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## Recent Legal Issues Concerning Takeover Bids and the Amendment to the Securities and Exchange Law of Japan

The emergence of hostile bids in corporate Japan has highlighted shortfalls in the country's current regulatory regime governing takeover bids. Noritaka Niwano discusses the issues surrounding two recent hostile bids in Japan that have prompted calls for amendments to the country's *Securities and Exchange Law*.



### Introduction

In a takeover bid (TOB), the purchaser (other than the issuer) is required to take the following steps: (i) disclose in advance certain information, including terms and conditions of the purchase and the status of the purchaser; and (ii) abide by strict rules when purchasing certain large volumes of shares or other equity securities of the issuer which are subject to continuous disclosure requirements, such as the filing of annual securities reports. The purpose of TOB rules is to secure a fair and equal opportunity for all shareholders to sell their securities, with these rules basically applying to purchases made outside the securities market. Here, 'a certain large volume' means, among other things: (i) circumstances where the shareholding ratio of the purchaser to all voting shares following the purchase exceeds 5% (excluding case (ii) below); and (ii) when purchasing from no more than ten persons within the past 60 days, circumstances where the purchaser's shareholding following the purchase exceeds one-third of the target.

Amendments to Japan's Securities and Exchange Law (SEL) in the past couple of years have narrowed the scope of transactions to which TOB rules apply. However, this year some cases have arisen that demonstrate certain blind spots in the current TOB rules, particularly in the context of hostile M&As. These cases have also sparked discussions about the necessity of amending the SEL and related regulations to address such weak points. In this article, I would like to summarize these cases and how these issues were addressed. In addition, I would like to bring attention to some remaining problems which may arise in the future.

### Acquisition of shares in Nippon Broadcasting System by livedoor

#### i) Outline of the case

Nippon Broadcasting System is a joint stock company primarily engaged in the AM broadcasting business. Its common shares were listed at that time on the second section of the Tokyo Stock Exchange (thereafter, the shares were delisted). Fuji Television Network owned approximately 12.4% of the issued and outstanding common shares of Nippon Broadcasting, and commenced a TOB such that it would acquire all of the issued and outstanding common shares in Nippon Broadcasting. Livedoor owned approximately 5.4% of the common shares in Nippon Broadcasting. During the purchasing period of the aforementioned TOB by Fuji TV, livedoor purchased (through an affiliate) common shares of Nippon Broadcasting by a transaction utilizing the ToSTNeT-1 system (Tokyo

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Stock Exchange Trading Network System – 1) operated by the Tokyo Stock Exchange, and came to own approximately 35% of the common shares.

ToSTNeT-1 is an electric off-hour trading system operated by the Tokyo Stock Exchange for large block cross orders and basket cross orders. General rules of time priority and price priority are not applied to ToSTNeT-1 and trading similar to negotiated transactions outside the securities market is possible. Nippon Broadcasting's board considered that livedoor would not be an appropriate controlling shareholder of the company and began to issue stock acquisition rights (i.e. warrants) to Fuji TV in order to remain in the Fuji TV group. Livedoor then initiated court proceedings to seek an injunctive order over the contemplated issuance of the stock acquisition rights.

### *ii) Issues*

While issues in this particular case cover a broad range, particularly in connection with the TOB, the fact that livedoor implemented the purchasing of common shares in Nippon Broadcasting through the ToSTNeT-1, rather than a TOB, was questioned because livedoor did not comply with the mandatory applicable TOB rules, and thus violated the SEL. As discussed in the above, where the shareholding ratio following the purchasing is expected to exceed one-third, the purchase must be effected by way of TOB. However, Japanese law allows, even in such a case, purchases through trading in a securities market to be made outside the framework of a TOB. The reason for such an exception is that, in light of the nature of the securities market being a free and open marketplace, it is not necessarily appropriate to restrict such transactions made through a securities market even if the purchase is made for the purpose of acquiring a controlling position of the target company unless such purchase violates any law, regulations or internal rules of the securities market. Transactions made through ToSTNeT-1 are, as a matter of formality, transactions made through the Tokyo Stock Exchange, which is a securities market. Nevertheless, there have also been strong arguments that transactions made through ToSTNeT-1 are similar to outside market negotiated transactions and attempt to technically evade TOB regulations, and that such transactions should not be allowed outside the TOB framework.

