the legality of takeover defense measures.

⁵ In the Supreme Court's decision on the Bull-Dog Sauce Co., Ltd. case (Supreme Court decision of August 7, 2007), the court ruled that "when the gratis issue of stock acquisition rights to shareholders with differential terms is not for the purpose of maintaining corporate value and the interests of shareholders as a whole but mainly for the purpose of maintaining the control of directors managing the company or certain shareholders supporting such directors, such gratis issue of stock acquisition rights should in principle be understood as being issued according to an grossly unfair method. The understanding that firm defense system can be established with the shareholder structure that would ensure formally passing a resolution of the general meeting of shareholders is inconsistent with these rulings in the judicial decision.

moment to consider again the desired objectives of takeover defense measures and to examine how the acquirers and the target companies should behave in the face of takeovers.

In undertaking such an examination, it should be recognized that the Guidelines present basic ideas on the adoption of takeover defense measures prior to the commencement of a takeover and that adopting takeover defense measures in accordance with the Guidelines does not mean that their implementation is permitted unconditionally. It should also be recognized that takeover defense measures that are adopted after the commencement of a takeover are not the subject of the examination in the Guidelines.

In the following sections in this report, the whole of adoption and implementation of takeover defense measures at the present day is the subject of examination.

Nearly all judicial precedents that have attracted public interest dealt with the cases where takeover defense measures were implemented to deter the takeovers by claiming that they would be detrimental to the shareholder interests. The takeover defense measures that were used in these cases are different from those with the objective of ensuring adequate time and information or opportunities for negotiation. Bearing this fully in mind, it is necessary to clarify the reasoning revealed in past judicial precedents and to examine the essence of takeover defense measures.

3. Elaboration

(1) Basic Perspectives and How Directors of the Target Company Should Behave

The Guidelines specify that “takeover defense measures should reflect the reasonable will of the shareholders” (principle of shareholders’ will). The decision to accept or reject a takeover should in the end be made by shareholders.

On the other hand, since directors have the obligation of maximizing the shareholder interests, they must not avoid making a decision on their own and pass on the decision to the formality of the general meeting of shareholders. They must responsibly decide whether or not to adopt and implement takeover defense measures and then fulfill their responsibility of explaining their decision to shareholders. Therefore, from the perspective of protecting the shareholder interests, which is the objective of takeover defense measures, it will be important to specify how directors of the target company should behave in the face of takeovers.

How directors should behave in the face of takeovers in the face of takeovers will, however, differ in each case, depending on the content of the takeover proposals or the attributes of the acquirers. Because it will be difficult to present uniform standards of conduct, basic principles for the operation of takeover defense measures are presented in the items below.

- (i) The board of directors must not obscure the interests to be protected by takeover defense measures by referring to the interests of stakeholders other than shareholders in cases that does not protect or enhance the shareholder interests, or must not broadly interpret implementation terms for the purpose of

managerial entrenchment.

- (ii) The board of directors must not judge that the implementation of takeover defense measures is necessary only for reasons that in themselves can hardly justify that the takeover is detrimental to the shareholder interests, such as for the takeover planning to use the assets of the target company to secure the debt of the acquirer or to have the target company dispose of its idle assets to pay high dividends by the resulting profits.
 - (iii) The board of directors must not deprive shareholders of the opportunity of deciding whether to accept or reject the takeover by unnecessarily extending the period for considering the takeover proposal beyond the reasonable extent or by intentionally and repeatedly extending that period.
 - (iv) The board of directors, from the perspective of whether or not a takeover proposal enhances the shareholder interests, must faithfully consider⁶ takeover terms, the content of the takeover proposal, such as the takeover's effect on the shareholder interests, and the attributes and financial capacity of the acquirer.
 - (v) The board of directors, when by improving takeover terms there is the possibility that the takeover proposal will contribute to the shareholder interests, the board of directors must faithfully negotiate with the acquirer with the view of improving such terms.
 - (vi) The board of directors, when it judges that the takeover proposal will enhance the common interests of shareholders, must immediately decide not to implement takeover defense measures without verifying the will of shareholders at the general meeting of shareholders.
 - (vii) The board of directors must fulfill its responsibility to explain to shareholders matters such as the board's evaluation of the takeover proposal based as much as possible on facts so shareholders can decide whether to accept or reject the takeover.
 - (viii) The board of directors, if it establishes a special committee, must ensure substantial independence of the committee from incumbent management and must bear final responsibility for deciding whether or not to follow the committee's recommendations.
- (2) Categorization of the Perspectives about Takeover Defense Measures
- Whether or not takeover defense measures will enhance the shareholder interests will differ in each case, depending on their objectives and contents and on the characteristics of the takeovers. Bearing this in mind, in order to deal with the issue of legality of takeover defense measures, it would be necessary to examine judicial decisions on past cases, by focusing on the objectives of takeover defense measures and how they are operated. As a result of such examination, takeover defense measures

⁶ The consideration of takeover proposals should be made from the financial perspective, such as by retaining outside experts for analysis.

can be broadly categorized as follows.

- (i) Cases where adequate time and information necessary for shareholders to appropriately decide whether to support or oppose the takeovers and opportunities for negotiation between the acquirers and the target companies are ensured by takeover defense measures

Decision of the Tokyo District Court on the Japan Engineering Consultants Co., Ltd.⁷ case (July 29, 2005)

- (ii) Cases where takeover defense measures are implemented based on the substantive judgment in view of the contents of the takeover proposals in order to deter the takeovers

Deterring takeovers by implementing takeover defense measures generally deprives shareholders in favor of the takeovers of the opportunities to sell their shares to the acquirers. Therefore, the implementation of takeover defense measures based on the substantive judgment in view of the contents of the takeover proposals should in principle be limited. Based on the examination of past judicial decisions, cases where such implementation would be permitted are categorized into the following two typical cases in accordance with the characteristics of the acquirers and their behavior.

- (a) Cases where takeover defense measures are implemented against abusive takeovers that are clearly detrimental to the shareholder interests

Decision of the Tokyo High Court on the Nippon Broadcasting System Inc. case⁸ (March 23, 2005)

- (b) Cases where takeover defense measures are implemented based on the substantive judgment that the takeover proposals are detrimental to the shareholder interests

Decision of the Supreme Court on the Bull-Dog Sauce Co., Ltd. case⁹

7 *Hanrei jiho* [Judicial precedent report] No. 1909: 87. Regarding a case where not the gratis issue of stock acquisition rights with differential conditions for exercise and call option clauses, but stock split, which does not cause the acquirer to bear a loss of the dilution of his shareholding ratio resulting from the implementation, was used as the defensive measure, the court ruled that, for shareholders to decide whether to delegate the management of the company to either incumbent management or the hostile acquirer, the board of directors can be permitted to take suitable measures against the hostile takeover in order to ensure necessary information provision and a suitable period for consideration, as long as such measure does not violate the spirit or the intent of related laws and orders.

