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Corporate Governance Reform (3)

—Private Placement—

Private placement under review to protect shareholders from dilution

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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.
- Decisions regarding private placement of new shares and stock warrants generally fall under the sole authority of boards of directors. However, some observers have pointed out a need for greater regulation, given that private placement can dilute the ownership of existing shareholders.
- This report outlines private placement under existing legislation and discussions regarding its problems by the investigative committees.

What Is Private Placement?

Some have pointed out that tighter regulations are necessary for private placements, given that they can significantly dilute shareholders' ownership.

Companies are entitled to issue new shares or reissue treasury stock to raise capital. These are called share offerings (Corporate Law Articles 199-213).

Shares can be offered to (1) the public, (2) specified third parties (private placement), or (3) all existing shareholders through pro rata allocation of rights to purchase new shares. When shares are allocated to only some existing shareholders, it is considered private placement.

Private placement occurs without shareholder input

Japan's Corporate Law gives the boards of directors of public companies the authority to decide on implementing private placements without shareholder approval (Articles 201.1 and 199.1-2). While the definition of a public company under the Corporate Law differs from the general notion in the securities markets, all listed companies are classified as "public." Thus, all listed companies are able to carry out private placements at the sole discretion of their boards. There are two exceptions to this rule. Shareholder approval is required when issuing new shares at a price particularly advantageous to private placement purchasers. Also, existing shareholders are able to block new share issuances implemented without reasonable justification. In other words, boards are free to change their companies' shareholder structures as long as they do not violate these exceptions.

Private Placement Rules

Approval at shareholder meeting previously required for private placements

The current incarnation of the Corporate Law does not require shareholder approval for private placements unless the issue prices are particularly beneficial to the purchasers. Looking at the development of the Corporate Law (formerly Commercial Code), shareholder approval was a prerequisite for private placements in the 1955 version. The 1966 version, however, authorized boards of directors to make the decision.

Law protects shareholder wealth, which is affected by share price

Under the law, private placement is regulated based on what part of existing shareholder interest needs legal protection. According to the law, the interest that should first be protected is shareholder wealth, represented by the share price. Issuing new shares at a price close to market value is unlikely to trigger a setback in the share price, and thus should not damage shareholder wealth. This suggests that companies do not need to consider shareholder opinion. On the other hand, new share issuance at a price below market value would erode existing shareholder wealth, and thus requires shareholder approval.

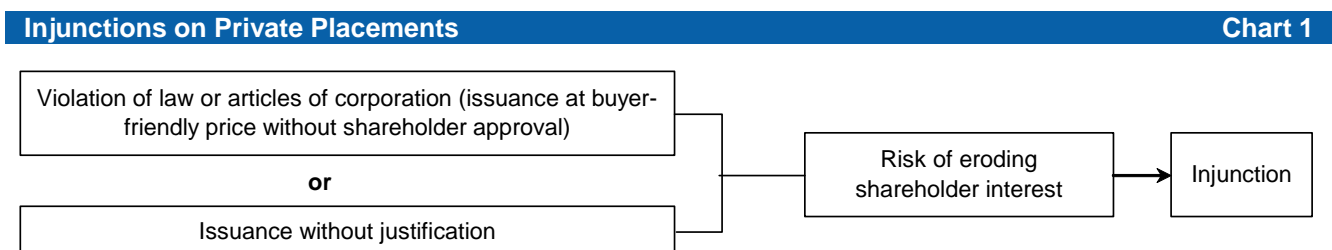
Failure to safeguard shareholder ownership

Meanwhile, shareholder interest regarding corporate control, i.e., shareholder ownership, is not protected. This is because the law assumes that even when a private placement reduces the stakes of existing shareholders, they can regain their ownership by making additional purchases on the market. Another reason is the limit to the number of shares that can be issued. Companies are only allowed to issue up to the number authorized under their articles of incorporation. Since public companies must have shares outstanding totaling at least 25% of the authorized number of shares, they can issue only up to three times their shares outstanding. Accordingly, this rule guarantees that existing shareholder ownership will not be diluted more than 25%¹.