### *iii) Court judgment*

In this case, the Tokyo High Court stated that transactions made through ToSTNeT-1 fell within the definition of “transactions through a securities market” under the SEL, and that the failure to conduct a TOB was not a violation of the SEL. On the other hand, the court also pointed out that there could be criticism that the purchase should have been made through a TOB, because the general investors in the market lost the fair and equal opportunity to enjoy the value of the control premium of the target company due to the purchasing made through ToSTNeT-1. However, this statement did not in any manner affect the conclusion itself.

### **Amendment to the Securities and Exchange Law in terms of off-hour trading**

In the court decision referred to above, purchasing more than one-third of a target company's shares through off-hour trading through ToSTNeT-1, rather than by way of a TOB, was concluded to be lawful. However, it was generally recognized that always allowing ToSTNeT transactions to be made outside the framework of TOB would not be

desirable, and that the court case called attention to this blind spot in the current TOB rules. Therefore, an amendment to the TOB rules was rushed into the then-proposed set of amendments to the SEL. Within the amended SEL, a portion dealing with improved TOB rules came into force immediately, and the off-hour trading in a stock exchange has been excluded from the definition of transactions through a securities market. In other words, it is now explicitly stipulated in the law and regulations that in cases where purchasing is required to be made through a TOB, the TOB rules cannot be avoided by off-hour trading in a stock exchange.

### **Takeover bid by Yumeshin Holdings of shares in Japan Engineering Consultants**

#### *i) Outline of case*

Another case in which a blind spot of the current TOB system was demonstrated is a court case concerning a TOB by Yumeshin Holdings of common shares in Japan Engineering Consultants and a stock subdivision by Japan Engineering Consultants.

Japan Engineering Consultants is a joint stock corporation primarily engaged in the construction consulting business. The company's common shares are listed on the Nasdaq Securities Exchange. Yumeshin Holdings sought to acquire the majority of the issued and outstanding shares of Japan Engineering Consultants, and communicated its intention to the company. Thereafter, Japan Engineering Consultants announced a series of protective measures to defend against hostile M&As in a document entitled 'Notice Concerning Our Policy to Deal with Large Volume Purchasing'.

According to the Japan Engineering Consultants announcement, the board of the company believes that whether or not to accept the large volume purchasing should be a matter finally determined by shareholders. As such, the board should review for the benefit of shareholders certain information concerning the contemplated large volume purchase provided by the purchaser, and present an opinion of the board about the purchase. In particular, Japan Engineering Consultants requires: (i) the large volume purchaser to provide in advance sufficient information to Japan Engineering Consultants; (ii) that the purchaser be allowed to commence the purchase only after expiration of a certain review period taken by the board of Japan Engineering Consultants; and (iii) that if the purchaser does not comply with this rule, Japan Engineering Consultants may take certain countermeasures, including without limitation, stock subdivision and issuance of stock acquisition rights in order to protect interests of Japan Engineering Consultants and its shareholders.

Yumeshin Holdings did not comply with these rules and announced that it would conduct a TOB of common shares in Japan Engineering Consultants. Japan Engineering Consultants, in turn, announced that its board decided to implement 1:5 stock subdivision as a countermeasure against the TOB. Yumeshin Holdings on one hand filed a petition for provisional disposition seeking enjoinder of the stock subdivision by Japan Engineering Consultants, and on the other hand commenced a TOB.

#### *ii) Issues*

While issues in this particular case again cover a broad range of topics, particularly in connection with the TOB, the author believes

that the most important general issues are: (i) whether it is possible for a purchaser to take appropriate actions under the current TOB rules when the record date of the stock subdivision is set as of a date during the TOB purchasing period; and (ii) whether such stock subdivision is considered to be unlawful or having been conducted in a materially unfair manner if the purchaser can take no appropriate reactions against the share subdivision.

More specifically, these issues include, firstly, that the purchaser is forced to buy the diluted shares following the subdivision at a price set based upon the higher price prior to the subdivision because under the current TOB rules the purchaser is not allowed to reduce the purchase price once proposed. If the purchaser is able to set a condition to reduce the purchase price at the time of dilution during the TOB purchasing period, this issue may be addressed. However, it is not clear whether a purchaser is allowed to set such a condition in the TOB terms so as to reduce the purchase price upon occurrence of any dilution event.

Secondly, while the number of shares will be increased due to the stock subdivision, such newly issued shares may not be purchased through the currently conducted TOB because such shares have yet to be legally and effectively issued at the time. Given this, the purchaser may not be able to achieve the purpose of the TOB.

Thirdly, it is also unclear whether the TOB can be designed so that the purchaser can withdraw the offer if the target company decides on a stock subdivision where the recorded date is set during the TOB purchasing period.

