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Recent Developments concerning Japanese Poison Pills

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I. Introduction

Historically, the principal defensive measure that Japanese listed companies employed to ward off hostile takeovers was to allocate new shares or share options to third parties (including existing shareholders) friendly to management. In connection with a court's review of the lawfulness of such issuance, the management would have to prove, in sum, (i) a rational reason as the main purpose of the issuance such as to obtain financing, the hostile takeover will damage the corporate value of the company or shareholders' common interest, or to gain time and information so that the shareholders can decide whether to accept the hostile takeover, rather than to maintain the management's position in the company; and (ii) that discriminatory treatment of the hostile acquiror is appropriate.

The leading court precedent on whether and under what circumstances defensive measure is lawful is the Bull-dog Sauce Co., Ltd. ("**Bull-dog**") case in 2007. Since then, there had not been much development on this topic, however, backed by Japan's corporate governance reformation in the past several years, we are recently seeing a series of important court decisions.

In this newsletter, we will take a brief look at the *Bull-dog* case in Section II., introduce recent court decisions that addressed issues which the *Bull-dog* case left unanswered in Section III., and then some key takeaways to be drawn from these case laws in Section IV.

II. *Bull-dog Case*

The main issue in the *Bull-dog* case was the lawfulness of share options with company's call option



under discriminatory conditions that Bull-dog decided to issue as an anti-takeover defense measure against activist fund Steel Partners.

Following the launch of a tender offer by Steel Partners targeting Bull-dog's shares, Bull-dog convened its shareholders' meeting, at which a supermajority resolution was adopted that authorized the grant of gratis share options with company's call option to all shareholders which upon exercise of such call option the company would grant all shareholders other than Steel Partners additional Bull-dog shares, while compensating Steel Partners cash with equivalent value, and thereby significantly dilute Steel Partners' position. Meanwhile, Steel Partners sought a court injunction against the gratis allotment of share options.

Steel Partners' argument was that such a discriminatory condition to the share options was against the principle of shareholder equality¹ and was implemented via an extremely unfair method.² The litigation ultimately reached the Supreme Court, Japan's highest court. The Supreme Court rejected Steel Partners' petition.³ The Supreme Court, in short, opined that having discriminatory conditions is lawful if it meets a two-prong test: (i) the shareholders decide that there is necessity for including discriminatory conditions to issuance of new share options; and (ii) the conditions are appropriate.

With respect to the first prong (necessity), the Supreme Court decided that a decision of a shareholders' meeting generally shall be respected, because whether or not a specific shareholder's acquisition of control rights would cause injury to the company's corporate value or the common interests of shareholders, in the end, would best be decided by the shareholders themselves.

The Supreme Court then decided that the second prong (appropriateness) also was satisfied despite a major decrease in Steel Partners' shareholding ratio in Bull-dog because, in addition to approval of the poison pill and its terms by most of the shareholders, Steel Partners may receive cash payment

¹ Article 109, Paragraph 1 of Companies Act: "[a] Stock Company must treat its shareholders equally in accordance with the features and number of the shares they hold."

² Article 247 of Companies Act: "[i]n the following cases, if shareholders are likely to suffer any disadvantage, shareholders may demand that the Stock Company discontinue an issue of the Share Options relating to solicitation under Article 238, Paragraph 1:

(i) in cases where such issuance of Share Options violates laws and regulations or the articles of incorporation;
or
(ii) in cases where such issuance of Share Options is effected by using a method that is extremely unfair."

³ Supreme Court decision dated August 7, 2007 (*Minshu* Vol.61, No.5, p.2215)

which protects them from monetary damage.

The Supreme Court thus concluded that Bull-dog's poison pill was lawful. However, this decision left some unanswered questions, for example: (i) in cases where the adoption and then the invoking of a poison pill are determined separately, would approval by a shareholders' meeting be necessary for both actions in order to satisfy the necessity requirement? If shareholders' approval is necessary, what are the resolution requirements, and to what extent a Board of Directors' approval will suffice? Also, (ii) would the acquiror always have to receive some compensation for the conditions of the takeover defense measure to be appropriate? What other conditions are regarded appropriate and what are not? Recent court decisions involving poison pills have dealt with these and other questions.