As noted above, private placement regulations focus on issue price—there are barely any rules on volume. However, it has been suggested that the pricing regulations are not enough to resolve conflicts of interests between existing and new shareholders, as well as between shareholders and management².

Private Placements

Private placements can be disputed when (1) the issue price is strongly in favor of the purchasers but shareholders have not approved, or (2) the reason for the issuance lacks justification.



Source: Compiled by DIR.

¹ Companies are able to sidestep this rule by implementing a reverse stock split prior to issuing new shares. This has recently been a problem regarding the minimum ownership guarantee provided by the authorized capital system.

² Masayuki Aketagawa, “Kokai Gaisha ni okeru Kabushiki oyobi Shinkabu Yoyakuken no Hakko Kisei ni Tsuite,” in *Kigyo Ho no Riron* (volume one): *Egashira Kenjiro Sensei Kanreki Kinen*, ed. Etsuro Kuronuma and Tomotaka Fujita (Shoji Homu, 15 January 2007).

Buyer-friendly Issuance Without Shareholder Approval

Shareholders are entitled to block private placements offering new shares at prices particularly advantageous to purchasers. Thus, boards of directors must determine fair issue prices in order to avoid any calls to stop the move. Nevertheless, the fairness of these prices frequently comes under debate.

Example of fund contesting buyer-friendly issuance

The Sun Telephone case (Tokyo District Court, 30 June 2006 ruling) is a prime example of investment funds challenging the appropriateness of a buyer-friendly issuance. Dalton Investments, a US fund manager holding a 27% stake in Sun Telephone, filed a lawsuit against the company, seeking a temporary injunction against a private placement of callable stock warrants. Dalton argued that the issuance was not approved by shareholders despite the unreasonably low price. It seems likely, however, that Sun Telephone had indeed taken pains to set a price that would not be considered advantageous to buyers, since Dalton Investments' nearly 30% stake would make it difficult for a special resolution for the private placement to be sanctioned. In the end, the court granted the injunction on the grounds that there was no clear justification for the issue price.

Example of difficulty of finding fair price

Exactly how the value of the company's call option should have been factored into the issue price was a bone of contention. Ultimately, the court decided that the issue price should not reflect the callable feature, due to the unlikelihood of Sun Telephone exercising the option. In this case, a call option for the company has been attached to the stock warrant for shareholders, making the pricing more complicated.

Issuance Lacking Justification

“Primary objective rule” based on judicial precedents

The above example shows that existing shareholders are protected when new shares are issued at particularly low prices, threatening their share of wealth. On the other hand, a private placement can still be blocked when the issue price is set close to market value. This occurs when the objective of the private placement is not in the interest of existing shareholders. The benchmark for making the judgment is the “primary objective rule,” which is informed by an accumulation of judicial precedents.

Chart 2 outlines the primary objective rule. Under this rule, private placements are considered unjustified when (1) a battle for corporate control exists within the company, and (2) the placement is large enough to significantly change the ownership structure. Private placements under such circumstances are assumed to be management efforts to maintain control.

Private placements of stock warrants bring up a new problem. Stock warrants only ensure a capital increase at some point in the future, so there is no imminent impact on the shareholder structure. Also, with no immediate cash coming in, it becomes difficult for companies to justify their action as “a means of raising capital.” We do not believe the traditional primary objective rule, with its emphasis on fundraising, is sufficient to judge whether an issuance of stock warrants is justified.

Primary objective rule applied to stock warrants

The battle between Livedoor and Nippon Broadcasting System is a well-known dispute over the fairness of a stock warrant issuance through private placement. The Tokyo High Court ruled it was not in the interest of shareholders to issue stock warrants through private placement in a bid to sustain management control amid a power struggle. The ruling, however, also stated that the private placement of stock warrants might be justified when launched as a countermeasure against predatory takeover raids. This case is notable as a precedent indicating that hostile takeovers are not necessarily predatory.

