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Judicial Review of Japanese Poison Pills from the Perspective of Shareholder Coercion

Between Shareholders' meeting and Board of Directors meeting, which corporate organ is better situated to evaluate the issue?

By Toshiyuki Arai

Context

Since 2005, Japanese courts have reviewed the legality of many poison pills[1] and whether they can withstand the shareholder equality principle. Among those cases, of particular interest have been (a) how courts evaluate approval mechanisms for poison pills between a shareholders' meeting and a board of directors meeting; (b) whether the majority of minority (MoM) voting test is appropriate to be invoked in the approval of a pill; and (c) whether there are different types of shareholder coercion (sell pressure; *kyoatsusei*) that should be considered in determining what approval mechanism is appropriate.

In discussing these issues, we will assume the underlying facts of In re Tokyo Kikai Seisakusho (discussed in our June 2022 alert). For ease of reference, we reattach the facts of the case at the end of this article. In that injunction application, the courts held that the board of directors could implement a poison pill but it has to be approved by a confirmatory shareholders' meeting but without the interested parties voting in the process (i.e., the MoM test).

Issuance of a pill: to be reviewed by shareholders or board of directors?

The leading Supreme Court case in 2007 (In re Bulldog Sauce)[2] established the general principle that the shareholders need to approve a poison pill. The relevant part of the holding reads as follows:

"Whether a certain shareholder acquiring management control would cause injury to the corporate value or the company's/shareholders' common interest needs to be ultimately decided by the owner of the company, the shareholders themselves."

The Tokyo Kikai case followed this rule recently, although there are meaningfully different circumstances between the two cases:

- The Bulldog board launched a pill by a board resolution subject to the approval of a shareholders' meeting over amendment of the articles of incorporation to enact the pill. It required a special majority of all shareholders as of the standard date; while the Tokyo Kikai decisions endorsed the MoM standard shareholders to approve the pill. Besides, the Tokyo Kikai shareholders meeting was for confirmation purpose only and not for a statutory function of shareholders.

- From the perspective of the sell pressure type, the circumstance involved in the Bulldog share purchase was a straight tender offer of all shares at flat Yen 1700 per share (after modification of price; thus it gave rise to no issue of pressure in this respect), while the Tokyo Kikai case was a stealth market purchase of shares of a significant percentage (32.72% by the time the pill was introduced) in a short period. The perceived problem in Bulldog was the fact that the acquirer stated no clear management vision or concrete ideas for betterment of the company, rather than the mechanics of the tender offer creating anxiety among the shareholders to sell their shares.

As a reference, Delaware courts allow the board of directors to review a poison pill based on the independent directors' opinion as supported by finance and legal experts. This is contrasted with the Japanese court's belief that, when the shareholders are empowered to elect (and terminate) directors, directors being allowed to implement the issuance of pills that impacts the right of shareholders is patently against the intended bifurcation of authority as intended under the Corporations Code. In re Nippon Broadcasting.[3] This is also consistent with the Bulldog holding.

The above observation is more conceptual than practical based on the corporate governance structure. In fact, the private placement of shares is entrusted with the board in some circumstances already under the Corporations Code,[4] so it is not outside the realm of possibility to begin with. Substantively, the Japanese court's view is more a product of how they observe the board's role, i.e., independent directors' unfettered independence is often questionable and there is a perceived dearth of expert support in law and finance for them to fulfill their duties. In that situation, it may be realistic to conclude that a shareholders' meeting should decide on the validity of a warrant issuance as the Tokyo Kikai courts did. The fact that there is no statutory underpinning for that confirmation mechanism does not appear to be fatal because some corporate organ should be assigned to review the warrant issuance in any event.

MoM (majority of minority) test

A much larger issue, however, is whether a shareholders' meeting should be allowed to exclude the interested parties from voting by design of a pill. In Tokyo Kikai, the acquirer had already bought nearly 40% by the standard date. Again as a reference, in other jurisdictions, the MoM test is hardly ever used to protect shareholders from a hostile acquirer, but is used to protect minority shareholders from abuses of a controlling shareholder. The concern here is whether the board is given too much discretion in designing a pill by resorting to the MoM test. Note in particular that this is the rule that is blessed by the Supreme Court of Japan at this point.