III. Recent Cases

(a) *Nippo Case*

Nippo Ltd. ("**Nippo**"), the target company, had adopted and announced a poison pill defense with advance warning by a shareholders' meeting, which requires an acquiror attempting to acquire 20% or more of Nippo shares to submit a letter of intent and certain information to be evaluated by the Board of Directors, shareholders and investors of Nippo prior to the acquisition. Freesia Macross Corp. ("**Freesia**"), having already acquired 19.68% of Nippo shares through the stock market before the shareholders' meeting resolution, ignored such advanced warning and proceeded to launch a tender offer aiming to acquire up to 27.57%. In reaction, the pill was invoked upon resolution of Nippo's Board of Directors.

In the ensuing litigation, Nagoya District Court, in the first instance,⁴ granted Freesia's injunction petition to halt Nippo's gratis allotment of share options. The decision body, although not completely clear, appears to have regarded problematic the fact that the pill was invoked upon Board resolution and not the shareholders'. However, this ruling was appealed to another body in the Nagoya District Court⁵ and then to the Nagoya High Court,⁶ where both tribunals rejected Freesia's injunction petition, ruling that Nippo's gratis allotment of share options is lawful. Both the second body in the Nagoya District Court and the Nagoya High Court put weight on the fact that Nippo's shareholders meeting approved the poison pill,

⁴ Nagoya District Court decision dated March 24, 2021

⁵ Nagoya District Court decision dated April 7, 2021

⁶ Nagoya High Court decision dated April 22, 2021

including its structure – and importantly the element that gave the Board certain discretion to invoke the pill – in the situation where there was a specific risk of hostile takeover. It should be also noted that the courts decided that approval of the poison pill by means of ordinary resolution of shareholders’ meeting, which only requires more than half of voting rights of attending shareholders rather than supermajority, would suffice.

With respect to the appropriateness of the conditions, although unlike the *Bull-dog* case there was no compensation for Freesia, the Nagoya High Court nonetheless found it appropriate. The rationale was that in addition to Freesia’s foreseeability of the economic loss, if Freesia discontinued its tender offer, Nippo may gratuitously take back all of the share options and thereby Freesia would avoid any economic loss on the shares it had purchased.

(b) Japan Asia Group Case

Contrary to the facts in the *Nippo* case, in the case where Japan Asia Group Limited (“**JAG**”) became target of a hostile takeover, JAG did not adopt a resolution at a shareholders’ meeting either when the poison pill was put in place or when it was invoked. By Board resolutions, the poison pill was put in place against an activist fund City Index Eleventh Co., Ltd. (“**City Index Eleventh**”) which rapidly purchased JAG shares in the stock market up to 22.53%, and was invoked after City Index Eleventh announced a planned tender offer and further continued to purchase JAG shares in the stock market up to 30.77% ignoring the procedures set forth in the anti-takeover defense measure. The pill included certain discriminatory conditions, i.e. it was not exercisable by the acquiror, and when JAG exercises the call option, JAG shares will be allotted to all shareholders other than the acquiror, while the acquiror will be allotted with another type of discriminatory share options with restrictions on exercise conditions.

In response to City Index Eleventh’s petition for an injunction against JAG’s gratis allotment of share options, all three courts⁷ which considered the matter granted the injunction and invalidated JAG’s poison pill defense. Although JAG argued that the pill was adopted in an emergency situation and that it planned to have the pill be ratified by approvals at a shareholders’ meeting, JAG had not taken any definite steps to convene such a shareholders’ meeting at time of the court decisions.