Example of fund disputing unfair issuance

Autobacs Seven vs. UK asset manager Silchester International Investors is a prominent example of an investment fund contesting private placement of warrant bonds (Tokyo District Court, 12 November 2007 ruling). Silchester filed a petition to block Autobacs’ private placement of warrant bonds on the basis of (1) failure to obtain shareholder approval for the issuance at a price advantageous to the purchasers, and (2) unfair issuance, which would provide the purchasers almost a 40% stake after conversion to common stock, diluting the fund’s 4.6% stake³. The Tokyo District Court rejected Silchester’s request on both grounds, citing the absence of a battle for corporate control.

In a bizarre twist of events following the Tokyo District Court’s ruling, Autobacs Seven canceled the warrant bond issuance on 14 November. This came after its announcement the day after the verdict that it had received all payments, then revising its statement in the evening, revealing that payments had not been completed. This sparked orders from the Tokyo Stock Exchange (TSE) and Osaka Stock Exchange (OSE) to submit a statement demanding disclosure improvement.

Broadening of Primary Objective Rule			Chart 2
Company claims	Shareholders’ claims	Judicial rulings	
Financing needs	Issuance aims to dilute shareholder ownership, therefore unfair	Traditional primary objective rule <ul style="list-style-type: none"> • Ongoing battle for corporate control • Private placement with significant impact on shareholder structure • Main goal to maintain control by incumbent management ↓ Issuance deemed unfair (30 July 2004 Tokyo District Court ruling)	
Necessary to prevent hostile takeover	Threat of hostile takeover questionable	Extension to anti-takeover measures Exceptions for issuance considered unfair under traditional rule: <ul style="list-style-type: none"> • When launched as means to protect overall shareholder interest (ex. issuance as defense measure against predatory takeover) ↓ Exceptionally, issuance deemed fair (23 March 2005 Tokyo District Court ruling)	

Source: Court rulings; compiled by DIR.

Problems Surrounding Private Placements

In light of the rules and examples discussed above, we believe the key questions going forward revolve around protection of shareholder interests and disclosure.

Shareholder Protection

Protecting influential shareholders that have less than controlling interest

Some shareholder activists may be displeased that shareholder wealth is protected only in exceptional cases involving power struggles. The above-mentioned Autobacs Seven vs. Silchester case shows that in some instances it is worth protecting the interests of shareholders who wield significant influence, though not to the point of a controlling stake. While investment funds do at times aim to acquire controlling ownership, most of them act with the intention of reforming dividend policies and business strategies by pressuring existing management. Many such so-called shareholder activists do not take over management but utilize their influence with the expectation that current management will optimize retained earnings and streamline unprofitable operations.

³ Silchester International Investors issued report on large shareholding on 22 November.

A shareholder's influence is backed by the size of their stake in the company. For example, most company officials would probably grant meetings to a shareholder with a 5% stake, whereas they might not for those with lower stakes. In other words, even in cases in which management control is not at stake, the level of ownership in a company holds significance in opening up dialogue with management. Therefore, if a company issues new shares to a select third party in an aim to dilute the influence of investment funds, the funds would, in a sense, suffer "losses." In Autobacs' case, the warrant bonds to be issued were enough to allow the shareholders closely related to management to take nearly full control of the company, if converted to common shares. We believe Silchester was concerned about losing its influence. That said, judicial precedents imply that it would be difficult to stop private placements aimed at mitigating the powers of shareholder activists when management control is not at stake.

Enhancing Disclosure

Intentions of new shareholders

Private placements can, on one hand, hurt shareholder interests, but can also open up business opportunities or facilitate corporate alliances—purposes that existing shareholders would probably consent to. Purchasers in private placements invest vast sums, so they are probably confident of gaining returns and are likely to try motivating management to achieve higher profits. This would obviously benefit all shareholders, new or existing alike. Thus, existing shareholders tend to take an interest in the intentions of private placement purchasers.

Occasionally, however, there have been cases where the aims of private placements were unclear. Imagine that a company sold new shares via a private placement to a newly established overseas fund, explaining that it was for boosting its financial position and gaining advice for a new operation. It is hard to say how convincing this story might be to existing shareholders. Thus, disclosure of information on private placement purchasers is becoming an issue.

Committee Discussions

The FSA Study Group and the TSE's Informal Committee have held discussions regarding private placements (Chart 3).

