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Client Alert

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Japan: Publication of Guidelines for Corporate Takeovers (Draft)

In brief

On June 8, 2023, the Ministry of Economy, Trade and Industry ("**METI**") published and invited public comment on the "Guidelines for Corporate Takeovers (Draft) - Enhancing Corporate Value and Securing Shareholders' Interests" (the "**Draft Guidelines**"). The Draft Guidelines have been prepared based on the discussions held by the Fair Acquisition Study Group established by METI in November 2022. Their purpose is to present principles and best practices that should be shared throughout the economy and to develop fair rules regarding M&A transactions, specifically with regard to how parties should behave when acquiring control of a listed company. The public comment period will end on August 6, 2023, and it is expected that the final guidelines will be formulated based on the comments submitted. The following is a summary of the Draft Guidelines.

Background, structure and meaning of the Draft Guidelines

Starting with the "Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests" formulated by METI and Ministry of Justice in 2005 (the "**2005 Guidelines**"), METI has provided guidelines and issued reports on principles, perspectives and best practices regarding M&A transactions in Japan. These include the "Fair M&A Guidelines - Enhancing Corporate Value and Securing Shareholders' Interests" (the "**Fair M&A Guidelines**") formulated in 2019.[1]

Since the introduction of the Corporate Governance Code, the number of listed companies adopting takeover response policies[2] has decreased. This is because shareholders (especially institutional shareholders) generally do not consider such plans to not be in their best interest, making it difficult to secure their approval. At the same time, the number of the unsolicited offers and proposals and cases in which counter tender offers have been announced or launched in competition with initial acquisition proposals have increased. These unsolicited offers have resulted in court decisions concerning the invocation of countermeasures[3] based on adopted takeover response policies and injunctions that have been imposed in connection with these. These trends are raising complex issues that target company boards of directors must address.

The Draft Guidelines have been prepared[4] in response to these trends to improve predictability and ensure best practices for parties involved in acquisitions and market participants and encourage economically beneficial acquisitions.

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[1] The Fair M&A Guidelines provide best practices for protecting the interests of the general shareholders of a listed target by requiring the target company and the acquirer (as applicable) to implement various measures to ensure the fairness of the transaction if the acquirer is (i) a controlling shareholder or (ii) the target's management.

[2] The terms "response policy" and "takeover response policies" refer to acquisition-related policy or policies which provide that, in certain cases, a company will resist attempts to acquire it typically by making a gratis issuance of stock acquisition rights with unequal exercise and redemption terms, without the primary purpose of raising funds or other business purposes (Article 1.4(e) of the Draft Guidelines).

[3] The term "countermeasures against acquisitions" or "countermeasures," (previously referred to as anti-takeover measures) refers to specific actions, such as the gratis issuance of stock acquisition rights stipulated in the takeover response policies (Article 1.4(e) of the Draft Guidelines).

[4] The Financial Services Agency consulted on the review of the Tender Offer Rule and the Larger Shareholding Reporting Rule, etc. at the general meeting of the Financial System Council on March 2, 2023. The first meeting of the Working Group on the Tender Offer Rule and the Larger Shareholding Reporting Rule, etc. was held on June 5, 2023.

The Draft Guidelines are structured as follows:[5]

> Chapter 2: Principles and Basic Perspectives
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> Chapter 3: Code of Conduct for Directors and Boards of Directors regarding Acquisition Proposals (related: Appendix 1, Specific Actions by Directors and Boards of Directors)
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> Chapter 4: Increasing Transparency Regarding Takeovers
>
> Chapter 5: Takeover Response Policies and Countermeasures (related: Appendix 2, Assessment of Coercion and Appendix 3, Takeover Response Policies and Countermeasures (Specifics)).

The Draft Guidelines primarily address acquisitions of the shares of listed companies to obtain control of them. The scope of the Draft Guidelines includes not only cases in which an acquirer makes an acquisition proposal based on a request or approach by the target company's management, but also cases in which an acquisition proposal is made without such a request or approach (i.e., a so-called "unsolicited offer/bid").[6]

Principles and Basic Perspectives

In Chapter 2, the Draft Guidelines present the following three principles that should generally be respected when acquiring control of listed companies.