Instinctively, we feel that the board of directors, i.e., a corporate organ that is controlled by the incumbent management in reality in Japan, is incentivized to exclude the acquiring shareholder. Particularly when there is a management contest between the incumbent management and the acquirer, or a difference of opinion between them as to the corporate worth of the company (both circumstances were present in Tokyo Kikai), the management shouldn't be allowed to be favored by mechanically excluding the acquirer from voting, its only competitor. If the court rubber stamps the independence of the board or the allegation about potential abuses of the acquirer, which it can and does seem to do at times, the exclusion will deprive the company of an opportunity to have a fair game for the two competing camps. The review of a poison pill is devised for the purpose of ensuring fair play from the perspective of (a) ensuring procedural prudence and (b) designing to achieve the highest corporate worth. The elimination of the acquirer from voting is probably too tilted towards the protection of the incumbent management. Many commentators already question this part of the holding and the Tokyo Kikai courts point to no precedent or similar theories to justify the test (other than to suggest that the acquirer has shown traits of unfairness as exhibited by breach of procedural requirements unilaterally imposed by the board in the pill, which of itself is questionable to justify the MoM test).

Different types of shareholder coercion

In reviewing the relevant cases from a Delaware law perspective,[5] we realize that there are potentially different types of sell pressure that are not distinguished by our courts. In Tokyo Kikai, the issue was the stealth market purchase of the shares in a very short time without the knowledge of the existing shareholders. In Bulldog, the issue was not how the share purchase was made (it was a plain tender offer) but rather the buyer's lack of explanation as to how it envisioned to run the company better once acquired.

To confirm, the major purpose of a pill review is to eliminate unnecessary sell pressure to prevent the stock sale in panic. The Tokyo Kikai type of sell pressure (Type I Pressure) can arise for example by a tender offer that is bifurcated with the front-end valued higher. It can also arise in the context of a stealth market purchase of shares in a short period of time.[6] These circumstances cause the existing shareholders to fear that the share price will collapse shortly and cause them to sell shares irrationally now without knowing the full context of the attempted acquisition. In other words, these circumstances tend to cause fire sale for fear of the unknown because there is (a) no information on the reasons and background for the acquisition and (b) no time to digest such reasons. In this situation, even assuming the line of cases discussed above, it is arguable whether a shareholders' meeting needs to get involved because the court is reasonably equipped to evaluate the impact. However, as we have reviewed, the cases do not distinguish this pressure from that under Bulldog (Type II Pressure as discussed below) that must be reviewed by shareholders.

However, the sell pressure is also caused by the lack of information on what the acquirer knows about the worth of the company (Type II Pressure), as shown in Bulldog. This pressure also derives from the lack of information on the current worth of the company under the incumbent's plan and circumstances. In the absence of objective evidence that the acquiring proposal contemplates the value to be too low, it is questionable whether such gap is a reasonable cause for fire sale (because the uncertainty will be present in any similar circumstance), and if so, it shouldn't be a circumstance impacting the pill one way or the other. (The acquirer's future plan is by definition uncertain, so an anxiety corresponding to it shouldn't be protected.) On the other hand, if such objective evidence can be presented by, for example, an expert opinion rendered by an independent committee, it would amount to be a ripe situation to critically review the pill. In this instance, a valid business issue that may prompt a fire sale has been presented, and the shareholders are best situated to assess the validity.

We recognize these are theoretical distinctions and both threats can co-exist in the same situation. If that happens, how that review should be had needs further consideration.

Be that as it may, the current status of the pill review under Japan's case law is to entrust the review with the shareholders without making distinctions between the two types of sell pressure. Division of authority argument aside, we believe that this stems from the fact that the courts may not altogether trust the Japanese board's ability to render independent and well-grounded judgment on how a pill should be evaluated. With that situation in mind, to ask shareholders to approve at all times is probably not too bad a result, provided that the MoM test is very questionable to be justified.

Takeaways

1. Japanese courts generally take the view that only shareholders are equipped to review a poison pill. This view derives from the division of authorities between shareholders and the board under the Corporations Code, as well as the skepticism over the board being capable of competently reviewing the issue.

2. The recent Tokyo Kikai Seisakusho injunction decisions endorsed the MoM test in approving the disputed poison pill. This is Japan's law for now, although it is heavily debated and it seems possible to change in the future.

