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Important Judicial Decisions Issued in 2022 relating to Takeover Defense Measures when there is a Dispute over Control of a Company

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I. Introduction

In this Article, we will introduce two important case decisions handed down by the Osaka High Court in connection with the Companies Act of Japan (the "**Act**") regarding takeover defense measures. Both decisions were later affirmed by the Supreme Court.

II. Case in which an injunction against the issuance of new shares was not granted in a dispute over control of management *(Osaka High Court Decision of February 10, 2022 (Nippon Telephone case))*[1]

(a). Outline

CYBRiDGE LLC. (the "**Applicant**") around January 2021 began acquiring, and had acquired more than 10% of the shares in Nippon Telephone Inc. (the "**Respondent**") by February 2021. Around May 2021, the Applicant proposed a business alliance to the Respondent, which was rejected.

Meanwhile, around October 2021, the Respondent began contacting Showcase Inc. (the "**New Shareholder**") as a candidate for a business alliance, and they concluded at capital and business alliance agreement as of January 2022 in which the Respondent issues new shares to the New Shareholder (the "**New Share Issue**").

After the New Share Issue, the Applicant's shareholding ratio in the Respondent decreased from 38% to 22%, while the New Shareholder's shareholding ratio rose to 40%.

Following the New Share Issue, the Applicant filed a provisional injunction against the Respondent to cease the New Share Issue, arguing that it was implemented by using an extremely unfair method (Article 210(2) of the Act).

(b). Court Decision

The Court applied the so-called "main purpose rule," the standard in the court precedents, and dismissed the Applicant's claims on the grounds that the New Share Issue was primarily for fundraising purposes, not for maintaining management control of the Respondent, in view of the following facts and circumstances.

- The Applicant had not effectively acquired control of the Respondent at the time of the New Share Issue.
- The New Share Issue was not a mere tool for maintaining management control but a response to a concrete need for fundraising. The purpose of maintaining management control did not outweigh the fundraising purpose, considering the Respondent's business activities, that the capital and business alliance was substantive and necessary, that the specific uses of the funds from the New Share Issue

[1] Hanrei Times No.1505, 69 (2023).

were not excessive, that the fundraising method was reasonably justified, and that the selection of the allocation destination was also appropriate.

(c). Key Takeaways

The Act does not define an "extremely unfair method," and the Japanese courts have judged based on the judicial "main purpose rule" to determine whether the issuance of new shares constitutes an extremely unfair method. This rule states that (i) when there is an ongoing struggle for control of management, and (ii) the issuance of new shares is primarily intended to maintain or secure management control, this is generally considered an "extremely unfair method" unless there are exceptional circumstances that justify the issuance to protect the interests of all shareholders.

This court decision is notable for considering not only the existence of a struggle for control but also whether the determination of control was imminent when identifying the purpose of the New Share Issue. Furthermore, the decision is distinguished by its thorough assessment of the fundraising purpose, examining the business necessity, the reasonableness of the specific uses of the funds, the rationality of the fundraising method, and the appropriateness of the selection of the planned allocation recipients.

III. Case in which an injunction was granted against the gratis allotment of stock acquisition rights as a takeover defense measure *(Osaka High Court Decision of July 21, 2022 (Mitsuboshi case))*[2]

(a). Outline

By March 2022, Adage Capital Limited Liability Partnership (the "**Applicant**"), together with its related parties, acquired 21.62% of the shares in Mitsuboshi Inc. (the "**Respondent**").

In February 2022, the Applicant requested the convening of a shareholders' meeting of the Respondent to dismiss its current directors. In response, the Respondent resolved by its Board of Directors in April 2022 to adopt a new policy (the "**Policy**") requiring compliance with procedures such as submitting a statement of opinion in the event a specific group of shareholders engages in "large-scale purchase actions."

Subsequently, the Respondent, considering the likelihood of an acquisition by the Applicant, resolved by its Board of Directors to implement a gratis allotment of stock acquisition rights (the "**Gratis Allotment**") as a countermeasure against the acquisition. The Gratis Allotment was then approved with 54% in favor at the Respondent's shareholders' meeting held in June 2022.

The details of the Gratis Allotment are outlined below.

- Persons designated as ineligible by the Respondent may not exercise the allotted stock acquisition rights.
- These designated persons will receive a different type of stock acquisition rights in exchange for the

[2] The Financial and Business Law Precedents No. 1667, 30 (2023).

acquisition of the original stock acquisition rights by the Respondent.

- The exercise conditions for these different type of stock acquisition rights include the withdrawal of the large-scale purchase actions.

Following the Gratis Allotment, the Applicant filed a provisional injunction against the Respondent to cease the Gratis Allotment, arguing that it was implemented by using an extremely unfair method (Article 247(2) of the Act).

(b). Court Decision

The Court determined from the perspective of maintaining the common interests of shareholders that if (i) it is necessary to introduce countermeasures even if this results in unilaterally reducing the shareholding ratio of certain shareholders, such as those competing for control with the current management, and (ii) implementing a gratis allotment of stock acquisition rights with discriminatory exercise conditions is reasonable in light of the nature and extent of the disadvantages to the acquirer, as well as whether and how the acquirer can take measures to withdraw, then such measures are not considered unfair and are made for the common interests of shareholders rather than merely to maintain control by the directors or specific shareholders supporting them.

The Court granted the provisional injunction in light of the following facts and circumstances.

- Regarding the necessity of takeover defense measures, the Court recognized the necessity of the Gratis Allotment because it was intended to provide shareholders with the time and information to consider the appropriateness of the large-scale purchase actions, and the Policy was approved with 54% in favor at the shareholders' meeting.
- Regarding the appropriateness of takeover defense measures, the Court found these inappropriate because (i) it was unclear how the acquirer should withdraw the large-scale purchase actions, effectively making them impossible to withdraw; (ii) the scope of those deemed ineligible was broad, leading to the exclusion of shareholders opposing the management's proposals at the discretion of the management; and (iii) although an independent committee was established, it was unclear whether the committee took to eliminate arbitrary decisions by the current management. The Court also found that at the shareholders' meeting, shareholders were concerned that if they did not vote for the proposal, they would be recognized as ineligible and treated unfavorably in the Gratis Allotment. Even though the proposal for the Gratis Allotment was passed by a very narrow margin, there remains doubt as to whether the shareholders truly cast their votes in support of the current management. Therefore, it cannot be immediately said that the resolution of the shareholders' meeting establishes the appropriateness of takeover defense measures.

(c). Key Takeaways

Based on multiple court decisions, including the one mentioned, the Ministry of Economy, Trade and Industry formulated guidelines on August 31, 2023. According to these guidelines, the legality of

countermeasures against hostile takeovers is limited. The guidelines indicate that the possibility of avoiding the damage of share dilution caused by the activation of a countermeasure, such as allowing the acquirer the time to withdraw or stop the takeover, is a factor in determining the appropriateness of the countermeasure.

This case is an example where the appropriateness of the countermeasure was denied because the method for withdrawing the takeover was practically closed. Another notable aspect of this case is the broad and difficult-to-determine scope of those deemed ineligible for the gratis allotment, indicating that recommendations from an independent committee alone are not sufficient to prevent arbitrariness.

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If you have any questions regarding the matters covered in this memorandum, please reach out to your usual TMI contact or the attorneys listed above.

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