- Principle 1: Principle of Corporate Value and Shareholders' Common Interests (i.e., whether an acquisition is desirable should be determined on the basis of whether it will secure or enhance corporate value and the shareholders' common interests)
- Principle 2: Principle of Shareholders' Intent (i.e., the rational intent of shareholders should be relied upon in matters involving control of the company)
- Principle 3: Principle of Transparency (i.e., information useful for shareholders' decision making should be provided appropriately and proactively by the acquiring party and the target company. To this end, the acquiring party and the target company should ensure transparency regarding the acquisition through compliance with acquisition-related laws and regulations.)

Principles 2 and 3 are prerequisites for achieving Principle 1. In principle, respecting shareholder intent in an acquisition takes the form of obtaining the shareholders' consent to the tendering of shares. As long as both the acquiring party and the target company comply with relevant regulations in relation to providing the necessary information and time, it is expected that shareholders will make appropriate decisions (i.e., informed judgments).[7]

Code of Conduct for Directors and Boards of Directors Regarding Acquisition Proposals

1. Phased approach under the code of conduct

Chapter 3 of the Draft Guidelines outlines the following phased approach to acquisition proposals under the code of conduct for each director and board of directors.

① Response upon receipt of an acquisition proposal

[5] The Draft Guidelines indicate that no distinction should be drawn between the provisions in the Appendices and those in the main text, and together they form a single set of guidelines.
[6] Where an acquisition proposal is made without a request or approach by the target company's management, conflicts may arise between the acquiring party and the target company regarding the merits of the acquisition. The Draft Guidelines take these management conflicts of interest issues into consideration.
[7] The Draft Guidelines state that takeover response policies or countermeasures may be invoked in response to an acquisition attempt without consent, at the initiative of the target company in exceptional and limited circumstances where the regulatory framework described above is considered to be insufficient. In such an event, it is fundamental to confirm the reasonable intent of the shareholders at a shareholders' meeting with respect to approval or rejection of the takeover response policies and countermeasures.

First, upon receipt of an acquisition proposal, the target company's management should promptly submit or report it to the board of directors in principle. Whether an acquisition proposal should be submitted to the board of directors will be judged formally and objectively.[8]

The board of directors to which the acquisition proposal is submitted shall in general give "sincere consideration" to a "bona fide offer." In this regard, a determination could be made that an acquisition proposal does not constitute a "bona fide offer" if its concreteness, purpose or feasibility could reasonably be considered dubious. However, care should be taken to avoid arbitrarily interpreting the meaning of a "bona fide offer" and simply rejecting a proposal that could increase a target company's corporate value. If the board of directors proceeds to "sincere consideration" of a "bona fide offer," it is expected to obtain additional information from the acquiring party about the acquisition proposal and consider the acquisition's appropriateness from the perspective of whether it will enhance corporate value.

② Formulation of an approach by the Board of Directors to reaching agreement on an acquisition

When deciding on a direction toward reaching agreement on an acquisition, the board of directors of a target company (including any special committee it has established) should make reasonable efforts to ensure that the acquisition will secure the shareholders' interest[9] in addition to determining whether the acquisition is appropriate from the perspective of enhancing the company's corporate value, and should negotiate diligently with the acquiring party.[10]

Specifically, the following points will be considered and negotiated depending on the acquisition ratio and the consideration.

- If the proposal is an all-cash, full acquisition, the appropriateness of the price will be particularly important to the target company's shareholders because the acquisition will be their last opportunity to benefit (including obtaining a control premium) from their investment.
- If the proposal is a partial acquisition, the possibility of negotiating a change to a full acquisition should be explored. Even if the price is favorable, shareholders may not be able to sell all of their shares at that price in a partial acquisition. In addition, since some shareholders will remain minority shareholders after the acquisition, not only the appropriateness of the transaction terms in terms of price, but also whether the acquisition will increase corporate value over the medium to long-term will be a particularly important decision factor.
- If all or part of the consideration for the acquisition is shares, shareholders who accept the offer will retain the shares received. This means that they will be concerned about the price (i.e., the exchange ratio) and whether the value of the corporate group post-acquisition (i.e., the value of shares received as consideration) will increase over the medium to long-term.

