June 2022

Reasonableness of Poison Pill Examined

—3 Japanese courts deny injunctive relief against an anti-takeover measure by giving weight to shareholders meeting approval without the acquirer allowed to participate

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Background

How an anti-takeover measure can be justified has been argued in many different ways in the last 20 years. In recent significant decisions involving an injunctive motion by the acquirer triggered by the issuance of a poison pill against an in-market purchase of shares, Tokyo District Court, Tokyo High Court, and Supreme Court[1] all ruled to tolerate the defense measure by outlining requirements to overcome the presumption against the incumbent management of an unfair intent to retain control.

Facts

The acquirer and its subsidiary (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 further 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" for *majority of minority*). 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 Companies Act.

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

Characteristics of the Measures

To understand the Measures in the context of other poison pills, the Measures have the following characteristics:

- The Measures were in response to in-market purchases and not to a tender offer
- The Measures were adopted in response to an existing and present threat of a takeover (at the time the Acquirer held 32.72%)
- Only the board resolutions were secured to adopt the Measures
- The Acquirer neither disclosed its plans for further purchase of shares nor its management vision
- Confirmatory Shareholders Meeting was required to continue the effect of the Measures

Issues

1. How should the court go about evaluating whether the Measures constitute grossly inappropriate issuance?
2. How does the "sell pressure" exist under the facts?
3. How much weight should be given to the Confirmatory Shareholders Meeting in the absence of statutory underpinnings for such a meeting? What should be the voting requirement for consent if the meeting should be given weight?

Summary of Decision

Given the identical conclusion of the three court decisions, we summarize herein the Tokyo High Court decision that is most detailed. The Supreme Court affirmed the High Court's decision.

1. The Acquirer's effort to continue in-market purchase of the Target's shares presents a "sell pressure" (*kyoatsu-sei*) to the Target's existing shareholders.

2. The sell pressure is defined as a sense of needing to dispose of the owned shares before the stock price will likely fall in the absence of adequate information to evaluate how the stock price would perform and in the aversion of risk to avoid potential damages to the enterprise value due to a takeover attempt.

3. It is not immediately unreasonable to validate the effect of the Measures by the disinterested shareholders voting through the Confirmatory Shareholder Meeting for purposes of reviewing whether the takeover attempt will have an adverse impact on the enterprise value and the common interest of the shareholders generally.

4. In light of such circumstances, the fact that the Acquirer had no vote in the Confirmatory Shareholders Meeting is not unreasonable and it does not give rise to an issue with respect to the "one-share one-vote principle" under Article 308, Paragraph 1 of the Companies Act.

Discussion

The courts start reviewing the issues with the presumption that any unequal issuance of shares/share equivalents would constitute an illegal attempt to monopolize the management control by the incumbent management in the absence of justifiable circumstances involving the Measures to overcome such presumption. Circumstances reviewed to analyze the reasonableness were, among others, whether the undue sell pressure existed in the facts and whether the pressure was so material as to rationalize the Measures taken.

The courts gave weight to the lack of clarity by the Acquirer as to its plans for further purchase and its intended management policy if it were to replace the current management. In the absence of such information, the courts felt, the shareholders would be inevitably pressured to sell their stock to avoid the downside caused by the lack of relevant information and plan. And the lack of information and time to make an informed determination would lead to the deterioration of enterprise value. These facts may have some truth under the circumstances, but whether the approval process without the Acquirer should be the universal rule is an issue to be further examined as we discuss below.

This issue is also impacted by the difference in sell pressures that exist in tender offers as opposed to in-market purchases. These courts did not go into details of this analysis. In a tender offer, the offer terms (e.g., price and duration) are set out clearly, while in a private market purchase, how the purchase operation will be conducted is left totally ambiguous. Among others, the price and duration are unclear and such uncertainty could lead to more anxiety among shareholders leading to more sell pressure. On the other hand, such pressure may not be felt very much by unaware shareholders.

The concern about uncertainty is understandable, but how the Target should secure the shareholder consent (if necessary at all) and the scope of shareholders that should be allowed to vote on such decision require more nuanced discussion. At the outset, there is no statutory mechanism that requires a Confirmatory Shareholders Meeting. Nor is the MoM Requirement a product of statutory provision; it is merely a creation of the Target's board resolutions. Be that as it may, the courts felt that the

Confirmatory Shareholders Meeting was not inconsistent with the desirable procedural requirement to secure the consent of the shareholders with respect to the presence of sell pressure and ensuring appropriate steps and timeframe to secure information on how the Target will be operated by the Acquirer.

The issue of why the Acquirer should be excluded altogether from the Confirmatory Shareholders Meeting remains unclear under the decisions. This arrangement is unprecedented anywhere to start with. Some commentators take the view that acquirers by definition will favor the ongoing takeover without reference to the common good of the shareholders and it is a waste to have them partake in the vote. However, such position may be inappropriate at least with respect to a reasoned and well-explained takeover attempt because the argument is preconditioned to disfavor any acquirer without regard to any favorable circumstances (including the common good the takeover may achieve). Some commentators feel that it would take actual abusive circumstances with the acquirer to exclude the acquirer from voting and exclusion should not be a *per se* rule, although such condition would make the requirement less clear and harder to apply in practice. Overall, the decision's reach is yet to be ascertained.

Takeaways:

1. In attempting a takeover, to explain the acquirer's plan and management vision is extremely important. To be ambiguous about the information will be viewed as evidence of uncertainty that will increase the sell pressure.

2. For a target company to devise an emergency poison pill in the face of an attempted takeover is not necessarily frowned upon by the Japanese courts. But it requires well thought-out mechanisms to ensure fairness.

3. While it is possible to implement a poison pill by a board resolution, it would materially enhance the chance of success in court to involve shareholders to vote even if it is a confirmatory shareholders vote among disinterested shareholders. The lack of statutory grounds for such voting process doesn't seem to bother the courts.

4. There are three other poison pills cases[2] that appeared in the last year, and how these decisions are inter-dependent on one other is a perspective that should not be missed in reviewing this case.

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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] 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.

[2] 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., April 2, 2021, Shoji Homu 446-163; Tokyo High Ct., April 23, 2021, Shoji Homu 446-154 (in re Nihon Asia Group); 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).