8 *Hanrei jiho* [Judicial precedent report] No. 1899: 56. In this case, the court ordered the provisional injunction against the issuance of stock acquisition rights to a third party, for the reason that the relevant takeover can not be found to be abusive. In that decision, however, the court ruled that takeovers within a certain scope are categorized as abusive ones and against such takeovers the board of directors can implement takeover defense measures.

9 *Saiko saibansho minji hanrei shu* [Civil case precedents of the Supreme Court] Vol. 61 No. 5: 2215. Regarding a case where a takeover defense measure was implemented based on the resolution of the general meeting of shareholders, the court recognized that nearly all shareholders other than the acquirer

(August 7, 2007)

Based on the above, regarding each category of (i) and (ii), issues of the relationship with the principle of shareholders' will and the granting of cash or other financial benefits to the acquirer can be understood, in relation to past judicial precedents, as follows.

- (3) Cases where adequate time and information necessary for shareholders to appropriately decide whether to support or oppose the takeovers and opportunities for negotiation between the acquirers and the target companies are ensured by takeover defense measures (3. (2) (i) above)

- (i) Relationship with the principle of shareholders' will

Arbitrary operations should not be permitted, such as repeatedly requesting information from the acquirer or unnecessarily extending the period for consideration of the takeover proposal, on the pretext of ensuring adequate time and information or opportunities for negotiation with the objective of dissuading the acquirer from the takeover.¹⁰

When such arbitrary operations are avoided, the board of directors would be permitted to adopt takeover defense measures and implement them against the acquirers who do not temporarily halt, violating procedures within a scope recognized as reasonable, in case of ensuring adequate time and information necessary for shareholders to appropriately decide whether to support or oppose the takeovers or opportunities for negotiation to extract better takeover terms for shareholders through negotiation with the acquirers.

In relation to this point, the court ruled in the Japan Engineering Consultants case that "for shareholders to appropriately decide ...the board of directors is permitted to exercise its authority to provide necessary information and to gain a suitable period for consideration..." and that "in some cases, it should also be allowed to take appropriate measures against an acquirer who does not respond to reasonable requests,...from the perspective of protecting the interests of shareholders as a whole, by reason that necessary information and a suitable period for consideration is not ensured."¹¹

had judged that the acquisition of control by the acquirer would be detrimental to the company's interests and thus the shareholder interests and affirmed the implementation of the takeover defense measure.

10 Requiring the acquirer of information disclosure exceeding the level necessary for shareholders to appropriately decide whether to support or oppose the takeover and then implementing takeover defense measures on the ground that such disclosure is not done should be allowed. Needless to say, the board of directors of the target company should not be allowed to decide arbitrarily the level of information necessary for shareholders' decision, and it should be determined objectively.

11 Specifically, the rulings of the court are as follows (Tokyo District Court decision of July 29, 2005, on the Japan Engineering Consultants case).

"In case of contest for corporate control, the decision of whether to delegate the management of the company to either incumbent management or the hostile acquirer ... should be made by shareholders. For

In contrast, to the cases where takeover defense measures are implemented based on the substantive judgment that the takeover proposals are detrimental to the shareholder interests, after the acquirers observe reasonable procedures and adequate time and information for shareholders to appropriately decide and opportunities for negotiation are ensured, the analysis in this section does not apply. For such cases, the more restrictive analysis of (4) below should be referred to.¹²

- (ii) On the granting of cash or other financial benefits to the acquirers
The decision whether to accept or reject a takeover should in the end be made by shareholders. Therefore, in cases where the acquirers do not follow reasonable procedures and do not allow shareholders adequate time and information to appropriately decide whether to support or oppose the takeovers or opportunities for negotiation, there is no need to grant cash or other financial benefits in implementing takeover defense measures. In such cases, the acquirers have the opportunity of consummating the takeovers successfully, by ensuring shareholders the opportunities to decide by giving them adequate time, information, and opportunities for negotiation and having shareholders express their support for the takeovers. Thus, when the acquirers do not observe the procedures, it would be within the scope of reasonableness to implement takeover defense measures without granting cash or other financial benefits (see the note on page 18).
- (iii) Level of information disclosure to shareholders

shareholders to appropriately decide this matter, the board of directors is permitted to exercise its authority to provide necessary information and to ensure a suitable period for consideration. Therefore, it would not be a abuse of the authority of the board of directors if, when a hostile acquirer contesting corporate control appeared, the board of directors requests the hostile acquirer to present a business plan and establish a period for consideration, to discuss with the acquirer to consider the business plan, to express its views as the board of directors, and to propose alternatives to shareholders, as long as the materials requested and the period for consideration are reasonable."

"... The board of directors can not only request at its discretion that a hostile acquirer present a business plan and establish a suitable period for consideration for the purpose of providing appropriate information to shareholders to make their appropriated decisions possible, but, in some cases, it should also be allowed to take appropriate measures against an acquirer who does not respond to reasonable requests, ... from the perspective of protecting the interests of shareholders as a whole by reason that necessary information and appropriate period for consideration is not ensured.

12 For example, such cases belong to the category of (3) rather than (4), where takeover defense measures are used in the face of takeovers to temporarily halt them until general meetings of shareholders scheduled within a certain period, where shareholders' will on whether to accept or reject the takeovers is to be queried, so that adequate time and information necessary for shareholders to decide and opportunities for negotiation would be ensured. In such cases, verifying the shareholders' will on whether to accept or reject the takeovers by choosing at general meetings of shareholders between opposing resolutions on the election of directors proposed by the company and directors proposed by shareholders is merely the occurrence of what is scheduled under the category of (3), not belonging to the category of (4).

Within the category of (3), since the objective of takeover defense measures is to provide adequate time and information necessary for shareholders to appropriately decide whether to support or oppose the takeovers or opportunities for negotiation, information disclosure to shareholders is an important issue.¹³

(a) Information disclosure by the target company

As already noted, the board of directors should fulfill its responsibility to explain matters to shareholders so they can decide whether to support or oppose the takeover. From such a perspective, it would be desirable for the target company to disclose matters in specific detail, including indicating financial figures, such as (1) management vision and management policies of the incumbent management or an alternative proposal, (2) evaluation of the purchase price by the incumbent management, and (3) judgment of incumbent management, if any, that the takeover will be detrimental to the shareholder interests.¹⁴

The regular disclosure of management vision or management policies ((1) above), however, is a companies' responsibility to shareholders. If such disclosure is made adequately, it would also be possible, in the face of takeovers, to present the same material to shareholders, revised as necessary with current information.

(b) Information disclosure by the acquirer¹⁵

There are certain limitations to information disclosure by the acquirer, given that the acquirer does not undertake due diligence and that disclosing all specific figures, such as profit for the post-takeover period, is equivalent to forcing the acquirer to show his hand and would give rise

13 The subject of examination here is the information provision that is required by or required from the target company, from the perspective of the managerial responsibility for explaining so that by using takeover defense measures shareholders can appropriately decide whether to support or oppose the takeover. From the perspective of ensuring the fairness of capital markets and of providing and disclosing appropriate information to shareholders and investors, a disclosure system has been established under the Financial Instruments and Exchange Act, to which both the target company and the acquirer must naturally comply.

