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Litigation - Japan

Supreme Court Rules on Squeeze-Out Compensation in Management Buy-Outs

December 15 2009

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Summary

In 2009 a number of Japanese courts issued decisions on the issue of fair compensation for minority shareholders squeezed out in management buy-outs. In each case, minority shareholders faced with compulsory acquistion procedures using wholly callable shares sought adequate consideration of such shares.

On May 29 2009 the Supreme Court issued its first-ever ruling on the issue, upholding a decision related to the management buy-out of Rex Holdings, a listed company.(1) The court did not rule directly on the amount of compensation due to the minority shareholders that were squeezed out. However, it upheld the Tokyo High Court's decision of September 12 2008 that the Y230,000 a share compensation calculated by Rex was unfairly low and that a fair level of compensation was Y336,966.(2)

On September 1 2009 the Osaka High Court ruled on the management buy-out of Sunstar Inc, another listed company. It held that the amount of compensation calculated by Sunstar - Y650 a share - was also unfairly low and that a fair level of compensation was Y840 a share.(3)

These cases provide the latest guidance on the Japanese courts' approach to evaluating the fairness of compensation for minority shareholders that are the object of squeeze-outs in management buy-outs.

Background

Wholly callable shares are a relatively new classification of share. Introduced under the Companies Act 2006, they may be issued only if the articles of incorporation so allow, in which case the company may acquire all of its wholly callable shares by means of a shareholders' resolution.(4) In many recent management buy-outs of Japanese listed companies, senior managers or financial sponsors - or a combination thereof -have formed and capitalized a special purpose company whose sole purpose is to hold the target's shares. The special purpose company launches the takeover bid. Once the bid succeeds, the target typically changes all of the common shares into wholly callable shares by adding the appropriate form of call provision to the issued common stock authorized in the articles of incorporation. The wholly callable shares are subsequently called by means of a shareholders' resolution in order to squeeze out the minority shareholders remaining in the target. The target calls the wholly callable shares pursuant to a formula which allows the minority shareholders to receive only fractional ownership interests of common shares as compensation for the wholly called shares. In compensation for the wholly called shares, the target pays cash from the sales of such fractional ownership interests to the minority shareholders. Dissatisfied shareholders may object and petition for a ruling on the price of the wholly callable shares that they may claim as compensation.(5)

Rex Case

In November 2006 a takeover bid was launched to effect a management buy-out of Rex at an offer price of Y230,000 a share. The takeover bid price was equal to the sum of the one-month average of Rex's market price, calculated from the date on which the bid and

intended buy-out were announced, plus a 13.9% premium.

The management buy-out was successful, with 91.5% of Rex shares being tendered in the takeover bid or acquired later. A squeeze-out of minority shareholders that had not tendered their shares was proposed and implemented at the original takeover bid price.

Acting pursuant to Article 172(1) of the act, a Rex minority shareholder filed a petition to determine the acquisition price for the squeeze-out. The shareholders alleged that the acquisition price did not fairly reflect the share value, especially as Rex's management had intentionally lowered the share price by means of downward revisions of the company's financial results, both three months before the announcement of the bid and on the day of the bid.

The Supreme Court unanimously concurred with the Tokyo High Court, which had held as follows:

- In the event of a squeeze-out, the act requires the provision of fair compensation for shareholders. Such compensation should be the sum of: (i) the objective share value, which is the value of the shares acquired at the time of the squeeze-out (calculated on the basis of an average market price over an extended period near the time of the squeeze-out, but excluding the period after the announcement of the bid and intended management buy-out); and (ii) a premium payable to cover the loss of expected profits from future increases in the stock price as a result of the compulsory acquisition, taking account of various case-specific factors (eg, Rex's business plan, expected profitability and business performance).
- The objective share value must be based on the average closing price of the company's shares for the six months preceding the day on which the bid and intended buy-out are announced.
- The premium payable in addition to the objective share value should be 20%. Where no information is available from the company to determine the premium (ie, a business plan or a third party's valuation report on the company's shares), as in this case , the calculation must take account of premiums recently offered in analogous management buy-outs.
- On this basis, fair compensation was deemed to be Y336,966 a share - over Y100,000 more than the bid price.
- In respect of the objective share value, the share price for the period between the first of Rex's downward revisions of its financial results before the announcement of the takeover bid and the intended buy-out and the announcement was not to be excluded from the determination.

In August 2009, following the ruling in this case, it was reported that several Rex shareholders that had tendered their shares in the takeover bid had filed suit for damages against Rex and its management.

Sunstar Case

In February 2007 a takeover bid for Sunstar, a listed company, was launched in order to effect a management buy-out at an offer price of Y650 a share. The price was equal to: (i) the three-month average market price from the date of the announcement of the takeover bid and intended management buy-out, plus a 23% premium; and (ii) the six-month average of Sunstar's market price from the date of the announcement, plus a 19% premium.

The management buy-out was successful, with approximately 87% of Sunstar's issued and outstanding shares being tendered from shareholders, excluding the shareholders behind the bid (ie, Sunstar, the entity behind its employee stock ownership plan and the special purpose company formed for the purpose of the buy-out).

A squeeze-out of minority shareholders was implemented, with the consideration for minority shareholders being the same as the takeover bid price. Pursuant to Article 172 (1), several Sunstar minority shareholders filed a petition to determine the acquisition price for the squeeze-out.

As in the Rex takeover, a downward revision of financial results had been announced about three months before the bid. The shareholders alleged that the acquisition price did not fairly reflect the share value because it was based partly on an intentionally lowered share price.

The Osaka High Court essentially followed the Tokyo High Court's analysis in the *Rex Case* on the method for determining fair compensation. It ruled as follows:

- The objective share value should be based on the market value of Sunstar's shares one year before the announcement of the takeover bid and intended management

buy-out, as Sunstar was suspected of having artificially driven down the market price once its management had begun to prepare for the buyout.
- The premium payable in addition to the objective share value should be 20%, taking account of premiums paid in other recent management buy-outs and transactions and the 19% premium paid in the takeover bid.
- A fair level of compensation was Y840 a share - Y190 higher than the takeover bid price.

Regulatory Amendments

In December 2006, after the Rex buy-out, the tender offer regulations were amended. Where there is a third-party valuation report or opinion to be considered in evaluating the acquisition price of a target's shares, the report or opinion must be disclosed to shareholders with the statement registering the takeover bid. In September 2007, after the Sunstar buy-out, the Corporate Value Study Group(6) issued guidelines for management buy-outs. Although not legally binding, the guidelines have been widely accepted and followed. Among other things, they require bidders to ensure that shareholders have sufficient opportunity to consider and decide on a management buy-out. The provision of adequate information to shareholders is identified as a key requirement.

Comment

In both decisions, the courts decided that the compensation proposed by the company was unfairly low and that higher compensation was necessary. However, it is unlikely that this analysis will be successfully invoked in all similar cases filed by minority shareholders in future management buy-outs.

The decisions - as well as the related changes in tender offer regulations and buy-out practices - stress the importance of giving shareholders the opportunity to consider the management buy-out. Unfortunately, these two decisions do not fully clarify the procedures that must be followed if the courts are to find that shareholders have been given such an opportunity. Future decisions in similar cases may establish best practices for structuring a successful management buy-out in Japan.

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Endnotes

(1) Decisions 2008 (KU) 1037 and 2008 (KYO) 48.

(2) Decision 2008 (RA) 80.

(3) Decision 2008 (RA) 950.

(4) Article 171(1).

(5) Article 172(1).

(6) A body commissioned by the Ministry of Economy, Trade and Industry.

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