

# Japan Corporate & Finance Insights

## G-Next Case Involving Petition for Provisional Injunction Restraining Issuance of New Shares and Share Options

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## I. Overview

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The case leading to Tokyo District Court Decision - August 8, 2024 (this “**Case**”) involved the largest shareholder and founder (holding 35.36% of the issued shares) (the “**Shareholder**”) of G-Next Inc. (the “**Company**”), a company listed on the Tokyo Stock Exchange Growth Market, filing a provisional injunction order seeking to enjoin the Company from issuing new shares and share options. The Shareholder set his right to demand an injunction against the Company under Article 210(2) of the Companies Act and his right to demand an injunction against the issue of share options under Article 247(2) of the same Act as rights to be preserved, his claim being that: (i) the issuance of 766,300 shares of common stock (the “**New Shares**”) (the “**New Shares Issuance**”), which are currently being processed pursuant to the resolution of the Company’s Board of Directors meeting held on July 26, 2024 (the “**Board of Directors Meeting**”); and (ii) the third-party allotment of the Company’s share options (the “**Share Options**”) (the “**Share Option Issuance**” and together with the New Shares Issuance, the “**New Shares / Share Options Issuance**”), which were under process pursuant to the resolution of the Board of Directors Meeting, were being carried out in a grossly unfair manner, primarily for the aim of maintaining the control of the Company by the incumbent management or the new management recommended by the incumbent management.

In the case of third-party allotments of shares and share options, the target company (the management) often claims that the reason for issuing shares and share options is “the need to raise funds”. In this Case, the issue was whether the New Shares / Share Options Issuance was carried out in a grossly unfair manner (i.e., whether it fell under any grounds for an injunction).

A “grossly unfair manner” involves issuing new shares or share options “as a means to achieve an unjustified purpose”, and a typical example of this is when a director issues new shares or share options to maintain control of the company. In previous cases where multiple purposes appeared to coexist, the applicability of the “grossly unfair manner” has been determined by the main purpose of these multiple purposes (commonly known as the “main purpose rule”).

The “main purpose” must then be objectively identified from the external factual circumstances. Specifically, if either (i) there is not currently a dispute over control, or (ii) the relevant new share issuance will not significantly impact the dispute over control of the company (such as if the new share issuance will not reduce the shareholding ratio of a shareholder fighting for control), the likelihood of maintaining management control as the main purpose is lower. Conversely, if both (i) and (ii) are affirmed, the likelihood of maintaining management control increases, and one should focus on the question of whether the issuance is “deemed to have the raising of funds as its main purpose,” taking into consideration the necessity and urgency of the capital increase, the rationality of using the funds, the scale of funds raised, the rationality of strengthening equity capital by issuing new shares through a third-party allotment, the rationality of the allocated party, and various other circumstances.

In this Case, the court also made a decision in line with such previous court rulings.

## II. Decision: Dismissed

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### a. Competition for Management Control.

The court in this Case made the following analysis:

The Director Rights and Obligations Holders<sup>1</sup> had not nominated themselves as candidates for the Board of Directors. Furthermore, there was no sufficient evidence to suggest that the Director Rights and Obligations Holders would effectively control the Company once their nominees were appointed as directors. Conversely, the Shareholder intended to transfer the majority of his shares (approximately 33% of the issued shares) to a third party. Therefore, in this Case, neither the Shareholder nor the Company's directors intended to acquire management control of the Company themselves, nor was there any competition for management control between them in a typical sense.

However, it could be inferred that the Director Rights and Obligations Holders had lost confidence in the Shareholder, who had decided to transfer management control to a third party via a share transfer without consulting the Company's officers. Therefore, it was possible that the Director Rights and Obligations Holders may not have wanted the Shareholder's chosen transferee to become the new de facto controlling shareholder.

The situation where those who the Shareholder did not want would become the controlling shareholder was unwelcome to the Shareholder as it might have diminished the cash value of the control premium that the Shareholder was contemplating.

Therefore, although the Shareholder and the Director Rights and Obligations Holders may not have been in competition for management control in the typical sense, they could certainly be viewed as such in a broader sense.