14 However, with respect to the evaluation of the purchase price ((2) in this sentence), it would be difficult to demand to disclose the price which the management think would be appropriate.

15 For shareholders to decide whether to support or oppose a takeover, it would be desirable to fairly secure the opportunity for the acquirer and the target company to directly explain matters such as their proposals to, and to discuss and negotiate with shareholders. For this purpose, it would be desirable for the acquirer to be able to know who the shareholders of the target company are, such as by inspecting the shareholder register. Even in the case that there is formally a cause for rejection of the acquirer's request to inspect the shareholder register, it is not understood that the request can always and uniformly be rejected under the Companies Act (Tokyo High Court decision of June 12, 2008, on the Nihon Housing Co., Ltd. case).

to difficulties in terms of his takeover strategies. Thus, it is reasonable to think that there are limitations to the disclosure of detailed management plans, management outlooks, or profit forecasts for the post-takeover period.^{16,17}

However, given the objective of takeover defense measures to ensure adequate time and information necessary for shareholders to appropriately decide whether to support or oppose the takeover or opportunities for negotiation, it would be desirable for the acquirers to disclose their attributes and basic management policies for the post-takeover period.¹⁸

(4) Cases Where Takeover Defense Measures Are Implemented Based on the Substantive Judgment in View of the Contents of the Takeover Proposals in Order to Deter the Takeovers (3. (2) (ii) (a) and (b) above)

(i) Relationship with the principle of shareholders' will

- (a) Cases where takeover defense measures are implemented against abusive takeovers that are clearly detrimental to the shareholder interests (3. (2) (ii) (a) above)

Against abusive takeovers that are recognized to be clearly detrimental to the shareholder interests, the board of directors may implement takeover defense measures upon its own judgment from the perspective of protecting the shareholder interests. (Tokyo High Court decision on the Nippon Broadcasting System case)¹⁹

16 For example, it would be inappropriate, in comparison with the status of disclosure by the target companies, to implement takeover defense measures on account of the acquirers not providing all information which the target companies have requested to comprehensively disclose, (1) as the basis for calculation of the purchase price, presupposed facts and assumptions of the calculation, the calculation method, numerical information used in the calculation, and the synergy amount and the basis for its calculation or (2) as management policies for the post-takeover period, the details of such matters as business plans, financial plans, capital policies, dividend policies, and asset usage plans.

17 In particular, in the case of an all-or-nothing offer with no minority shareholders left after the takeover, (where a cash tender offer for all shares is made on condition that two-thirds or more of voting shares of the target company are tendered and where the acquirer is committed to, when he acquires two-thirds or more of voting shares, immediately conduct a cash-out merger or other organizational restructuring to pay the remaining shareholders the same amount as the purchase price in the preceding tender offer), it is reasonable to think that the acquirer does not need to disclose detailed management plans, management outlooks, or profit forecasts for the post-takeover period.

18 Given the necessity for the shareholders of the target company to evaluate the adequacy of the purchase price and for the board of directors of the target company to present an alternative proposal to shareholders, the acquirer should disclose basic management policies for the post-takeover period to serve as a reference for the shareholders and the management of the target company.

19 Specifically, the rulings of the court are as follows (Tokyo High Court decision of March 23, 2005, on the

- (b) Cases where takeover defense measures are implemented based on the substantive judgment that the takeover proposals are detrimental to the shareholder interests (3. (2) (ii) (b) above)

As noted above, the implementation of takeover defense measures based on the substantive judgment that the takeover proposals are detrimental to the shareholder interests should be limited.²⁰ Should such takeover defense measures be implemented, as is discussed below, the requirements of necessity and reasonableness should be satisfied.

Shareholders' support expressed at the general meeting of shareholders can be considered as a fact that indicates the implementation of takeover defense measures reflect the reasonable will of shareholders (Notes 1 and 2). It should be recognized, however, that takeover defense measures are not immediately justified simply because a majority of shareholders expressed their support for their implementation. In other words, in relation to the issue of legality, such matters as whether the board of directors has fulfilled its responsibility to explain matters to shareholders in the process of verifying their will as well as the attributes of the acquirer, the content of the takeover proposal, and the shareholder structure of the target company should be considered in judging the fairness of the implementation of the takeover defense measures (see footnote 5 on page 5).

Note 1: Under the Companies Act, excluding matters for resolution of the general meeting of shareholders, significant matters on company management are decided by the board of directors (in the case of companies with board of directors), and one way for shareholders to decide the company's management and governance is appointment or dismissal of directors. Thus, a so-called precatory resolution on adoption or implementation of takeover defense measures receiving the majority

Nippon Broadcasting System case).

“When there are special circumstances justifying the issuance of stock acquisition rights from the perspective of protecting the common interests of shareholders, specifically, when the company can explain and establish that the hostile acquirer is not seeking reasonable management in good faith and that there are circumstances that the acquisition of control by the acquirer would cause irreparable detriment to the target company, the issuance of stock acquisition rights that would influence who should acquire the control of the company cannot be prohibited.”

²⁰ In cases where the contents of takeover defense measures are disclosed before the commencement of a takeover, should the acquirer follow reasonable procedures, and should adequate time and information necessary for shareholders to appropriately decide, and opportunities for negotiation between the acquirer and the target company be ensured, it is assumed that the will of shareholders on whether to accept or reject the takeover will be expressed, in principle, either by shareholders deciding for or against the takeover proposal or by shareholders choosing to appoint or dismiss directors at the general meeting of shareholders.

vote of voting shares at a general meeting of shareholders can be considered as a fact that indicates the takeover defense measures reflect the reasonable will of shareholders.

Note 2: With respect to the cases of (b), there is the view that it is too rigid to require that a general meeting of shareholders always be convened not only when adopting takeover defense measures but also when implementing such measures in the face of takeovers. On the other hand, it is essential that the decision on the implementation of takeover defense measures is based on shareholders' will. Therefore, for the decision to implement takeover defense measures to be made exclusively by the board of directors, at the very least, specific requirements for the implementation should be defined in accordance with individual situations when such measures are adopted and, after such requirements being verified, prior approval of assigning the decision to the board of directors in the face of takeovers should be given by shareholders. In addition, the implementation of takeover defense measures by the board of directors should be within the scope of the approval and in accordance with the specific requirements. It should, however, be recognized that in such cases the board of directors will particularly bear a responsibility to explain that their decision is in accordance with the specified requirements and within the approved scope.

- (ii) On the granting of cash or other financial benefits to the acquirers
 - (a) Cases where takeover defense measures are implemented against abusive takeovers that are clearly detrimental to the shareholder interests (3. (2) (ii) (a) above)

Since the implementation of takeover defense measures in these cases can be viewed to be analogous to legitimate self-defense, there is no need to grant cash or financial benefits to the acquirers.