3. In reviewing shareholder coercion, different types of sell pressures should be distinguished, and the inherent coercion derives mostly from Type I Pressure (mechanical pressure as in Tokyo Kikai and Nippon Broadcasting). Under the current case law, however, Type I and Type II Pressures are treated the same to be approved by the shareholders. It would warrant a careful review as to whether Type II Pressure indeed exists and if so whether such pressure should impact the validity of the pill. Type I Pressure may be simply reviewed judicially given the mechanical nature of the pressure (which isn't the current courts' view.)

[Facts of Tokyo Kikai Seisakusho Case]

The acquirer and its subsidiary (collectively, the "Acquirer") commenced share purchase in the market of the target company (the "Target") from March 2021. The Target was listed on the First Section of the Tokyo Stock Exchange. The Acquirer completed the acquisition of 32.72% of the voting stock by July 21. The Acquirer filed a mass shareholding report on July 20 in which the purpose of holding was described as a pure investment, and subsequently filed an amendment report on July 21 in which the purpose was modified to the acquisition of control.

Noticing this operation, the Target's board of directors resolved to adopt certain anti-takeover defense measures (the "Measures") on August 6. The Measures put in place certain procedural requirements for the commencement of a large share percentage acquisition, absent compliance with which the Target will be authorized to trigger the Measures. The Measures consisted of the following features, among others:

- Shareholding trigger is 20% or more
- Free warrants issued to all existing shareholders but with unequal exercise conditions
- Independent committee review required for implementation
- No shareholders' meeting held to issue the pills
- Issuance of secondary warrants to Acquirer that are intended to compensate for the Acquirer's damages
- Validity limited through June 2022 shareholders' meeting

The Acquirer nonetheless continued in-market purchase of the Target's shares. The Target's board resolved on August 30, at the recommendation of the independent committee, to issue free warrants to all shareholders but to exclude the Acquirer from exercising them. The resolutions provided that the effect of the Measures would cease if the confirmatory shareholders meeting (the "Confirmatory Shareholders Meeting") to be held on October 22 did not approve the Measures. The requirement for approval was 50% or more of the disinterested shareholders voting in favor of the Measures (excluding both the Acquirer (holding nearly 40%) and the Target's incumbent management; the "MoM Requirement"). A proxy advisory firm recommended voting in favor of the Measures.

The Acquirer commenced on September 17 an injunctive action to preclude the effect of the Measures based on (a) the illegality/violation of charter documents and (b) the grossly inappropriate method of issuance, both under Article 247 of the Corporations Code.

The Confirmatory Shareholders Meeting on October 22 approved the Measures by 79% voting in favor of the pill, with the Acquirer excluded from voting.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings Tokyo lawyer:

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[1] See, Supreme Ct., August 7, 2007, Minshu 61-5-2215 (In re Bulldog Source); Tokyo District Ct., October 29, 2021, Shoji Homu 453-107; Tokyo High Ct., November 9, 2021, Shoji Homu 453-98; and Supreme Ct., November 18, 2021, Shoji Homu 453-94 (In re Tokyo Kikai Seisakusho); Tokyo District Ct., April 2, 2021, Shoji Homu 446-166; Tokyo District Ct., April 7, 2021, Shoji Homu 446-163; Tokyo High Ct., April 23, 2021, Shoji Homu 446-154 (In re Japan Asia Group); Nagoya District Ct., April 7, 2021, Shoji Homu 446-144; Nagoya High Ct., April 22, 2021, Shoji Homu 446-130 (In re Nippo Sangyo); Tokyo District Ct., June 23, 2021, Shoji Homu 450-151; and Tokyo High Ct., August 10, 2021, Shoji Homu 450-143 (In re Fuji Kosan).

[2] Supreme Ct. Decision, August 7, 2007, Minshu 61-5-2215 (In re Bulldog Source).

[3] Tokyo District Ct., March 16, 2005, 1173 Hanrei Taimuzu 140; Tokyo High Ct., March 23, 2005 Case No. (ra) 429 of 2005, 1899 Hanrei Jiho 56; 1173 Hanrei Taimuzu 125; 1214 Kinyu Shoji Hanrei 6.

[4] Corp. Code, Articles 199, Para.1 and 201, Para.1.

[5] See Air Products & Chemicals, Inc. v. Airgas, Inc. 16 A.3d 48, 122 (Del. Ch. 2011).

[6] See In re Nippon Broadcasting and In re Tokyo Kikai Seisakusho.