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Corporate Value Study Group's Report on Takeover Defenses

In principle, payments to a prospective acquirer are not required when defenses are implemented

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Summary

- On 30 June, the Ministry of Economy, Trade and Industry's Corporate Value Study Group released a report on how takeover defense should be conducted considering recent changes in surrounding circumstances.
- The report describes how the takeover target's directors should behave at the time of a takeover attempt, and states, amongst other points, that the conditions for implementing a defense must not be interpreted so broadly as to include defenses for the purpose of self-trenchment.
- The report includes an examination of whether or not to permit the implementation of a takeover defense measure, and whether or not payments need to be made to the prospective acquirer in the event of the defense being implemented, examining three different situations and concluding that payments are, in principle, not required.

1. Introduction

Having considered recent changes in the surrounding circumstances, on 30 June, 2008, the Japanese Ministry of Economy, Trade and Industry (METI)'s Corporate Value Study Group released its report on how takeover defense should be conducted ("the Report": a Japanese-language report entitled "Kinji no Shokankyo no Henka wo Fumaeta Baishuboeisaku no Arikata")¹.

In conjunction with the Ministry of Justice, METI published its "Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests" (hereinafter referred to as the "Guidelines") on 27 May, 2005. The current Report gives details of takeover defense measures adopted after the publication of the Guidelines, and, taking into consideration cases where the defenses have been implemented, reinforces details of the Guidelines.

Unlike the Guidelines, the current Report does not include the Ministry of Justice as joint author, so it appears that there is some debate as to its legal status².

¹See Ministry of Economy, Trade and Industry website (Japanese language report: <http://www.meti.go.jp/report/data/g80630aj.html>).

²The Ministry of Justice / FSA took part as observers.

2. Current Approach to How Takeover Defense Measures Should be Conducted

The Report sets out the current approach to how takeover defense measures should be conducted.

First of all, concerning payments to the prospective acquirer when a takeover defense measure is implemented, the Report concludes that for the following reasons, payments should not be made to the prospective acquirer.

- (1) Making payments to the prospective acquirer is problematic because it has the adverse effect of encouraging the implementation of takeover defense measures, with a resulting loss to shareholders of the opportunity to sell shares to the prospective acquirer after securing the time, information and occasion for negotiation necessary to make an appropriate decision on the pros and cons of the attempted takeover, thereby hindering the development of sound capital markets.
- (2) If payments are made in this way, there is a risk of the interests of the takeover target's shareholders being impaired as a result of funds that ought to have contributed to the common interests of the shareholders of the takeover target being transferred to the prospective acquirer.
- (3) A takeover defense measure should not be implemented at all if the directors of the takeover target are unable to responsibly explain that a takeover defense measure can be implemented without making payments because it is a takeover that would damage shareholder interests.

Next, after making the following points, the Report states that responsible and disciplined behavior is expected of the takeover target's directors at the time of a takeover attempt.

- (1) Regarding suggestions that takeover defense measures would be legitimized if the directors avoided making their own decision and obtained majority assent from shareholders by formally putting the question to a general meeting, there is the problem that this would result in sending an incorrect message to interested parties that an unassailable defense can be configured as long as the composition of shareholders permits such a decision of a general meeting of shareholders.
- (2) At the time of an actual takeover attempt, if the directors of the takeover target, who are charged with the duty of diligence of a good manager, were to avoid making the primary judgment as to whether or not the takeover proposal meets the interests of shareholders, and instead were to pass the whole weight of the judgment on the pros and cons of the takeover on to a formal decision of a general meeting in an attempt to legitimize their own positions, that could be construed as shirking responsibility.

As stated here in (1), the Report makes it clear that it is not acceptable to simply obtain majority assent from shareholders by means such as schemes involving long-term shareholders or cross-shareholdings.

For the "shareholder interests" mentioned here in (2), it is clearly stated that the concept envisaged is the discounted present value of future cash flow (Report, Note 2). The Report also asserts that this concept should not be arbitrarily extended in interpreting the Guidelines or the current Report (Report, Note 2).

Here, the Report seems to be attempting to put a stop to broader interpretation of the scope within which defense measures are permitted on the grounds that the Guidelines state, "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" (Page 3 of the English translation of the Guidelines).

3. Areas Examined in the Report

As described above, the Report aims to reinforce the Guidelines. Whereas the Guidelines concern takeover defense measures at the time of adoption, the Report concerns the handling of takeover defense measures at the time of implementation and other issues at the time of a takeover attempt.

The areas examined in the Report include the following points at the time of a takeover attempt.

- (1) How directors of the takeover target should behave
- (2) Whether or not to permit the implementation of a takeover defense measure, and whether or not payments need to be made to the prospective acquirer in the event of the defense being implemented
- (3) Establishing special committees, etc.

(1) How Directors of the Takeover Target should Behave

The Report largely gives the following basic approaches for how the board of directors should behave at the time of a takeover attempt.