- (b) Cases where takeover defense measures are implemented based on the substantive judgment that the takeover proposals are detrimental to the shareholder interests (3. (2) (ii) (b) above)

As noted above, in cases where the substantive judgment that the takeover proposals are detrimental to the shareholder interests is recognized as being based on shareholders' will, the requirement of necessity for implementation can be viewed as satisfied. Furthermore, the requirement of reasonableness should be satisfied. From such a perspective, when the acquirer disputes the implementation of takeover defense measures, such as through the appointment or dismissal of directors at the general meeting of shareholders, and when the acquirer's proposal fails to gain the majority vote of shareholders other than himself, it should be possible, for example with time to withdraw or halt the

takeover ensured, for the acquirer to avoid the loss incurred by the dilution of the shareholding ratio resulting from the implementation of the takeover defense measures (possibility of avoiding loss for the acquirer). When such a process is guaranteed for the acquirer, it is reasonable not to grant cash or other financial benefits to the acquirer (Note).

Note: In the Supreme Court's decision on the Bull-Dog Sauce Company case, the court ruled that when the acquisition of control by a certain shareholder would impair the interests of the company and thus the shareholder interests (necessity), it would not violate the intent of the principle of the equal treatment of shareholders to discriminate against that shareholder in order to prevent such impair, as long as the discriminatory treatment does not violate the principle of impartiality and does not lack reasonableness (reasonableness). Based on this reasoning by the court, it can be viewed as a fact which indicates the necessity of takeover defense measures, that a majority of shareholders decided that the takeover proposal is detrimental to the shareholder interests, such as through the appointment or dismissal of directors. Furthermore, as mentioned above, if the acquirer has the possibility of avoiding loss, takeover defense measures cannot lack reasonableness without granting cash or other financial benefits to the acquirer since the acquirer can avoid the loss of the dilution of the shareholding ratio resulting from the implementation of the takeover defense measures by withdrawing or halting the takeover proposal after contesting the implementation of the takeover defense measures.

(In addition, when the contents of takeover defense measures are disclosed before the commencement of a takeover, since the acquirer will begin the takeover while being aware of the potential loss of the dilution of the shareholding ratio resulting from the implementation of the takeover defense measures, it is possible to think that the acquirer has accepted the risk of such a loss (acquirer's acceptance of risk has taken effect).It has been indicated that for this reason it is not necessary to grant cash or financial benefits to the acquirer.)

(5) The Structure of a Special Committee when Establishing Such a Committee

In some cases, as a way to gain the understanding of shareholders that takeover defense measures will not be operated arbitrarily, a special committee, whose recommendations are to be respected as much as possible, is established.

There is an argument, however, that the responsibilities of such a committee are vague from the perspective of shareholders, and it should be recognized that formally establishing such a committee and following its recommendations will not immediately justify the decisions of the board of directors.

Hence, the board of directors should decide with responsibility on the necessity of establishing a special committee and the committee's composition, and it should bear the responsibility of explaining to shareholders that this decision is reasonable. It has been indicated that it would be desirable if a special committee is mainly composed of independent, outside directors. Whatever the case, substantial independence of the committee from the incumbent management should be ensured.

Furthermore, when a special committee is established and when its recommendations are to be respected as much as possible in the face of takeovers, it should be recognized that the board of directors bears final responsibility for its decision to follow the committee's recommendations and the responsibility of explaining to shareholders that this decision is reasonable.

4. In Conclusion

This report presents the essence of takeover defense measures at the present day in light of environmental changes after the establishment of the Guidelines.

This report was published on June 30, 2008. It should be noted that this report could not be referenced for discussion over takeover defense measures in June 2008, when general meetings of shareholders peak.

Appendix: Roster of the Corporate Value Study Group

Chairman	Hideki KANDA	Professor, Graduate Schools for Law and Politics, The University of Tokyo
	Izumi AKAI	Attorney at Law, Sullivan & Cromwell LLP
	Yasuhiro ARIKAWA	Associate Professor, Graduate School of Finance, Accounting and Law, Waseda University
	Kenichi FUJINAWA	Attorney at Law, Nagashima, Ohno & Tsunematsu
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	Hironobu HAGIO	Executive Director and Research Director, NLI Research Institute
	Yasushi HATAKEYAMA	President and CEO, Lazard Fr(e)res K.K.
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	Yuki KIMURA	Director of Corporate Governance, Pension Investment Department, Pension Fund Association
	Masakazu KUBOTA	Managing Director, Nippon Keidanren
	Yasuo KURAMOTO	Director and Vice Chairman, Fidelity Japan Holdings K.K.
	Nami MATSUKO	Executive Director, Investment Banking Consulting Department, Nomura Securities Co., Ltd.
	Motoyoshi NISHIKAWA	Chief Legal Council, Nippon Steel Corporation
	Kenichi OSUGI	Professor, Chuo Law School
	Taisuke SASANUMA	President, Private Equity Association of Japan
	Nobuo SAYAMA	Managing Director, GCA Savvian Group Corporation. Professor, Graduate School of International Corporate Strategy, Hitotsubashi University
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	Kazuhiro TAKEI	Attorney at Law, Nishimura & Asahi
	Mamoru TANIYA	Founding Partner and Chief Executive Officer, Asuka Asset Management, Ltd.
	Shirou TERASHITA	President and Chief Executive Officer, IR Japan Inc.
	Minoru TOKUMOTO	Associate Professor, School of Law, University of Tsukuba
	Tateki UMEMOTO	Chief Compliance Officer and General Manager of Legal Affairs, RECOF Corporation
	Noriyuki YANAGAWA	Associate Professor, Faculty of Economics, The University of Tokyo
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	Hideki KONO	Director, Listing Department, Tokyo Stock Exchange, Inc.

Hidenori MITSUI

Director for Corporate Accounting and
Disclosure, Planning and Coordination Bureau,
Financial Services Agency

Bull-Dog Source
(Supreme Court Judgment of August 7, 2007,
Supreme Court Reports (civil cases) vol.61 no.5, p.2215)

[Summary of Facts]

This was a provisional disposition case in which X (Steel Partners Japan Strategic Fund (Offshore), LP), a shareholder of Y (Bull-Dog Sauce Co., Ltd.) which listed in the Second Section of the Tokyo Stock Exchange, sought a provisional injunction against Y with regard to Y's allotment of share options without contribution (Article 277 of the Companies Act). The issues were whether or not Y's allotment of share options without contribution, carried out as a countermeasure against X's takeover bid, was in breach of the principle of the equality of shareholders and in violation of legislation, and fell within 'a method that is extremely unfair'.

The following is the summary of the detailed facts.

X and its affiliates were Y's largest shareholders, holding approximately 10.25% of the total number of issued shares. On 18 May 2007 (all dates hereinafter are in 2007), a limited liability company A, wholly-owned by X, commenced a takeover bid pursuant to the Securities and Exchange Act, for the purpose of acquiring all of Y's issued shares (hereinafter referred to as the "Takeover Bid"). (The original acquisition price was 1,584 yen per share, which included a premium of roughly 12.82% to 18.56% over the average market price of Y's shares. The acquisition price was raised to 1,700 yen per share after Y placed the adoption of a defensive measure against the acquisition on the agenda at a shareholders' meeting.)

