Regulation of Japan's Capital Markets and the Battle for Control of Nippon Broadcasting System

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I. Introduction

On 8 February 2005 the Internet service provider Livedoor announced that it had acquired 35% of the shares of Nippon Broadcasting System. Coming only a few weeks after Fuji Television Network had made a tender offer for Nippon Broadcasting's shares as part of a plan by the Fuji Sankei Communications Group to consolidate the group's shareholdings, the announcement came as a shock.

It was clear that Livedoor was out not only to control Nippon Broadcasting but also to use this as a means of exercising influence over the Fuji Sankei Group as a whole. The response of Nippon Broadcasting's board of directors (on 23 February) was to decide to issue stock acquisition rights to Fuji TV. The next day, however, Livedoor filed for a temporary court injunction to stop this going ahead.

When the Tokyo District Court sat on 11 March, it granted Livedoor's application for an injunction. The response of the Fuji Sankei Group was to file a protest, but this was rejected by the court on 16 March. The group therefore appealed to the Tokyo High Court. However, on 23 March (the day before Nippon Broadcasting was due to issue the stock acquisition rights to Fuji TV) the appeal was rejected, and Nippon Broadcasting abandoned its plan.

Since then, however, the situation has become even more complicated with, for example, Softbank Investment, the investment arm of the Softbank Group, announcing that it has borrowed Nippon Broadcasting's shares in Fuji TV and will be launching a joint investment fund with the two companies.

The case has attracted a great deal of public attention—not least because of the parties involved: on the one hand, an IT venture business led by a young entrepreneur; on the other, a popular commercial radio station. And, as if this were not enough, the case has also raised a number of controversial issues involving the Commercial Code and the Securities and Exchange Law.

Figure 1 Key Events in the Battle for Control of Nippon Broadcasting

1/17	Fuji TV announces its tender offer for Nippon Broadcasting shares (target: 50%)
2/8	Livedoor decides to issue ¥80bn in bonds with stock acquisition rights Livedoor acquires 35% of the shares of Nippon Broadcasting (via Lehman Brothers)
2/10	Fuji TV reduces its tender offer target to 25%-plus of Nippon Broadcasting's shares
2/15	Financial Services Agency announces its intention to amend rules on after-hours trading
2/21	Livedoor's stake in Nippon Broadcasting tops 40% in terms of voting rights
2/22	Fuji TV's stake in Nippon Broadcasting reaches 33% in terms of voting rights
2/23	Nippon Broadcasting announces issue of stock acquisition rights to Fuji TV
2/24	Fuji TV decides to extend the period of its tender offer for Nippon Broadcasting shares once again Livedoor applies to the Tokyo District Court for a temporary injunction against Nippon Broadcasting
3/2	Financial Services Agency announces that acquisition of one third or more of a company's shares by means of after-hours trading will be subject to tender offer rules
3/7	Fuji TV's offer period ends, leaving the company with 36.47% of Nippon Broadcasting's shares
3/11	Cabinet approves bill to amend Securities and Exchange Law to extend coverage of tender offer rules to after-hours trading Tokyo District Court announces decision to issue injunction against Nippon Broadcasting Nippon Broadcasting protests against court injunction
3/16	Tokyo District Court rejects Nippon Broadcasting's protest, and Nippon Broadcasting appeals to Tokyo High Court
3/23	Tokyo High Court rejects Nippon Broadcasting's appeal, and Nippon Broadcasting abandons plan to issue stock acquisition rights
3/24	Softbank Investment announces that it has borrowed Nippon Broadcasting's shares in Fuji TV and will be launching a joint investment fund with the two companies
4/18	Livedoor, Fuji TV and Nippon Broadcasting agreed on terms of settlement. Fuji TV will buy all of the Nippon Broadcasting shares held by Livedoor.

Source: NICMR.

II. After-Hours Trading and Japan's Tender Offer Rules

1. How Livedoor acquired its stake and the impact this has had

1) The much criticized use of after-hours trading

The 9.27 million shares in Nippon Broadcasting that Livedoor acquired on 8 February were purchased using the Tokyo Stock Exchange's ToSTNeT-1 after-hours trading system.

No sooner did the details emerge than an article appeared in the Sankei Shimbun newspaper (part of the Fuji Sankei Group) under the headline "28-minute covert operation during out-of-hours trading." The article criticized Livedoor for having "slipped through the regulator's net" and quoted "market sources" as calling for the rules governing tender offers to be tightened should there be more such cases. Similarly, "blogs" laced with comments by people purporting to be investment bankers or lawyers that the transaction was probably illegal—or, if not illegal, certainly not the kind of thing that they would recommend to their clients—began to appear on the Internet.