### b. Impact on Shareholders' Shareholding Ratio.

As a result of the New Shares Issuance, the Shareholder's shareholding ratio (in terms of voting rights) would decrease from 35.36% to 29.92%, meaning that the Shareholder would lose his ability to block the special resolution independently. In addition, if the Share Options were issued and exercised by the third-party allottee (the "**Allottee**"), the Shareholder's shareholding ratio would be reduced to 24.10%, and the Allottee would replace the Shareholder as the largest shareholder. Therefore, the New Shares / Share Options Issuance constituted a case where a significant number of new shares were issued and allocated to a third party, which would have a significant impact on the shareholders' shareholding ratio.

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<sup>1</sup> This term refers to a corporate officer who has retired from office due to expiration of the officer's term of office or resignation, but that continues to have rights and obligations as an officer until a newly elected officer assumes office. This occurs where there are no officers in office or where there is a vacancy which results in a shortfall in the number of officers prescribed in the Company Act or Articles of Incorporation (Article 346(1) of the Companies Act).

### **c. Main Purposes of New Shares / Share Options Issuance.**

#### **Necessity and Urgency of Capital Increase**

The court in this Case decided that because the Company had recorded operating losses, ordinary losses and net losses for three consecutive terms, falling into insolvency at the end of June 2024, and unless it increased its capital, there was a high possibility that it would become insolvent by approximately 100 million yen or more by the end of March 2025, in light of the Company's continued negative operating cash flow, there was an urgent need for the Company to increase its equity capital, eliminate its insolvency and take drastic measures to address the situation.

The Company is a small listed company that had been unprofitable for a long period of time, and since issuing credit is a serious matter it is the directors' duty to resolve the insolvency as soon as possible, such as by increasing capital. In order to maintain relationships with financial institutions, customers, employees and others, the Company came to the reasonable decision that it was necessary to carry out fundraising to resolve the insolvency and that there was an urgent need to carry out a capital increase before that time.

#### **Reasonableness of Use of Funds and Size of Fundraising**

It was not unreasonable to use the funds from the New Shares / Share Options Issuance to improve the quality of the Company's main services, invest in AI products, recruit personnel and reorganize the Company. Furthermore, the Company's board of directors had been discussing fundraising, including the issuance of new shares, for approximately one year before the conflict between the Shareholder and the Director Rights and Obligations Holders arose. In addition, on May 9, 2024, the Shareholder himself stated that it was necessary to increase the capital by 600 million yen. In light of these facts, the scale of the fundraising for the New Shares / Share Options Issuance could be considered reasonable.

#### **Reasonableness of Strengthening Equity Capital by Issuing New Shares and Share Options By Way Of Third-Party Allotment**

Issuing new shares and share options was a reasonable method of raising funds in response to insolvency, as it would increase equity capital. On the other hand, a public capital increase was not realistic for the Company, as it was a small listed company and had financial problems. Furthermore, the choice of a third-party allotment of new shares could not be deemed unreasonable, given that shareholder allotment and rights plans lack certainty regarding the amount of the capital increase.

#### **Reasonableness of Allottee**

The Allottee was one of several candidates that had previously been considered and that had expressed an intention to make the payment within a reasonable and timely period. The Shareholder had also suggested other parties for allotment, but there was no evidence to suggest that the other parties were suitable candidates, and this could not be considered a valid reason for treating the Allottee as unreasonable.

### **Maintaining Control of the Company**

The Director Rights and Obligations Holders were expected to lose their rights and obligations without making themselves candidates for directors of the Company, and the Special Committee, which was established on the premise that the Director Rights and Obligations Holders would reach a conclusion in accordance with the opinions of the Special Committee regardless of the content of the Committee's opinions, issued an opinion to the effect that the New Shares / Share Options Issuance to be issued in this Case were necessary and reasonable. Furthermore, in light of the content and course of the discussions at the Board of Directors of the Company to date, it was apparent that the Company was not simply protecting itself but was aiming to maintain and improve its corporate value and the common interests of its shareholders.