⁷ Tokyo District Court decision dated April 2, 2021, Tokyo District Court decision dated April 7, 2021, and Tokyo High Court decision dated April 23, 2021

(c) ***Fuji Kosan Case***

In this case, too, Fuji Kosan Company, Ltd. (“**Fuji Kosan**”) had not adopted a shareholders’ meeting resolution either for introduction of or invoking a poison pill defense against Aslead Capital Pte. Ltd. (“**Aslead**”). Fuji Kosan adopted the pill by Board resolution after Aslead commenced a tender offer for Fuji Kosan’s shares. The structure of the pill was similar with the *JAG* case. However, here the courts reached a different conclusion than in the *JAG* case: both the Tokyo District Court⁸ and the Tokyo High Court⁹ denied Aslead’s petition for an injunction against Fuji Kosan’s gratis allotment of share options.

What appears to have been dispositive is that Fuji Kosan, unlike *JAG*, had taken the procedures to convene a shareholders’ meeting to be held a month after the poison pill was invoked, and the poison pill itself was subject to cancelation in the event that shareholders’ approval was not obtained at that meeting. Further, the shareholders of Fuji Kosan actually adopted an approval resolution at the shareholders’ meeting held right after the decision of the Tokyo District Court came out.

Further, similar to the *Nippo* case, the appropriateness was found to be satisfied despite the absence of compensation, because Aslead was able to avoid its economic loss if it discontinued its tender offer.

(d) ***Tokyo Kikai Seisakusho Case***

The basic background facts of the poison pill defense that Tokyo Kikai Seisakusho, Ltd. (“**TKS**”) adopted against Asia Development Capital Co., Ltd. (“**ADC**”), the hostile acquirer, were that TKS first adopted and then invoked a poison pill only with resolutions passed by its Board of Directors, and then a shareholders’ meeting was convened to ratify the Board’s determination when the pill was invoked and the pill itself also was subject to ratification at the shareholders’ meeting, which if not obtained would result in the pill being cancelled. The structure of the pill was basically similar with the *JAG* and *Fuji Kosan* cases. The main differences in this case were (i) ADC rapidly bought up TKS’ shares in the stock market up to 32.72% (on published basis – note that five business days is allowed for publication of

⁸ Tokyo District Court decision dated June 23, 2021

⁹ Tokyo High Court decision dated August 10, 2021

large shareholding report after actually acquiring shares, so ADC's actual ownership ratio was even higher) by the time the pill was adopted, and subsequently up to 39.94% voting rights as of the record date of the shareholders meeting, not through the means of tender offer (which is allowed under Japanese laws); and (ii) the approval at the shareholders' meeting was made by a "MoM (Majority of Minority) resolution", which required a majority of the votes of the attending shareholders with voting rights, but excluding ADC and its related parties' voting rights (as well as the voting rights of shares held by TKS' management).

The Tokyo District Court¹⁰ and the Tokyo High Court¹¹ both refused to grant ADC's petition for an injunction. In these decisions, the courts recognized that the shareholders were exposed to a coercive situation when faced with ADC making open market purchases. Coerciveness is generally recognized when shareholders are forced to sell its shares to the acquiror because possible disadvantage is foreseen if they do not. Specifically in this case, the facts that ADC acquired TKS shares rapidly up to nearly 40% in the stock market without allowing other shareholders necessary time and information to make its investment decisions, and that ADC did not explain its management policy or business plans to be implemented post acquisition while was not seeking to acquire all of the remaining shares, consisted the basis of coerciveness. Under such situation, the courts found that it was "not immediately unreasonable" for TKS to seek a MoM resolution from its shareholders, because the shareholders' meeting is held to obtain and confirm the opinion of shareholders who are faced with a coercive situation, and thus excluding ADC from having its votes be counted is permissible.