Based on records of their proceedings, it appears these committees are seeking to resolve issues surrounding private placement by encouraging more detailed disclosure. However, it should be noted that not all disclosed information or opinions are credible. One need only look at recent disclosures and debates regarding anti-takeover measures to see the myriad ways in which the quality and volume of such information can be challenged.

Overseas investors say shareholders should be given pre-emptive rights over newly issued stocks

Many institutional investors have questioned private placements taking place in Japan, with overseas investors showing notable interest. According to the Asian Corporate Governance Association's "White Paper on Corporate Governance in Japan" (May 2008)⁴, influential UK and US institutional investors have urged that "pre-emption rights should be introduced for shareholders, so that they have adequate protection against dilution from the issuance of new shares or convertible securities to third parties or a small number of select shareholders."

⁴ http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf

Discussion Regarding Private Placement		Chart 3
FSA Study Group on the Internationalization of Japanese and Financial and Capital Markets	TSE Informal Committee	
<p>Issues discussed (1)</p> <ul style="list-style-type: none"> • Large-scale private placements affecting corporate control have occurred frequently. Under current rules, even such weighty private placements require only the approval of a company's board. How should shareholder interest be protected? • What should be disclosed? When? Should the objective of fundraising, actual fund usage, and purchaser profiles be disclosed in further detail? • What disclosure rules should be put in place? How should government authorities and securities exchanges enforce rules, and how should the two cooperate? • Should securities exchanges regulate/examine private placements that would result in share dilution exceeding certain levels, or those involving problematic shareholders? What if the private placements were necessary for rehabilitating businesses? 	<p>(21 Nov 2008 meeting minute)</p> <ul style="list-style-type: none"> • Private placements are sometimes used when companies desperately need large amounts of capital, such as for corporate rehabilitation. • While some private placements may be problematic, they should not hinder other, more meaningful ones. • Assuming rules will be put in place requiring some action to protect shareholder wealth from private placements larger than a certain scale, a threshold of 20% of shares outstanding seems too tough given that equity-method affiliates are defined as those in which firms own more than 20% (and less than 50%). • The threshold should be set at a percentage similar to the level at which purchasers in anti-takeover measures or tender offers come under disclosure requirement. • Announcements of private placements not intended for implementation are problematic. • Disclosure of how capital is to be raised and what it is to be used for are significant. • Disclosure of opinions by outside directors may be effective. • Requests for opinions of outside directors should conform to the Corporate Law. Companies seeking opinions from outside directors should be required to consult external auditors regarding legality. • Obligating the disclosure of their outside directors' opinions should not be considered a significant burden for listed companies. 	

Source: Committee disclosures, minutes; compiled by DIR.

UK and US stress shareholder involvement

Such proposals may seem to threaten agile fundraising, but they probably stem from the fact that private placements are not implemented as freely in the UK/US as in Japan. According to FSA Study Group documents, the US generally requires approvals at shareholder meetings for issuances of new shares leading to changes in voting control or exceeding 20% of shares outstanding. In the UK, shareholders meetings generally need to approve share issuances to parties other than existing shareholders. Non-Japanese investors accustomed to such procedures probably fear the Japanese way of allowing private placements merely on the say-so of the board of directors is not sufficient to protect shareholder interests.

Some corporate law researchers have suggested that large-scale share issuance should require shareholder approval. Others go so far as to say shareholders should be granted pre-emptive rights for the purposes of protecting their interests⁵.

There have been media reports⁶ that private placements will be a key issue in the next revision of the Corporate Law, indicating the possibility of a legislative debate. Private placements have thus far provided companies a means of countering takeovers under the pretense of fundraising. Depending on the outcome of the revision, such anti-takeover measures may no longer be allowed.

Another issue regarding regulatory revision is their impact on fundraising agility. With financial markets persistently tight, companies must act quickly to get their hands on any funds available. The need for shareholder approval would slow the process, possibly placing some companies at risk of liquidation. The focal point going forward could be a balance between allowing quick fundraising and protecting shareholder interests.

⁵ See footnote 2.

⁶ <http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20081206D06JFF03.htm>