### **Decision on Main Purposes of New Shares / Share Options Issuance**

In light of the above, it can be said that there was a conflict between the Director Rights and Obligations Holders and the Shareholder regarding control of the Company's management. The New Shares / Share Options Issuance, including the exercise of the Share Options, would result in a decrease in the Shareholder's voting rights ratio to the extent that he would no longer be considered the controlling shareholder. However, the Company was in an extremely difficult financial and management situation, and raising funds through the New Shares / Share Options Issuance was a necessary and urgent means of strengthening the Company's equity capital, which had fallen into insolvency, and maintaining and restoring its creditworthiness. In light of the progress made by the Board of Directors and the Special Committee as well, it can be acknowledged that the main purpose of the New Shares / Share Options Issuance was to raise funds and not to maintain control of the Company by the Director Rights and Obligations Holders or the new management recommended by the Director Rights and Obligations Holders by reducing the Shareholder's shareholding ratio.

#### **d. Proceedings of Shareholders Meeting and Course Leading to New Shares / Share Options Issuance.**

The Shareholder argued that the New Shares were issued in a grossly unfair manner, maintaining that:

- (i) the Director Rights and Obligations Holders were acting with the aim of maintaining control of the Company's management because they did not put the motion to amend the Shareholder's proposal for the election of directors to a vote due to unfair proceedings; and
- (ii) without these unfair proceedings, the Director Rights and Obligations Holders would have lost their authority, meaning the resolution to issue the New Shares / Share Options Issuance could not have been passed by the board of directors,

However, the court found no gross unfairness, noting that the resolution to continue the meeting had been rejected by the shareholders including the Shareholder himself and the Chairman had no duty to redo that decision.

The court also made the following judgments:

(1) The New Shares / Share Options Issuance was mainly due to the fact that the Shareholder, despite the repeated discussions on fundraising, etc. at the board of directors' meetings in which he was also a member, suddenly announced a few days before the Board of Directors Meeting that he would transfer most of his shares at 1.5 times the market price, and did not fully explain at the same board meeting the conditions for such transfer, etc. These circumstances imply that the Shareholder prioritized selling the majority of his shares at a high price over fulfilling his responsibilities as a representative director to pursue the common interests of shareholders.

(2) In light of these circumstances and other factors, it could not be said that the New Shares / Share Options Issuance constituted a grossly unfair manner, even taking into account the shortcomings in the proceedings of the Board of Directors Meeting as maintained by the Shareholder.

#### **e. Conclusion.**

Following these arguments a. to d. above, the court dismissed the petition because the New Shares / Share Options Issuance did not constitute a case where the issuance was used as a means to achieve an unjustified purpose and was not made in a grossly unfair manner.

### **III. Significance**

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The significance of this Case is that:

- (i) The court applied the so-called "main purpose" rule when deciding on the provisional injunction order regarding the issuance of new shares.
- (ii) The court decided that (a) it could be said that there was a conflict between the Director Rights and Obligations Holders and the Shareholder regarding control of the Company's management, (b) and the New Shares / Share Options Issuance, including the exercise of the Share Options, would result in a decrease in the Shareholder's voting rights ratio to the extent that he would no longer be considered the controlling shareholder, however, (c) raising funds through the New Shares / Share Options Issuance was a necessary and urgent means of strengthening the Company's equity capital, which had fallen into insolvency, and maintaining and restoring its creditworthiness, and it was acknowledged that the main purpose of the New Shares / Share Options Issuance was not to maintain control of the Company by the Director Rights and Obligations Holders or the new management recommended by the Director Rights and Obligations Holders by reducing the Shareholders' shareholding ratio, so such New Shares / Share Options Issuance was not made in a grossly unfair manner.

On the other hand, in connection with whether the allotment of share options without contribution constitutes grounds for an injunction as a "grossly unfair manner" in the event of a takeover defense (a policy against takeovers) rather than fundraising as in this Case, many cases can be seen in which the acquirer claims an unjustified purpose, such as maintaining management control, and the target company's management claims a "legitimate purpose" based on

the necessity and reasonableness of the countermeasure. Please note that this Case concerned a case in which the need to raise funds was claimed and was not a case involving the allotment of share options without contribution as a defense measure against a takeover.

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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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