2. Ensuring fairness by establishing a special committee

The Draft Guidelines refer to situations in which the establishment of a special committee would be useful as a fairness ensuring measure to ensure the interests of shareholders. They also state that the necessity of establishing a special committee should be considered on a case-by-case basis, depending on the severity of any potential conflicts of interest, the need to supplement the independence of the board of directors and the need to provide explanation to the market. Specifically, the Draft Guidelines provide that a special committee is useful in the following situations:

- When the appropriateness of the transaction terms is considered particularly important to the interests of the shareholders because the proposal includes a cash-out
- When considering takeover response policies or countermeasures
- Other cases in which accountability to the market is considered high (e.g., when there are multiple publicly-known acquisition proposals)

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[8] The Draft Guidelines include several factors to be considered. These include the specifics of the proposal (e.g., in written form rather than oral, whether the acquiring party is identified, inclusion of the purchase price and timing of the acquisition), and the credibility of the acquiring party, such as its track record and financial strength.

[9] In addition to the price, the purchase ratio and purchase consideration are included. The probability of a transaction occurring is also an important factor.

[10] The Draft Guidelines indicate that it is reasonable to seek to improve the terms of an acquisition to get the best available transaction terms for shareholders. Means of doing so identified in the Guidelines include publicly announcing facts concerning the acquisition to create an environment where other potential acquirers may make competing proposals after the announcement (indirect market check) and seeking out potential acquisitions that will benefit the shareholders (proactive market check).

Increased transparency regarding acquisitions

Chapter 4 of the Draft Guidelines describes how transparency in acquisitions should be improved from the perspective of both the acquirer and the target company in order to realize Principles 2 and 3 (i.e., the principles of shareholder intent and transparency).

1. Disclosure by the acquiring party at the time of the acquisition

It is advisable that a person/entity that intends to file a large shareholding report or tender offer registration statement make full disclosure of the purpose of the acquisition in accordance with the applicable regulations. In the case of an open-market purchase, in principle, the mandatory tender offer rules — including disclosure — do not apply. However, to ensure that the target company's shareholders understand the impact of the transaction on corporate value, the Draft Guidelines advise an acquirer attempting to acquire control within a short period of time through an open-market purchase to disclose information in an appropriate form to the markets and the target company equivalent in specificity to that which would be disclosed in a tender offer registration statement. This includes the purpose of the purchase, the number of shares to be purchased, a summary of the acquiring party and the basic post-acquisition management strategy after the acquisition.

Also, the Draft Guidelines explain that it is advisable for a party engaging in a pre-acquisition purchase (a so-called "toehold" purchase) that will definitely make a subsequent tender offer to disclose such intention of the subsequent tender offer to the market and the target company.

2. Disclosure of substantial shareholders

Although there are certain disclosure requirements for so-called "substantial shareholders" (i.e., beneficial shareholders) under the large shareholding reporting regulations, there are cases in which "substantial shareholders" are not identified at a stage not subject to such regulations (e.g., holding 5% or less of the total shares). The Draft Guidelines explain that a substantial shareholder making a takeover proposal is required to confirm its status as a substantial shareholder with the target company and provide information regarding its relationships with nominal shareholders. They further state that it is advisable for the acquirer to respond in good faith when asked by the target company about any joint holders.

3. Advance notice of planned tender offer

An acquirer may provide advance notice of a planned tender offer when it is necessary to announce a planned acquisition prior to launching a counter tender offer by another potential acquiring party. This can help the acquirer obtain the support of the target company’s shareholders before launching the tender offer. Advance notice of a tender offer may also be provided when an acquisition needs to be announced during the planning stages due to the need to obtain permits and approvals (e.g., clearance under the competition laws).

The Draft Guidelines acknowledge the practical necessity of giving advance notice of a planned tender offer but state that it is advisable that the tender offer have a reasonable basis, such as the availability of funds required for its settlement and an acquiring party make disclosure of specific information that could assist market judgment, such as the conditions under which the takeover bid will be conducted and the scheduled start date of the tender offer.

Takeover response policies and countermeasures

1. Overall strategy

Chapter 5 of the Draft Guidelines lays out takeover response policies and countermeasuresby revising the contents of the 2005 Guidelines taken into account recent trends mentioned above.

Takeover response policies — if used appropriately — may furnish shareholders with sufficient information and time to consider an acquisition offer. They can also contribute to overall transparency, give boards of directors leverage in their negotiations with acquiring parties and help protect the common interests of shareholders by extracting more favorable terms from acquiring parties or third parties. However, the Draft Guidelines state that takeover response policies should not be used to protect the incumbent management from "parties undesirable to the incumbent management" or to unreasonably frustrate the shareholders’ right to dispose of their shares via a tender offer or similar offer. The Draft Guidelines further provide that even where the purpose of a takeover defense measure is to confirm shareholder intent or ensure the availability of sufficient time, information or opportunity to negotiate, the neutrality of the actual operation of the measure to the parties concerned should be ensured.