- (1) The conditions for implementing a defense must not be interpreted so broadly as to include defenses for the purpose of self-entrenchment
- (2) The implementation of takeover defense measures must not be judged necessary solely for that purpose because it is difficult to assert that such a takeover would damage shareholder interests.
- (3) The time taken for considering a takeover proposal must not be needlessly extended beyond a reasonable time, depriving shareholders of the opportunity to decide on the pros and cons of the takeover.
- (4) Serious consideration must be given to the takeover proposal details, etc., including the effect that the takeover would have on shareholder interests, examining the takeover proposal from the perspective of whether or not it enhances shareholder interests.
- (5) In cases where there is potential for improvement to the takeover conditions that would result in the takeover proposal contributing to shareholder interests, a serious attempt must be made to negotiate with the prospective acquirer to improve the takeover conditions.
- (6) In cases where it is judged that the takeover proposal enhances shareholder interests, a decision to not implement the takeover defense measures must be made immediately, without waiting to put the question to shareholders at a general meeting.
- (7) In order for the shareholders to make a decision on the pros and cons of the takeover, the board of directors' assessment etc of the takeover proposal must be based as far as possible on facts, fulfilling the duty to be accountable to shareholders for an explanation.
- (8) In cases where a special committee is established, in addition to assuring its effective independence from current management, the board of directors must take eventual responsibility for deciding whether to follow the committee's recommendations.

(2) Whether or not to Permit the Implementation of a Takeover Defense Measure, and Whether or not Payments Need to be Made to the Prospective Acquirer in the Event of the Defense being Implemented

The Report investigates whether or not to permit the implementation of a takeover defense measure, and whether or not payments need to be made to the prospective acquirer in the event of the defense being implemented, dividing the potential situations into the following three cases.

- (1) Cases where opportunities for negotiation between the prospective acquirer and takeover target can be secured, along with the time and information necessary for shareholders to make an appropriate decision on the pros and cons of the attempted takeover (hereinafter referred to as “Type I”)
- (2) Cases where a material decision is made after consideration of the details of the takeover proposal, and defenses are implemented to stop the takeover
 - (a) Cases where defenses are implemented with respect to an abusive takeover that would clearly impair shareholder interests (hereinafter referred to as “Type II”)
 - (b) Cases where defenses are implemented on the basis of a material decision that the takeover proposal impairs shareholder interests (hereinafter referred to as “Type III”)

(a) Type I

The Report states that in this case, as long as the measure is not made use of in an arbitrary manner, implementation is permitted with regard to a prospective acquirer who does not pause, and who acts contrarily to procedures that are within the scope of what is considered reasonable.

Concerning payments, the Report concludes that payments are not necessary when implementing takeover defense measures in cases where a prospective acquirer acts contrarily to reasonable procedures, and does not permit opportunities for negotiation or the time and information necessary for shareholders to make an appropriate decision on the pros and cons of the attempted takeover.

(b) Type II

In this case, the Report concludes that from the perspective of protecting shareholder interests, the board of directors may at its own decision implement takeover defense measures with respect to an abusive takeover that would clearly impair shareholder interests

Concerning payments, the conclusion is that since this is considered to be a situation where the implementation of takeover defense measures falls into the category of legitimate self-defense, there is no need to make payments to a prospective acquirer.

(c) Type III

In this case, the Report concludes that the implementation of takeover defense measures based on a material decision as to whether the takeover proposal impairs shareholder interests should be decided in a restrictive manner. If measures are implemented, the implementation should be required to be meet conditions of necessity and appropriateness.

In addition, the Report concludes that the assent of shareholders at a general meeting can be considered as circumstances indicating that the implementation of takeover defense measures is based on the reasonable will of the shareholders. However, it goes on to say that it should be remembered that the assent of a substantial numbers of shareholders for the implementation of takeover defense measures should not be construed as immediately legitimizing such takeover defense measures, warning that simply gaining the assent of a general meeting of shareholders is not in itself sufficient to permit the implementation of takeover defense measures³.

Concerning payments, the Report concludes that the prospective acquirer needs the potential to avoid loss through the dilution of shareholding through the implementation

³On this point, the Guidelines state, “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” (Page 6 of the English translation of the Guidelines), which seems to imply that greater importance is to be attached to the decision of a general meeting.

of takeover defense measures, and that in cases where this process is guaranteed, there is considered to be no need to make payments to the prospective acquirer.

(3) Establishing Special Committees, etc.

As one mechanism for obtaining the understanding of shareholders that takeover defense measures are not being used arbitrarily, the Report mentions the establishment of a special committee, with utmost respect being given to the recommendations of the committee.

With regard to special committees, the Report states that formally establishing such a committee and following its recommendations must not be construed as directly legitimizing a decision of the board of directors.

The report also states that the board of directors must take ultimate responsibility for the decision to follow the recommendations, and is accountable for explaining to shareholders that the decision is reasonable.