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—*M&A Activities*—

Negotiations between bidder and target firm can be problematic

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Summary

- Japan's Ministry of Economy, Trade and Industry (METI), Financial Services Agency (FSA), and the Tokyo Stock Exchange (TSE) have set up investigative committees to examine the corporate governance of listed companies.
- In some recent cases, the board of directors of the company targeted in a hostile takeover bid has apparently requested excessive amounts of information regarding post-acquisition business strategies.
- The board's impartiality has also been called into question, even in friendly takeovers.

Negotiations Using Defensive Measures Against Takeovers

Defensive measures are legal means of diluting the stake of certain shareholders by issuing shares via third-party allotment or issuing new stock warrants to all shareholders but the one in question, i.e., the bidder in a hostile takeover. These poison pills tend to be viewed more as a negotiating tool than an actual threat. However, buyout terms cannot be effectively negotiated under zero threat, so there must be a possibility that defensive measures will be invoked.

Defensive measures are negotiating tools

Defensive measures temporarily stop the bidder and force a dialogue with the target firm, which by definition means its shareholders. The shareholders either agree that the offer price is acceptable, or they reject it and negotiate the next step. Of course, the sheer number of shareholders prevents any individual from having much of a voice, so shareholders appoint managers (the board of directors) to negotiate for them.

But can also be seen as means to protect board's interests

In negotiations, though, managers may prioritize their own interests above those of shareholders. This is a classic case of an agency problem.

Agency problems can also arise in friendly takeovers. For example, the board may approve a takeover proposal, even though the offer price is not sufficiently beneficial to the shareholders. This risk has arisen in some recent MBOs. However, the problem is magnified in hostile takeover bids, as general shareholders cannot tender their shares to the bidder once defensive measures are invoked. In friendly takeovers, shareholders have the choice whether or not to sell at the offer price.

Defensive tactics can be used to increase disclosure

More Japanese companies have started responding to hostile takeovers with an "advance warning system." This involves using defensive measures to buy more time to consider the buyout terms. During the interim months, the target firm requests detailed information about the bidder's post-acquisition strategy and the impact of the deal on shareholders.

But disclosure process may spark battles

However, the pertinence of these negotiations may be called into question. The target company only has the power to request information and ask for additional disclosure if dissatisfied with the response. However, it may pose questions that are nearly impossible to answer or otherwise make what the bidder deems unreasonable demands. This difference of opinion occurred in Steel Partners Japan Strategic Fund's takeover bid for Sapporo Holdings and Nidec's proposal to Toyo Denki. Both bidders eventually scrapped the takeover. These cases could be cited either as examples of successful usage of defensive measures or as a refusal to negotiate.

Controversial Disclosure Requests **Chart 1**

Takeover proposal	Target firm's assertion	Bidder's assertion
For Sapporo Holdings • 15 Feb 2007: Steel partners bid Y825/share in a proposal to increase its stake to as much as 66.6% of voting rights. • 10 Mar 2008: Submitted revised proposal seeking 33.3% of voting rights for Y875/share. • 17 Feb 2009: Withdrew takeover bid.	We have consistently consulted with SPJF regarding potential benefits to shareholders and have endeavored to find a solution that would be satisfactory to all stakeholders, including Steel Parnters.	From the start, Sapporo has refused to negotiate to make the buyout terms acceptable to shareholders.
For Toyo Denki • 16 Sep 2008: Nidec offered Y635/share in a proposal to lift its stake to at least 50.1% of voting rights. • Oct-Nov 2008: Three written Q&A exchanges. • 11 Dec 2008: Both parties met. • 15 Dec 2008: Nidec announced it was scrapping its proposal for a capital and business tie-up.	8 Dec: Nidec has provided insufficient information in response to the questionnaires we have sent to date.	We have sincerely responded to all of Toyo Denki's requests for information. However, although three months have passed since receiving the proposal, Toyo Denki's board effectively has not started to consider the proposal in terms of the likely increase in enterprise value or the resultant benefits to its shareholders.

Source: Company materials; compiled by DIR.