2) The compulsory tender offer system

Under the Securities and Exchange Law (Article 27-2), anyone whose stake in a listed company comes to exceed 5% as a result of acquiring shares in off-market transactions is obliged to make a tender offer in accordance with the procedure laid down. Acquisition of shares from a very small number of shareholders (10 or fewer) is exempted from this regulation unless a shareholder’s stake comes to exceed one third of the shares outstanding as a result of the acquisition.

This does not apply if the shares have been purchased on a securities market operated by a stock exchange. This is because transactions on securities markets are deemed to be open, fair and transparent—in contrast to transactions involving only a limited number of participants, favoring individuals or conducted in secret.

The reason the Securities and Exchange Law prohibits a small group of participants from conducting in secret a transaction that takes the shareholding of one of those participants over a certain percentage is the principle that, since bids to acquire a controlling interest in a company are normally made at a price that is higher than the market price, all the shareholders must be given the same opportunity to benefit from this "control premium." The compulsory tender offer system is therefore intended to ensure that all shareholders are treated equitably.

The same principle underlies the procedure a company is required to follow in order to acquire its own shares under the Commercial Code. This must be done by means of either a market transaction or a tender offer, unless a general meeting of shareholders has voted to allow the company to purchase the shares from particular shareholders (Article 210(1), Article 210(2)(ii) and Article 210(9) of the Commercial Code). The same applies if a company's articles of incorporation require its board of directors to vote to acquire its own shares (Article 211-3(1)(ii) of the Commercial Code).

These provisions are designed to ensure that stock purchases are not made from a small number of shareholders to the disadvantage of all the others. This is also why the Code allows shareholders to demand that they be included in any purchases of shares from a small number of shareholders (Article 210(7) of the Commercial Code).

3) Problems raised by after-hours trading

Livedoor used the Tokyo Stock Exchange's ToSTNeT-1 after-hours trading system to acquire its shares in Nippon Broadcasting. As the system was established and operated by the Tokyo Stock Exchange it is regarded as forming part of a "stock exchange-operated securities market."

According to the letter of the law as it stands, Livedoor's share purchase would appear to be regarded as having been conducted on a stock exchange-operated securities market and therefore exempt from the tender offer requirement. Nevertheless, it can hardly be considered an appropriate way of ensuring that a transaction accords with the spirit of the tender offer requirement, which is that all shareholders should be treated equally.

ToSTNeT-1 was introduced to enable institutional investors to have block trades executed without producing the kind of market impact that occurs when these are executed during normal trading hours. Transactions are conducted out of normal trading hours at either the previous trading day's volume-weighted average price or a price that is within a certain percentage range of the market (auction) price. To all intents and purposes, ToSTNeT-1 is used only by institutional investors, and most of the transactions are cross trades (involving simultaneous sales and purchases of the same stock) by securities companies.

It is virtually impossible for other investors to participate in a cross trade. Although cross trades can also be executed as part of normal trading (a practice that was once widespread on Japan's regional stock exchanges), they are, theoretically, negotiated transactions involving a small group of investors and in which it is not practical for a large number of investors to participate. They are therefore not considered suitable for tender offers.

Another after-hours trading system operated by the Tokyo Stock Exchange (ToSTNeT-2) is often used by listed companies for purchasing their own shares. ToSTNeT-2 is used for matching orders that have been entered in the system within a certain time on a "first come, first served" basis at a previously decided price (e.g., closing price or volume-weighted average price). However, the Tokyo Stock Exchange does not allow companies to use ToSTNeT-2 to execute cross trades in order to acquire their own shares as it takes the view that this excludes orders from other investors and therefore violates the principle of shareholder equality laid down in the Commercial Code.

4) Revision of tender offer rules

In view of this, at least in theoretical if not practical terms, Livedoor's purchase of Nippon Broadcasting's shares can hardly be considered a "market transaction" if it was carried out using a cross trade.

As soon as the details of Livedoor's trade emerged, the Financial Services Agency made it clear that it considers the current tender offer rules to be inadequate and that it intends to amend the Securities and Exchange Law so that investors are required to use the tender offer system in cases where the use after-hours trading would result in their acquiring more than one third of a company's shares. These amendments were approved by the Cabinet only four weeks later on 11 March, and the bill is due to come before the Diet during its current session.

2. What Japan can learn from tender offer systems in the United States and Europe

1) Opinion on the compulsory tender offer system is divided

Opinion on the present system, which requires investors to make a tender offer in a wide variety of circumstances, is divided.