Chapter 5 describes takeover response policies and countermeasures in terms of respecting the shareholder intent (i.e., obtaining their approval), ensuring their necessity and proportionality, making prior disclosure of them and having dialogue with market participants.

2. Respecting shareholder intent

Invoking countermeasures based on a response policy concerns changes in the persons/entities that control a company. As such, the Draft Guidelines state that the rational intent of the shareholders should be followed and explain the significance of shareholders' meeting resolutions and exceptional measures for confirming shareholder intent.

① Significance of a shareholders' meeting resolution invoking countermeasures

Courts have to date evaluated the legality of invoking countermeasures based on a response policy by examining their necessity and proportionality. Where the approval of a shareholders' meeting is obtained to invoke countermeasures — including cases in which a shareholders' meeting ratifies a decision by the board of directors to approve the gratis issue of stock acquisition rights — the necessity of the countermeasures is inferred, in principle.

Approval by a shareholders' meeting demonstrates the need to ensure the time and information necessary to confirm the shareholders' intentions regarding the acquisition proposal. In addition, when coercive acquisition tactics are used by an acquirer, shareholders need to be given an opportunity to consider the acquisition proposal without coercion and decide whether to approve or reject it separately from the decision to sell their shares.[11]

② Significance of adopting a response policy through a shareholders' meeting resolution

There are two types of response policy, depending on the timing of their adoption: a normal-phase type and an emergent-phase type. Some advocates argue that establishing and disclosing the rules before a specific acquiring party appears —during the so-called "normal" phase — enhances predictability for acquiring parties, shareholders and other interested parties by enabling them to anticipate that a response policy may be utilized in the event that a certain number of shares are acquired. However, response policies adopted during the "normal" phase may be assessed differently by the company adopting them and institutional investors. Even when a company believes its response policy to be reasonable, it will have difficulty utilizing it without obtaining the understanding and consent of shareholders and institutional investors.

In a court decision in a case in which a board of directors invoked countermeasures based on a response policy adopted by a resolution of a shareholders' meeting, the court upheld the content of the response policy and the legality of the invocation of countermeasures after a relatively lenient examination.[12] If the board of directors invokes countermeasures based on a response policy adopted by a shareholders' meeting, where the board's discretion is restricted, a court is more likely to find that invocation by the board is the reasonable intention of the shareholders.

There are practical examples of boards of directors adopting response policies at their own discretion during the so-called "emergent" phase due to time constraints. However, if the effective period of such a policy is repeatedly extended by the board, the policy may effectively deter acquisitions. Consequently, it is advisable for a target company to take measures to avoid arbitrary operation of its response policy (e.g., obtaining approval at a shareholders' meeting for any extension of the effective period) in order to ensure that the policy reflects shareholder intent. Alternatively, the response policy may be terminated when sufficient negotiations with the acquiring party have taken place.

③ Resolutions requiring a majority of the votes of non-interested parties[13]

In one court decision, a court upheld excluding the voting rights of the acquiring party, the target company's directors and their related parties, thereby allowing the adoption of a resolution at a shareholders' meeting on the invocation of

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[11] For example, (i) an acquisition where the first-step purchase terms are favorable but the second-step (usually a squeeze-out) terms are unfavorable or unclear (i.e., a coercive two-step transaction) is understood to have a strong coercive effect. (ii) When a ceiling is set for the number of shares sought to be acquired (i.e., a partial tender offer), certain existing shareholders will remain as minority shareholders. Thus, a partial tender offer may consummate acquisitions that reduce corporate value because the remaining minority shareholders will experience a reduction in corporate value. Such acquisitions are understood to have a coercive effect.

[12] For example, the Nippo Sangyo case (Nagoya High Court decision, April 22, 2021) did not refer to a so-called "main purpose rule" in determining the legality of a normal-phase response policy. In this sense, it is reasonable to conclude that its legality was determined after a relatively lenient examination.