If hostile takeover bids are abandoned, general shareholders lose the opportunity to sell their shares at the offer price. Sapporo Holdings closed at Y422 on 16 February 2008, well below the bid of Y875, and Toyo Denki closed at Y338 on 12 December 2008, a sharp discount to the Y635 offered. Of course, the takeovers failed not only due to gridlocked negotiations, but also to volatility in the stock market and revised funding plans. Thus, we would caution against the conclusion that defensive measures alone deprived the general shareholders of a chance to sell their stake at a premium.

Problems in Friendly Takeovers

The relevance of negotiations has been called into question in some friendly takeovers, as well.

Board's neutrality may be in question

When the board of directors publicly approves the offer price in a friendly takeover, there may be doubts regarding how much shareholders' interests were factored into discussions. The deal may be unfavorable to shareholders if the board releases a business plan that provides a reason to reduce the price and then sets a low price, which is also endorsed by external directors.

Companies use external financial advisors to assure that price-setting is impartial and fair, but the advisor's neutrality cannot be guaranteed. The FAs sign no direct

contract with general shareholders, which may raise doubts about their commitment to acting in the shareholders' best interests.

Meanwhile, the law authorizes minority shareholders who oppose the squeeze-out (cash-out) to claim fair-price compensation for their shares and to file a court petition to determine the price if no timely agreement is reached. However, the process requires time and money, and it is not easy to prove that the board of director's judgment was flawed. In short, the board is responsible for negotiating with the bidder to protect shareholder interests, but in both friendly and hostile takeovers, there is no way to certify that the role has been adequately fulfilled.

Investigative Committees Aware of Problems

Disclosure problems are not new

The current framework for defensive measures owes largely to a report entitled "Takeover Defense Measures in Light of Recent Environmental Changes" released by the Ministry of Finance at a Corporate Value Study Group meeting in June 2008. In it, the MOF acknowledges that there are limits to how much information the bidder can provide, since disclosing all specific figures would be equivalent to putting all its cards on the table, which would likely interfere with its takeover strategies. The report goes on to state that it is inappropriate for a target company to invoke defensive measures simply because the bidder has failed to provide all the requested information, including details on the basis for calculating the tender price and business strategies following the takeover.

An FSA study group and a TSE committee have also taken up the issue of information demanded by target firms. As you can see in Chart 2, the discussions underlined how difficult it is to set regulations regarding appropriate disclosure due to differences between individual cases. The groups also noted that in friendly takeovers such as MBOs, the fact that the board is the buyer makes it hard to protect the interests of general shareholders. The committees acknowledged the problem but have not yet arrived at a concrete solution.

Meanwhile, shareholders may not only have low expectations that the board of directors will protect their best interests, but develop an activist mindset as well. This could prompt them to seek legal aid more aggressively in the future.

Discussion Topics Regarding Information Disclosure in Hostile Takeovers and MBOs **Chart 2**

FSA Study Group	TSE Committee
Information disclosure when defensive measures invoked	
• In Japan, it is assumed that defensive measures exist with the objective of ensuring adequate time and information for shareholders to make a decision about takeovers, plus creating opportunities for negotiations between bidder and target firm. In most cases, defensive measures will not be invoked. What are your views amid the current environment? • In a takeover, the board of directors is expected to provide a convincing explanation of its business plan to shareholders and investors. Does this seem appropriate now?	21 Aug 2008 • With proper use, rights plans promote sufficient information disclosure by both the company and potential buyers. Disclosing information to the stock market creates accountability in the buyer and prevents abusive takeovers. • We should consider how much information should be requested in Japan, using disclosures by bidders and target firms in overseas hostile takeovers as a reference. • It would be difficult to require all companies to have independent external directors. But given the risk that managers will use defensive measures to protect their own interests, we might want to require companies that introduce defensive measures to have a majority of external directors on their board.
Problems in friendly takeovers	
In MBOs or other procedures where authority is transferred, classified shares and a combination of stock-for-stock mergers and issuance of new stock warrants are sometimes used to squeeze out existing shareholders. What are your views, considering the need to protect shareholder rights, shareholder equality, and the need to assure liquidity in the secondary market?	18 Mar 2008 Complaints about MBOs often revolve around unfavorable pricing. Fairness opinions are conducted in almost all cases, but there are questions surrounding their effectiveness.

Source: Committee reports; compiled by DIR.

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