On 25 May, Y submitted a statement of opinion to the Kanto Finance Bureau Chief which contained questions for A. In response, on 1 June, A submitted a report to Kanto Finance Bureau Chief which contained answers to the questions.

On 7 June, due to the fact that A's report, which contained answers to Y's questions, included no specific statements with regard to business plans or capital investment recovery policies for after the acquisition of the right to control the business, Y's board of directors passed a resolution opposing the Takeover Bid. The board of directors also decided to submit to the annual shareholders' meeting, scheduled to be held on 24 June 2007 (hereinafter referred to as the "Shareholders' Meeting"), the following proposals as countermeasures against the Takeover Bid: (1) A proposal to amend the articles of incorporation to make matters concerning an allotment of share options without contribution matters for a special resolution of a shareholders' meeting; and (2) conditional on the approval of the previous proposal, a proposal to carry out an allotment of share options without contribution (hereinafter referred to as the "Allotment of Share Options without Contribution"). The

proposals were approved at the Shareholders' Meeting with approximately 88.7% of the total voting rights present in favor and approximately 83.4% of the total voting rights in favor.

Incidentally, the Allotment of Share Options without Contribution allocated shareholders share options at the ratio of three shares per owned share. The shareholders, except for X and its affiliates (hereinafter referred to as XX), were able to receive issued shares by exercising the share options allocated. XX's share options, however, had discriminatory exercise conditions which rendered XX ineligible to exercise the allocated share options, as well as discriminatory acquisition provisions which made it possible for Y to acquire XX's share options by monetary grant.

On 13 June, prior to the Shareholders' Meeting, X petitioned for a provisional disposition seeking an injunction against the Allotment of Share Options without Contribution, pursuant to Article 247 of the Companies Act. The court at first instance (Tokyo District Court decision, 28 June 2007, Kinyu Shoji Hanrei No. 1270: 12) ruled that, when an allotment of share options without contribution was granted to shareholders, and the allotment without contribution resulted in substantive changes in the status of shareholders, the provisions in Article 247 of the Companies Act would apply by analogy, and the purport of the principle of the equality of shareholders was applicable. Ruling that the Allotment of Share Options without Contribution was not in breach of the principle of the equality of shareholders, however, and that it was not effected by 'a method that is extremely unfair', the court at first instance denied X's petition. The lower court (Tokyo High Court decision, 9 July 2007, Kinyu Shoji Hanrei No. 1271: 17) also dismissed X's appeal, ruling that the Allotment of Share Options without Contribution was necessary and reasonable in order to prevent harm to the value of the company, that XX was an abusive acquirer, and that Y's Allotment of Share Options without Contribution could neither be said to be in breach of the principle of the equality of shareholders, nor to have been effected by 'a method that is extremely unfair'.

[Summary of Decision]

Appeal dismissed.

The Supreme Court ruled as follows: (1) The purport of the principle of the equality of shareholders prescribed in Article 109(1) of the Companies Act applies to an allotment of share options without contribution. (2) When the common interests of the shareholders are prejudiced, it is not in breach of the principle of the equality of shareholders to treat certain shareholders in a discriminatory manner in order to prevent the harm, so long as this is not contrary to the principle of fairness or inappropriate. (3) The decision as to whether or not the common interests of the shareholders are prejudiced should ultimately be made by the shareholders, and should be respected, so long as there is no serious flaw such as would make the decision inappropriate. In light of the fact that almost all the shareholders, except for XX, determined that X's acquisition of the right to control the business would harm the common interests of the shareholders, that there was no serious flaw which would make the decision

inappropriate, and that the Allotment of Share Options without Contribution was neither in breach of the principle of fairness, nor inappropriate, the Supreme Court ruled that the Allotment of Share Options without Contribution was neither in breach of the principle of the equality of shareholders nor in violation of legislation, without ruling on whether XX constituted an abusive acquirer. Moreover, in light of the fact that the Allotment of Share Options without Contribution was not in breach of the principle of the equality of shareholders, that the Allotment of Share Options without Contribution was a measure to cope with an urgent situation, which was implemented pursuant to a decision made at a Shareholders' Meeting, that consideration was paid equivalent to the value of the share options allocated to XX, and that the Allotment of Share Options without Contribution was not carried out in order for the directors and other officers to maintain the right to control the business, the Supreme Court ruled that the Allotment of Share Options without Contribution did not fall within cases involving 'a method that is extremely unfair', and dismissed X's appeal.

Bell System 24
(Tokyo High Court Judgment of August 4, 2004,
Finance and Commerce Judicial Precedent No.1201 p.4)

[Summary of Facts]

The Obligor Bellsystem24 (X), Inc., which was a corporation primarily engaged in the telemarketing business, planned to issue 5,200,000 new shares, which exceeded the existing total number of issued shares in the Obligor (4,898,700 shares), utilizing the third party allotment capital increase method (hereinafter referred to as the “New Share Issue”). In this case, the Obligee CSK Corporation (Y), which was the largest shareholder in the X (holding approximately 40% of the total issued shares), petitioned for a provisional disposition seeking an injunction against the New Share Issue, on the basis that it fell under share issues made... using a “method which is extremely unfair” prescribed in Article 280-10 of the Commercial Code.

On 30 July 2004 the decision of the lower court, namely the Tokyo District Court, dismissed the petition. The Y filed an appeal in response. However, the appeal court, the Tokyo High Court, dismissed the appeal.

In its decision the lower court firstly recognized a series of facts with respect to matters including an outline of the New Share Issue, discord over the management of the X between the Y's representative, who was an outside director of the X, and the current management of the X, including the X's representative, and details of the business plan for which it was intended to use the increased capital obtained through the New Share Issue (a business alliance with a third party corporate group). The Court stated with respect to the interpretation of the meaning of an issue of new shares made using a “method which is extremely unfair” prescribed in Article 280-10 of the Commercial Code, that this wording applied to situations where the issue of new shares was used as a means to achieve improper purposes. The Court further stated that when there was a conflict over the right to control a stock company, new shares were issued in such a quantity as to significantly affect the stockholding ratio of existing shareholders and were allocated to third parties, and it was determined that the primary purpose of the issue of new shares was to lower the stockholding ratio of a particular shareholder and to maintain the current management's right to control, such issue of new shares would fall within means used for achieving improper purposes. In addition, the Court ruled that, in this case, although it was undeniable that the X's representative and some of the X's current management intended to maintain their right to control by lowering the Y's stockholding ratio, the X needed to raise funds through the New Share Issue in order to carry out the business plan regarding the business alliance with a third

party corporate group, and that the business plan itself was, on an initial examination, reasonable. The Court ruled that, at least at the time the Board of Directors passed the resolution for the New Share Issue, it could not be found that the primary purpose of the New Share Issue was to maintain the right to control of the X's current management, namely, that the New Share Issue was a means for achieving such an improper purpose, and dismissed the petition for an injunction against the new share issue in the case.