(e) Mitsuboshi Case

The Mitsuboshi Co., Ltd. ("**Mitsuboshi**") case is the most recent among this series of poison pills court cases, and it will have a practical impact because all of the courts¹² which considered Mitsuboshi's poison pill that had been adopted against an acquiror which was buying up Mitsuboshi shares in the stock market, Adage Capital LLP ("**Adage Capital**"), found the pill unlawful and granted Adage Capital injunctive relief. Such grant was the outcome, even though Mitsuboshi had taken steps to convene a shareholders' meeting to be

¹⁰ Tokyo District Court decision dated October 29, 2021

¹¹ Tokyo High Court decision dated November 9, 2021

¹² Osaka District Court decision dated July 1, 2022, Osaka District Court decision dated July 11, 2022, Osaka High Court decision dated July 21, 2022, and Supreme Court decision dated July 28, 2022

held a month after the poison pill was invoked, and the poison pill itself was subject to cancellation in the event that shareholders' approval was not given at the meeting. Facially, it would appear, this is similar to the *TKS* case but even more lawful because the shareholders' approval was subject to an ordinary resolution, not MoM.

There was a key differentiator, however, from the *TKS* decision. Here, Adage Capital was allegedly cooperating and collaborating with other shareholders in purchasing the Mitsuboshi's shares and seeking to obtain control. While the courts determined that invoking the poison pill targeting Adage Capital (and other shareholders cooperating and collaborating with Adage Capital) was necessary, when the details of the poison pill were examined, each court concluded that the conditions of the pill lacked appropriateness. The reasons to deny appropriateness were, most importantly, (i) what requirements Adage Capital shall satisfy to cancel the invocation of the poison pill was completely unclear¹³, along with (ii) the management of Mitsuboshi had broad discretion to regard whether a shareholder was cooperating and collaborating with Adage Capital and therefore be subject to the discriminatory conditions of the pill (it was possible that all shareholders objecting to the management can be regarded by management as cooperating and collaborating with Adage Capital), and (iii) while Mitsuboshi had established an independent committee that would seek to secure fairness in management's determination, what measures the independent committee implemented to eliminate arbitrary advices was not clear.

IV. Key Takeaways

The judgments in the cases summarized in Section III. have established additional principles providing further gloss on the landmark *Bull-dog* case and have made some of the lines in the conduct of hostile takeovers in Japan somewhat clearer. The key takeaways from these decisions are:

- Generally, there must be an opportunity for the shareholders' meeting to consider and if appropriate approve the necessity for implementing or invoking a poison pill; however, (i) this opportunity can occur only at adoption so long as the shareholders give the Board of Directors certain discretion to invoke the pill, as illustrated in the *Nippo* case; or (ii) under an extraordinary emergency situation, after the Board of Directors has determined to implement

¹³ Later, during a hearing in the first instance, in response to the court's instruction what the requirements for cancelling the invocation of the poison pills were, Mitsuboshi made the requirements clear but which included excessive restrictions to Adage Capital and other allegedly cooperating shareholders' rights. Such excessive restrictions were regarded as deviating from the purpose of a poison pill.

and invoke a pill so long as a concrete step to convene such a shareholders' meeting has been taken, as illustrated in the *Fuji Kosan* and the *TKS* cases, and in comparison with the *JAG* case.

- An ordinary resolution adopted at such a shareholders' meeting would usually be sufficient for that approval.
- It is not clear from the *TKS* case under what circumstance that a MoM resolution will be acceptable as an appropriate shareholder approval mechanism. Court may find differently, if at the time of the MoM resolution, the acquirer already owns majority votes, the level of coerciveness is weaker than the *TKS* case, or the acquirer plans to launch tender offer instead of purchasing shares in the stock market.
- It is not necessary that an acquirer receive compensation for its inability to benefit from discriminatory share options. However, the company should take measures designed so that the acquirer's economic loss should be avoided. This can be structured, for example, so that the acquirer is becomes entitled to exercise its discriminatory share options when it discontinues the takeover attempt.
- The requirements for the acquirer to avoid discriminatory treatment should be clearly provided, as suggested by the *Mitsuboshi* case.

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