Businessmen have complained about the high cost of complying with the procedure, which they have found themselves having to follow when companies have become subsidiaries as part of group restructurings or have tried to form strategic alliances. One of the reforms on Nippon Keidanren's wish list of reforms is that investors should be allowed to use negotiated transactions when acquiring shares from a very small number of shareholders, even if this brings their stake in the company to more than a third of its shares, instead of being required to make a tender offer.

On the other hand, the risk of a raid by a predator would increase if there was no tender offer system. Indeed, for Fuji TV, which had already announced its intention to make a friendly takeover bid, and Nippon Broadcasting, which had announced its acceptance, this must seem just such a case.

In the United States, where there is no compulsory tender offer system, there has been much criticism of two-stage takeover bids, where a predator first of all buys up a large number of shares and then uses them in an attempt to acquire the remaining shares as cheaply as possible by coercion. Some commentators have pointed out that the Japanese compulsory tender offer system has offered some degree of protection against such attempts. With the system of cross-shareholdings crumbling and the risk of hostile takeover bids increasing, this aspect of the compulsory tender offer system has, if anything, become even more important.

2) Tender offer systems in the United States and Europe

(1) US tender offer rules

There is no compulsory tender offer system under the Securities Exchange Act of 1934. However, when the Williams Act was passed in 1968, amending the Act, new disclosure rules required acquirers to provide investors with information to enable them to judge the merits of their offer, while the Securities and Exchange Commission (SEC) was given the authority to draw up a code of conduct for tender offers.

Although the Williams Act and the SEC's code of conduct established disclosure and trading rules governing tender offers, they do not contain any clear definition of what constitutes a tender offer. Instead, the rules governing tender offers are applied to any transaction that is considered to be a tender offer.

Whether or not a transaction constitutes a tender offer is determined by an "eight-factor test," originally proposed by the SEC and taken to have since been approved by court decisions. The eight factors used are as follows: (1) active and widespread solicitation of public shareholders; (2) solicitation of a substantial percentage of issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed number of shares; (6) offer open only for a limited period of time; (7) offeree subjected to pressure to sell shares; and (8) public announcement of a purchasing program precedes or accompanies rapid accumulation of the target's securities .[1]

[1] Lois Loss = Joel Seligman, Fundamentals of Securities Regulation 586 (Fourth edition, 2001).

This does not mean that a transaction will not be subject to the tender offer rules if it does not meet all eight criteria. One example of this is the famous case that is said to have established the test criteria[2]. In this case, more than 20 institutional investors acquired 30% of the shares of a listed company in after-hours trading in less than an hour and a half. The court decided that, since the case met all eight criteria except the one requiring a tender offer to be publicly announced and since the importance of each criterion varied from case to case, it could not exempt this case from the tender offer rules simply because there had been no public announcement. It therefore found that the companies had failed to follow the correct procedure for a tender offer and had acted illegally.

The facts of this case also have something in common with Livedoor's acquisition of a large number of shares in Nippon Broadcasting.

(2) European tender offer rules

In contrast, European countries do have a compulsory tender offer system like the one in Japan.

In the United Kingdom, for example, the City Code on Takeovers and Mergers requires (1) anyone acquiring 30% or more of a company's shares or (2) anyone already owning between 30% and 50% of a company's shares and wishing to purchase more to make a tender offer (Rule 9.1). In addition, the offer price must be "at not less than the highest price paid by the offeror … for shares of that class during the offer period and within 12 months prior to its commencement."

The EU Takeover Directive adopted in April 2004, on the other hand, requires anyone acquiring enough voting rights to be able to take control of a company to make a tender offer (Article 5(1)). In other words, there is no specific threshold such as 30%, and each member state is allowed to have its own legislation. The Directive also requires that offer prices be equitable and defines an "equitable price" as "the highest price paid for the same securities by the offeror … over a period, to be determined by Member States, of not less than six months and not more than twelve months before the bid" (Article 5(4)).

The slight differences between the UK system and EU directive are the result of differences of opinion about compulsory tender offers among EU members. In fact, it took 14 years for the EU directive, which was first proposed in 1990 after numerous revisions by the EU Commission, to be adopted.

[2] Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979).

The main aims of a system of compulsory tender offers are generally considered to be the need to ensure (1) that shareholders are treated equally, (2) that any control premium is divided equitably among shareholders and (3) that minority shareholders are protected from undesirable changes in control.

However, there are some who disagree vehemently, saying (1) that requiring acquirers to purchase shares from minority shareholders takes the principle of shareholder equality too far, (2) that requiring acquirers to divide any control premium equitably will increase the costs of an acquisition and prevent efficient changes of control, and (3) that there are other, less restrictive, means of safeguarding minority interests.