### **iii) Court judgment**

In respect to the first issue discussed above, Yumeshin Holdings in reality commenced the TOB at a price set based upon the number of shares following the stock subdivision, assuming that the subdivision had been effected. Therefore, the Tokyo District Court did not express any view on this point. As for the second issue discussed above, the court stated that it was possible to purchase through the currently conducted TOB the additional shares to be given upon subdivision, and that the purchaser could achieve the purpose of the TOB in a legal sense even if the stock subdivision was implemented. In practice, the settlement for purchasing the additional shares may be made only at a significantly later stage, but the court stated that there was no sufficient proof to demonstrate that such fact would frustrate the purpose of the TOB.

Regarding the third issue above, the court did not present an opinion. However, the Kanto Local Finance Bureau, a governmental authority set up to deal with TOB registrations, accepted the TOB registration which included terms and conditions allowing withdrawal of the offer upon occurrence of stock subdivision. The Financial Services Agency expressed its opinion through a press conference conducted by the minister in charge of financial matters, stating that an appropriate interpretation was that a withdrawal of the TOB would be allowed if a stock subdivision is implemented and it amounts to a significant obstacle to achieve the purpose of the TOB.

In conclusion, the court decided that the purchaser may take appropriate reactions even if a stock subdivision, of which the recorded

date is during the TOB purchasing period, is implemented, and that such stock subdivision would not violate laws or be considered to have been made in a significantly unfair manner.

### **Remaining issues in the future**

The court's judgment and the views expressed by the FSA have given certain guidelines in dealing with some of the particular issues raised regarding the TOB rules. In the future, these interpretations should be specifically codified in laws and regulations, and the rules should be clarified and stabilized.

Furthermore, the author believes that this is the first case in which a hostile TOB was conducted towards a Japanese target company which has introduced protective measures against hostile M&As (anti-takeover measures). Therefore, the relationship and balancing between the TOB rules and the anti-takeover measures should also be reviewed and developed.

As referred to above, the TOB rules require the purchaser to disclose certain information and significantly regulate the method of purchasing. This is for the purpose of providing fair and equal opportunities to all shareholders. We need to consider whether it is appropriate to allow anti-takeover measures which require the purchaser to comply with more stringent rules than those under current TOB rules. The latter are supposed to be a product of balancing interests between the purchaser and the target company when the purchase is conducted pursuant to the TOB rules.

If certain anti-takeover measures are to be allowed, as mentioned above, methods for coordinating the balance of interests between the purchaser and the target company (and its shareholders ultimately) need to be developed. In particular, under the current TOB rules, the terms and conditions of a TOB can be set only in a stringent and rigid manner. A framework which allows for the design and flexibility of TOBs should be developed so that the purchaser may take appropriate action against anti-takeover measures. For example, it should be permitted within the terms and conditions of the registration statement to describe a formula for purchase price reduction contingent upon the occurrence of certain conditions subsequent so that the purchaser may react appropriately to the anti-takeover measures.

### **Conclusion**

This year, a number of Japanese companies have introduced anti-takeover measures. While the validity and effectiveness of a particular scheme should be a matter of the *Commercial Code* and the *Corporation Law*, various adjustments and developments would also be required in connection with the TOB rules. The Financial Services Agency has established a working group concerning the review of the TOB system and commenced activities.

Looking outside of Japan, the EU TOB Directive (Directive of the European Parliament and of the Council on Takeover Bids) puts weight on the purchaser through a TOB in a way such that the target company is required to obtain a prior shareholders' approval if the target company wishes to take any countermeasures that may work to defend against the TOB during the period of the TOB. This is a different approach to that taken in the US where various types of anti-takeover measures are generally accepted. We should pay close attention to which direction

and to what extent Japanese TOB rules are modified in the future.

**About the author**

Noritaka Niwano is a partner with Anderson Mori & Tomotsune. His principal areas of practice are finance law and corporate law, including securities transactions and M&A. He is admitted to practice in Japan and the State of New York. Niwano has earned a Bachelor of Laws degree from the University of Tokyo, Faculty of Law and a Master of Laws degree from University of California, Berkeley. He also worked at the London office of Allen & Overy. He speaks Japanese and English.

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**About the firm**

The Japanese law firms of Anderson Mori and Tomotsune & Kimura merged their law practices as of January 1 2005. The name of the merged firm is Anderson Mori & Tomotsune, with principal offices located in Izumi Garden Tower, 6-1, Roppongi 1-chome, Minato-ku, Tokyo 106-6036, Japan. The combination of practices enables Anderson Mori & Tomotsune to provide an even higher level of legal services in a broader number of practice areas, with enhanced

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