[13] This kind of resolution is sometimes referred to as a "majority-of-minority (MoM) resolution."

countermeasures.[14] However, this could discourage even desirable acquisitions. Therefore, it must be noted that the invocation of countermeasures based on a resolution of a shareholders' meeting after certain shareholders' voting rights have been excluded may be permitted only in very exceptional and limited cases, taking into consideration the special circumstances of a case with respect to the mode of acquisition among other factors, such as coercion arising from the acquisition method and its legality and the time allowed for confirmation of shareholder intent.[15]

④ Adoption and invocation based on the judgment of the board of directors

An adoption of the response policy and invocation of countermeasures based solely on resolutions of the board of directors is not entirely denied. However, recent court decisions have allowed a shareholders' meeting ratifying the same to be held after the fact. In such cases, where there will be the time to hold a shareholders' meeting, it is considered that in reality, countermeasures may only be invoked based on the judgment of the board of directors when the need is high in light of the specific circumstances.

3. Ensuring necessity and proportionality

Countermeasures should only be invoked based on a response policy when necessary and in proportion to the need to protect shareholder equality and property rights and prevent self-serving abuse by management, among other factors. Appendix 3 of the Draft Guidelines organizes the relevant factors as follows.

① Ensuring necessity

Certain company policies are considered reasonable in the interest of securing sufficient time, information and negotiation opportunities. These include a policy requiring an acquiring party which intends to make open-market purchases or a tender offer to suspend the execution of its acquisition procedures for maximum duration of a tender offer (60 business days, in principle[16]). Also permitted are policies requiring an acquiring party which intends to make open-market purchases to provide information to shareholders equivalent to that required for a tender offer registration statement.

A company's response policy may be leveraged to negotiate for a less coercive acquisition arrangement — e.g., an "all or nothing" offer[17] — or confirmation of shareholder intent at a shareholders' meeting. However, it is not advisable to assert the existence of coercion to justify the use of a response policy or countermeasures without a substantial factual basis. For example, "late winners" may be observed in open market purchases when some shareholders resist selling early on and wait for the share price to rise.

② Ensuring proportionality

An acquiring party may be able to avoid the damage of having its shareholding ratio diluted by a company's invocation of countermeasures where it has sufficient time to withdraw or terminate the acquisition. Allowing such time may be a factor demonstrating the proportionality of the target company's countermeasures.

An acquiring party should not be allowed to receive cash or other benefits as a damage mitigation measure. This induces the invocation of countermeasures and deprives shareholders of the opportunity to sell their shares to the acquiring party after securing the time, information, and negotiation opportunities necessary to properly determine the

[14] See the Tokyo Kikai Seisakusho case (Supreme Court decision, November 18, 2021).
[15] In general, it is not always clear on what basis or to what extent a resolution by a majority of the non-interested parties may be permissible. One of the points raised by the Fair Acquisition Study Group is that when an acquiring party makes rapid open-market purchases, the shareholders' decisions may be affected by various problems, including information disclosure (i.e., the level of information is not disclosed to them in accordance with tender offer regulations), time (i.e., rapid purchases do not allow sufficient time for review) and the rush to sell (e.g., where a controlling interest is acquired in a short period of time through open-market purchases, shareholders will be rushed to sell). Because the voting rights to shares acquired under such problematic conditions should not count, a company may adopt a resolution excluding the voting rights of the acquiring party and its related parties in relation to such shares.
[16] Under the tender offer regulations, it is expected that the period may be extended beyond 60 business days in the event that another party launches a tender offer, etc. The 60-business-day period is provided only as a guide.
[17] The term "all or nothing" offer refers to a two-step transaction in which no ceiling is set and a lower limit is set such that the acquiring party's post-purchase ownership ratio is large enough to permit a reverse stock split or other structure allowing non-tendering shareholders to cash out at a price equal to the tender offer price. The existence of such a structure should be announced at the time of the tender offer.

merits of the acquisition. In practice, response policies — especially those introduced in the "emergent" phase — often grant so-called "second stock acquisition rights"[18] as a damage mitigation measure.

If the details of the target company's response policy are disclosed prior to the commencement of the acquisition process, it is possible to consider that the acquiring party assumes the risk of incurring damages, i.e., there is a predictability of damage, because it goes forward with the acquisition while being aware that the invocation of the countermeasure may cause dilution of its shareholding ratio.

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[18] The term "second stock acquisition rights" refers to stock acquisition rights (i) that can be exercised if the acquiring party's percentage of the shares falls below a certain percentage and (ii) acquisition clauses (so-called "clean-up clause") that allow a company to redeem unexercised stock acquisition rights after a certain period of time for cash consideration equivalent to the market price at the time of acquisition.