[Summary of Decision]

On appeal, the Court ruled that, although the suspicion that the representative and some of the current management of the Respondent (X) intended to maintain their right to control by lowering the stockholding ratio of the Complainant (Y) could not be easily denied, there was a need to raise funds through the New Share Issue in order to carry out the business plan. It followed that, in this case where it could also be found that the business plan was reasonable, even if the Respondent did intend to maintain its right to control by lowering the stockholding ratio of the Complainant, it was difficult to find that such intention was the only motive in the New Share Issue. Furthermore, ruling that the Court could not go as far as to find such intention to have been predominant over the appropriate intentions of developing the company and improving company performance, the Court ruled that the New Share Issue was not made using a "method which is extremely unfair." Moreover, the Court did not allow the assertions by the Complainant that the business plan included engaging in the leasing business, which was not part of the business purposes described in the articles of incorporation, that there was a breach of the directors' duty of care as prudent managers because relevant information was not disclosed at the Board of Directors meeting when the resolution on the New Share Issue was passed, and that the New Share Issue fell under issues of new shares "in violation of laws and regulations" on the grounds described above, and accordingly, dismissed the appeal.

Nippon Broadcasting System
(Tokyo High Court Judgment of March 23, 2005,
Hanrei-jiho No. 1899, p. 56)

[Summary of Facts]

Y (Nippon Broadcasting; the obligor and Final Appellant) was a member of Z's (Fuji Television's) group of companies. Z launched a takeover bid for Y's shares with the aim of securing control over the management of Y. X (Livedoor; the obligee and Adverse Party) held around 5% of Y's issued shares. By purchasing shares in Y during the takeover bid period in off-floor trading, X came to own 35% of Y's shares, and it also continued to accumulate Y's shares after that. At a meeting, Y's board of directors voted to issue a large quantity of share options to Z. The number of shares that would be issued if all of these share options were exercised would come to 1.44 times the number of Y's total issued shares, and if these were exercised, X's shareholding in Y would be reduced from around 42% to approximately 17%, whilst on the other hand, Z's shareholding would rise to about 59% even taking into account only the number of shares it would acquire if it exercised the share options. Arguing that the issue of the share options was made by a "method that is extremely unfair" as stipulated under Article 280-10 of the Commercial Code (see also Article 247(ii) of the Companies Act) applied *mutatis mutandis* under Article 280-39(4) under the Code (prior to the revision of that provision by Act No. 87 of 2005; the same applies hereinafter), X filed a suit for a provisional injunction to block the share option issue, which the Tokyo District Court granted: decision of 11 March 2005; Hanrei Taimuzu No. 1173: 143. Whilst Y filed an immediate objection against this ruling, the Tokyo District Court rejected the objection and issued a ruling that confirmed the order to allow the provisional injunction: decision of 16 March 2005; Hanrei Taimuzu No. 1173: 140. Y immediately filed an appeal to the court of last resort to challenge this ruling.

[Summary of Decision]

Appeal to court of last resort dismissed with prejudice on the merits (decision made final and binding).

"In a situation where a dispute has in fact arisen over the right to control the management of a company, if a share option issue is made principally for the purpose of reducing the shareholding ratio of a particular shareholder who, through hostile acquisitions of the company's shares, is vying for control of the company, and/or for the purpose of maintaining or securing such control by the current board of management or by another particular shareholder who supports or has *de facto* influence over that board, as a general rule it is appropriate to construe that issue as constituting an issue of share options made in "a significantly unfair manner" as stipulated in Article 280-10 of the Commercial Code applied *mutatis mutandis* under

Article 280-39(4) of that Code.

The reason for not permitting a share option issue principally for the purpose of maintaining or securing control of the management of the relevant company is, of course, because the directors stand in a fiduciary relationship in respect of the company's shareholders, who are the proprietors of the company. It follows that in the application of special circumstances that would justify a share option issue from the viewpoint of protecting the interests of the company's shareholders as a whole, as an exception to the general rule stated above, the correct view to be taken is that, [due to the special circumstances], such a share option issue, even if made principally for the purpose of maintaining or securing control of the company by a particular shareholder, would not constitute an unfair issue.

An example of such special circumstances would be where a hostile buyer of a company's shares intends to simply or largely prey on the company. Examples of such exploitation would be ① where the buyer has no true intention of playing a constructive role in managing the company, and is acquiring the shares for the sole purpose of boosting the share price so as to force the company and its supporters to take the shares back at an inflated price (known as a 'greenmail' case); ② where the buyer acquires the shares with the aim of gaining temporary control of the company so that it can conduct a 'scorched earth' policy of management towards the company, whereby it has the intellectual property, know-how, trade secrets, principal trading partners and customers that the company needs to conduct its business transferred to itself or to its group companies; ③ where the buyer acquires the shares with the expectation upon gaining control of the company of diverting the company's assets as security for or as sources of funds to repay debts of the buyer or its group companies; ④ where the buyer acquires the shares with the aim of gaining temporary control of the company in order to sell off its high-value assets such as real estate and/or securities that are for the time being not pertinent to the company's business. In that event, the buyer's aim will be to use the profits from such divestment to pay out temporarily high dividends or, to set its sights on taking advantage of the spike in the company's share price that would result from the payment of temporarily high dividends and sell off the shares when they peak. A hostile buyer acquiring shares for such exploitative purposes will not deserve protection as a shareholder, and since it will be clear that if nothing is done about such hostile buyer, the interests of the other shareholders will be harmed, the proper view to take is that the board of directors carrying out a share option issue principally for the purpose of maintaining or securing control of the company by a particular shareholder will be permitted as just and proper – to the extent judged to be necessary and reasonable as a means of defense against such buyer.”

“It follows that in a situation where a dispute over the control of management of a company has in fact arisen, if a share option issue is carried out for the purpose of maintaining or securing control of the company by a particular shareholder, as a general rule a petition for an injunction to stop the issue should be allowed on the grounds that it constitutes an unfair

issue. However, in the event that the company has prima facie evidence or proves that special circumstances are applicable that would justify such share option issue from the viewpoint of protecting the interests of shareholders as a whole (specifically, where the sound and proper management of the company is not the hostile buyer's true aim, and the acquisition of control by the hostile buyer will result in losses to the company that will be hard to restore), no injunction may be issued against a share option issue that would affect who has control of the company."

Nireco

(Tokyo High Court Judgment of June 15, 2005,
Hanrei-Jiho No. 1900, p. 156)

[Summary of Facts]

The obligee, the SFP Value Realization Master Fund Ltd. (X) was a shareholder of the obligor Nireco Corporation (Company Y), a company trading on the Jasdaq market. X held 2.85% of the outstanding shares of Company Y. At a meeting of its board of directors on 14 March 2005, Company Y voted to carry out a share option issue on the following terms, and it made a public announcement to the Jasdaq Securities Exchange of a “security plan” to that effect (hereinafter, the “Plan”).

(1) Company Y intended to forestall any losses to its corporate value as a result of a predatory acquisition of Company Y, and in the event of a proposal to acquire Company Y, it would issue share options with the aim of using them as a reasonable means for maximizing Company Y’s corporate value; (2) Share options were to be given to shareholders listed in Company Y’s shareholder registry as of 31 March 2005, without contribution, at the rate of two options for each share held; (3) The issue date of the share options would be 16 June 2005; (4) The amount to be paid in on the exercise of the share options would be ¥1; (5) The period for exercising the share options would be from 16 June 2005 to 6 June 2008; (6) The terms of exercise would be that the share options could be exercised should the mechanism commencement prerequisite be met at any time between 1 April 2005 and 16 June 2008. The “mechanism commencement prerequisite” was that Company Y’s board of directors had become aware of, and made a public announcement about, the existence of a specific holder of Company Y’s shares (namely, a person such as a person making a takeover bid for Company Y, where that person and persons in certain relationships with that person together hold 20% or more of Company Y’s total issued shares with voting rights); (7) As to cancellation, if the board of directors thinks it necessary in order to maximize Company Y’s corporate value, at any time before the mechanism commencement prerequisite is triggered Company Y could cancel all of the share options simultaneously without consideration by way of a resolution of the board of directors on a date to be determined by the board of directors; (8) That transfers of the share options would be subject to approval by Company Y’s board of directors; provided, however, that Company Y’s board of directors would approve no such transfer.

On that same 14 March, Company Y’s board of directors adopted guidelines for properly deciding the cancellation of the share options in this case. These guidelines stipulated that: (9) After taking into reasonable account the matters for consideration stipulated by the guidelines (such as matters pertaining to a fair value for Company Y’s issued shares to be

calculated on the basis of data including Company Y's business plan, matters pertaining to the effect of a takeover acquisition on Company Y's minority shareholders, and matters pertaining to the content of an acquisition proposal from a buyer), the board of directors was to adopt a resolution to either cancel the share options without charge or to not cancel them without charge, depending on which of those resolutions would maximize Company Y's corporate value; (10) When voting on this resolution, the board of directors was to set the utmost value on the recommendations of a special committee; and (11) The special committee was to be comprised of three members in total, two of whom would be attorneys, certified public accountants or persons with relevant knowledge and experience having no interest in the cancellation or non-cancellation of the share options in this case, who would be designated by Company Y's Representative Director & President and Company Y's board of directors. (Although while this case was pending these guidelines were amended by Company Y's board of directors at a meeting on 20 May, the details of those amendments can be omitted here.)

In order to be recorded as a shareholder in Company Y's shareholder registry on 31 March 2005 (the allotment record date (vesting date) for the share options), investors were required to purchase shares in the company at least four business days prior to the record date. This meant that, in this case, if investors did not buy Company Y shares by Friday 25 March, they could not receive an allotment of the share options.

On grounds including that the share option issue in this case constituted an unfair issue, X filed suit for a provisional injunction. (The Tokyo District Court did not accept X's other grounds, which were therefore not taken up by the Tokyo High Court in its ruling. Accordingly they are omitted from this report.) The originating court ruled in favor of the provisional injunction against the share options in this case. In response to Company Y's petition objecting to the provisional injunction, the originating court confirmed the initial ruling to allow the provisional injunction. Company Y therefore brought an appeal to the court of last resort under the Law of Civil Provisional Remedies, seeking to set aside the originating court's decision.

[Summary of Decision]

(1) On the purpose behind the Plan: "It may be accepted by and large that the Plan has – as Company Y asserts – a preventive function, in that the share options scheme in this case will be employed to put a temporary halt early on to any takeover by a buyer, thereby giving that buyer a motive to negotiate in earnest with the board of directors over the terms of the takeover, in effect ensuring that the buyer will create an opportunity for negotiations.

However, the consequence of reducing the shareholding ratio of a particular shareholder through the exercise of the share options, in order to defend the company from a predatory buyer, will be to maintain or secure control of the company by the managers at that time or by particular shareholders who support that management. In that context, given both the

prerequisite for and the effect of the exercise of the share options in this case described earlier, it cannot be denied that an important purpose of the share option issue also lies in maintaining or securing control of Company Y by the existing board of directors and/or its supporters among the shareholders.”

(2) On the points of concern with the Plan: “Since a board of directors stands in a fiduciary relationship to the shareholders as the owners of the company, company directors have been construed to have an obligation to exercise their authority so as not to cause unwarranted disadvantage to the shareholders.

However, the share option issue in this case however was to be without charge, and the exercise price was set at 1. Moreover, a large quantity of options is to be issued. Given these elements, shareholders who have no connection to a takeover are likely to be disadvantaged, for the following reasons.”

(3) On the financial losses to be caused to shareholders who have no connection to a takeover: “If the share options in this case are not cancelled any time before 16 June 2008 and are in fact exercised, resulting in the issue of new shares, investors who acquired shares in Company Y on or after the ex-rights date for the share options (28 March 2005) will continue to face the risk that their shareholding in Company Y will be diluted by around two-thirds, irrespective of whether they are a predatory buyer or not. It is furthermore not possible to predict under the Plan if a situation will ever arise in the future where the prerequisite for the exercise of the share options will be met or at what point in time it will be met. Even if the probability of that situation occurring is fairly low, it is nevertheless not possible for these shareholders to take the risk that these share options will be exercised at any time, thereby diluting their holdings of Company Y shares by about two-thirds and leading to a large fall in the share price, lightly. It is also not possible to deny that in regard to any potential rise in Company Y’s share price on the stock market over the coming three-odd years over which the Plan will operate, the risk of such an event will act as a powerful downward force that will curb any increase in price.

That being the case, faced with these destabilizing factors, Company Y’s shares will become less attractive as an investment, inspiring little to no desire on the part of investors and only strengthening the disinclination to acquire them. (Moreover, because the share options in this case are to be issued for no contribution, without any payment in of appropriate value, the price of the shares has already fallen by the value of the options.) As a result, there is a good possibility that the price of these shares will languish over the long term, meaning that existing shareholders who acquired the share options face the risk of both a decline in the share price as well as the loss of a long-term capital gain. Such disadvantages are properly described as unforeseen financial losses which could not arise were it not for the issue of the share options in this case.”

Japan Engineering Consultants
(Tokyo District Court Judgment of July 29, 2005,
Hanrei-jiho 1909, p.87)

[Summary of Facts]

The obligor Japan Engineering Consultants Co., Ltd. (hereinafter, “Company Y”) was a stock company that provided construction consultant services. The obligee Yumeshin Holdings Co., Ltd. (hereinafter, “Company X”) was a stock company with business purposes that included holding, buying, selling, investing in and managing securities. Company X advised Company Y that it intended to acquire 51% of Company Y’s shares. As of 21 July 2005, Company X held 509,000 shares in Company Y, equal to around 6.83% of Company Y’s total outstanding shares. Company X and Company Y held talks on 7 July 2005, but on the following day Company Y announced that it would introduce “certain rules concerning the advance supply of information” (hereinafter, the “Large Purchase Rules”) and that, in response to any large purchasing activity of its shares which did not comply with the Large Purchase Rules, Company Y’s board of directors would act in defense against such large purchasing activity, by selecting the course of action that it judged to be the most appropriate at that time. In response, at a meeting of its board of directors on 11 July 2005, Company X voted to make a takeover bid for Company Y, for ¥50 per share. Following that vote offensive and defensive moves by Company X and Company Y gradually grew in intensity, and at a meeting of its board of directors on 18 July 2005, Company Y ruled that the situation came within the operation of the Large Purchase Rules and voted to split its shares at a ratio of five for one (hereinafter, the “Share Split”) and to amend its articles of incorporation as a consequence so as to increase the total number of shares available for issue (hereinafter, the “Board Resolution”). In response, at a meeting of its board of directors on 19 July 2005, Company X voted to make a takeover bid on conditions including an offer price of ¥110 per share. (Prior to this on 15 July that year, Company X had sent a letter to the Kanto Local Finance Bureau in which it said it had taken the precaution of including an anti-dilution clause in the formal notice of its takeover bid, to the effect that in the event of a share split it would seek approval to both increase the number of share certificates that it expected to acquire and to amend the offer price, in order to reflect the share split.) Although Company Y’s board of directors adopted a resolution declaring its opposition to this takeover bid, Company X went ahead and began its takeover bid (hereinafter, the “Takeover Bid”).

It was in these circumstances that Company X (who was Company Y’s largest shareholder) brought this action for a provisional injunction against the Share Split in the Board Resolution of 18 July 2005. The legal grounds on which Company X based its action were: ① its right to seek an injunction by operation, or operation by analogy of, Article 280-10 of the Commercial

Code, on the grounds that the share split in question was in breach of legislation including Article 218(1) of the Commercial Code, Article 157 of the Securities Exchange Act and Article 90 of the Civil Code, or was carried out in an extremely unfair manner; ② its right to seek a declaration of invalidation of a board of directors resolution on the grounds that the board of directors resolution in question was in breach of legislation including Article 218(1) of the Commercial Code; and ③ its right to seek an injunction on the grounds that the share split in question infringed Company X's goodwill.

[Summary of Decision]

Petition dismissed without prejudice (decision made final and binding).

(1) The purpose of the Share Split

“The purpose of the Share Split is to block the obligee (Company X) from making the takeover bid before the annual shareholders meeting of the obligor (Company Y), by adoption of the Board Resolution before the obligee made the Takeover Bid.”

“Although one result of the Share Split will be to allow the current board of management to retain control of the company, we cannot go so far as to say that the Share Split is an endeavor by the directors to protect their own interests.”

“Since the Takeover Bid allows for the offer price to be amended from ¥50 on initial expectations to ¥110 on the premise of ex-rights as a result of the Share Split,there is no likelihood that Company X will sustain a significant financial loss by being forced to buy the diluted shares at the pre-split price.”

“Whilst if the Takeover Bid is successful the Share Split will have the effect of postponing the Takeover Bid from taking effect until 3 October of that year, from a legal standpoint it will not prevent Company X from achieving the objective of the Takeover Bid. Furthermore, since the Share Split is no different from any ordinary share split, one must conclude that it is not an action that will bring about a material change in the rights of existing shareholders.”

(2) The applicability, or applicability by analogy, of Article 280-10 of the Commercial Code to the share split

“In the event that a company issues shares either in breach of legislation or its articles of incorporation or in an extremely unfair manner likely to result in disadvantage to a shareholder of that company, the Commercial Code recognizes a right in that shareholder to sue the company for an injunction to stop that new share issue: Article 280-10. The purpose of that provision lies in providing a remedy in advance in respect of such a new share issue due the risk of disadvantage that shareholders face (because, for example, the company has disregarded their subscription rights, or the percentage of their voting rights will be reduced, or they will sustain a financial loss in the form of a lower share price once the new shares are

issued at a generally more favorable price). By contrast, a share split does nothing more than simply subdivide the shares so as to create a greater number of shares than at present. It follows that, excluding the event where two or more classes of shares might have been issued in the split, notwithstanding that the number of shares that a shareholder comes to own may increase as a result of the split, since there will be no change in the percentage of the shareholder's voting rights or in the overall value of his/her shares once all the shares resulting from the split are aggregated, it is not possible to imagine in any normal circumstances that the shareholder is likely to suffer a disadvantage, be it a reduction in the percentage of his/her voting rights or financial losses in the form of a lower share price. For that reason this provision of the Commercial Code did not provide a similar right to seek an injunction against a share split as provided in respect of a new share issue."

"Since this Court is unable to find that the Share Split will bring about a material change in the interests of Company Y's shareholders, there can be no application by analogy of Article 280-10 of the Commercial Code."

(3) Validity of the Board Resolution

"In the event of a dispute over managerial control of an enterprise, the decision to entrust management to either the current board of management or to the 'hostile' purchaser (in the sense of 'opposed by the company's current managers'; the same applies hereinafter) is to be made by the shareholders. Accordingly, so that the shareholders can make this decision properly, the board of directors may be regarded as permitted to exercise its authority so as to provide shareholders with any information that they will need and to secure a reasonable period of time for their due consideration of that information. It follows that following the appearance of a hostile purchaser vying for control of the company, it cannot be described as an abuse of authority by the board of directors for it to secure from that hostile purchaser a proposed business plan and a period of time to study that plan, hold formal discussions with that purchaser on the details of that business plan, express its opinion on the plan and accordingly on the takeover in its capacity as the board of directors and in addition, present any alternative plans to the shareholders, so long as both the content of the material to be submitted and the period for examination that the board requests are reasonable."

"The question of whether the defensive measures adopted by the board of directors are reasonable or not is to be decided by taking into overall consideration factors including the intention of the board of directors in adopting the defensive measures, the circumstances behind and leading up to the adoption of those defensive measures, whether or not the defensive measures will disadvantage existing shareholders, and if so, to what extent, and the effect of the defensive measures on impeding the takeover."

"Restrictions on the authority of the board of directors, which are based on maintaining the principle that it is the shareholders of a stock company that elect its directors and not

vice versa, derive from the general provisions in the Commercial Code regarding stock companies, and not from any specific legal provisions. For that reason, a resolution of the board of directors cannot be construed as invalid on the grounds that these restrictions have been breached. In addition, nor can the Board Resolution, be described as in breach of the legislative intention for this balance of elected authority prevailing under the Commercial Code.”

(4) Infringement of goodwill

“Since there can be said to exist no right in substantive law in the form of such goodwill, even if this Court were to find that Company X had goodwill on the facts before it, it can nevertheless find no basis in substantive law to the effect that the infringement of such right would entitle Company X to an injunction against the Share Split on the basis of that right ...”