The second point has proved especially controversial in Continental Europe, where, as in Japan, key business partners and financial institutions are often long-term shareholders. The concern there is that, as with group restructurings and the unwinding of cross-shareholdings in Japan, any move to transfer ownership of a large number of a company's shares with the agreement of its long-term shareholders could be subject to a compulsory tender offer. There has therefore been strong opposition to adopting unamended the City Code provision that an offer price must be "at not less than the highest price paid by the offeror … for shares of that class during the offer period and within 12 months prior to its commencement."[3]

In Switzerland, for example, the Stock Exchange Act of 1995 states that "the price offered shall be at least as high as the stock exchange price and shall not be lower than 25 per cent of the highest price paid by the offeror for equity securities of the offeree company in the preceding 12 months," while in Austria the Takeover Law of 1999 provides that the bid price should be at least equal to the average stock exchange price in the six months prior to the controlling block's purchase, but lower than any price paid by the bidder for that purchase in the 12 previous months, discounted by 15 per cent," and in Italy the Consolidated Financial Services Act of 1998 states that the offer price should be "not lower than the arithmetic average between the average market price of the last 12 months and the highest price paid by the bidder in the same period of time for the purchase of voting shares." There has therefore been opposition to the City Code, which requires an acquirer to pay the same price as it has paid in the past even when this is higher than the current market price.

3 Guido Ferrarini, "Share Ownership, Takeover Law and the Contestability of Corporate Control," Proceedings in the Conference on "Company Law Reform in OECD Countries," held in Stockholm on 7-8 December 2000.

3) Japanese tender offer rules and the likely outcome of the current debate

Unlike European legislation, which stipulates the level of an offer price, the Japanese Securities and Exchange Law simply tries to ensure that the same offer is made to all shareholders (Article 27-2(3)).

Japanese groups carrying out a restructuring have therefore tended to adopt the strange practice of making tender offers at below the market price in order to discourage tenders from retail investors, and it was the frustration that the complexity of this rule was out of all proportion to any benefits that was one of the reasons why Nippon Keidanren put it on its wish list of reforms (see above).

Nor does European securities legislation apply different rules to transactions, depending on whether they are carried out on or outside a securities market. While some may feel that this does not matter since exchange-operated securities markets are open, fair and transparent, the reasons mentioned above for having a compulsory tender offer system—the need to ensure that any control premium is divided equitably among shareholders and, especially, the need to ensure that minority shareholders are protected from undesirable changes in control—cast considerable doubt on this. This is because most investors do not know who is trying to take control of a company, even if someone is buying large numbers of its shares in the market, until they possibly hear about it later when a filing has been made under the 5%-rule.

A system that applies different rules to transactions, depending on whether they are carried out on or outside a securities market, is also open to criticism for its inability to respond to the changes in market structure that have occurred in recent years.

Securities companies these days are no longer required to execute orders on a stock exchange, and intermarket competition is accepted. In view of this, it seems strange that stock exchanges used to be accorded special treatment. Indeed, after-hours trading carried out using a multilateral trading facility[4] is perhaps just as conducive to intermarket competition and worthy of the same status as "floor trading," provided pricing and volume are transparent and ordinary investors have easy access.

Be that as it may, the Financial Services Agency has made it clear that it intends to rekindle the debate about the tender offer system. Hopefully, the debate will be a fruitful one and take as its starting point the need to ensure that investors have equal access to information.

[4] This is a system operated by a securities company which brings together multiple third-party buying and selling interests in financial instruments in a way that results in a contract.

III. Stock Acquisition Rights and Shareholder Equality

1) The Commercial Code's rules on third-party share issues

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On 11 March the Tokyo District Court granted Livedoor's application for a temporary injunction against the issue by Nippon Broadcasting of stock acquisitions rights to Fuji TV.

In order to safeguard shareholders' financial interests, the Code only allows companies to issue shares to third parties at a specially favorable price if this has been approved by special resolution of a general meeting of shareholders (Article 280-2(2) of the Commercial Code). The same applies to stock acquisition rights (Article 280-21).

Furthermore, if a company does issue shares or stock acquisition rights either in violation of the law or its articles of incorporation, or in an egregiously unfair way and this threatens shareholders' interests, the Code allows shareholders to file for an injunction against the issue (Article 280-10 and Article 280-39(4) mutatis mutandis). If a company does issue shares or stock acquisition rights to a third party at a specially favorable price without the approval of a special resolution of a general meeting of shareholders, this is illegal, and an injunction may be granted against it in accordance with the above rule. Similarly, an injunction may be issued if an issue is conducted in "an egregiously unfair way" even if the issue price is equitable.

All these rules are intended to deter companies from ignoring their shareholders' wishes and pressing ahead with third-party issues that favor a minority of shareholders and violate the principle of shareholder equality.

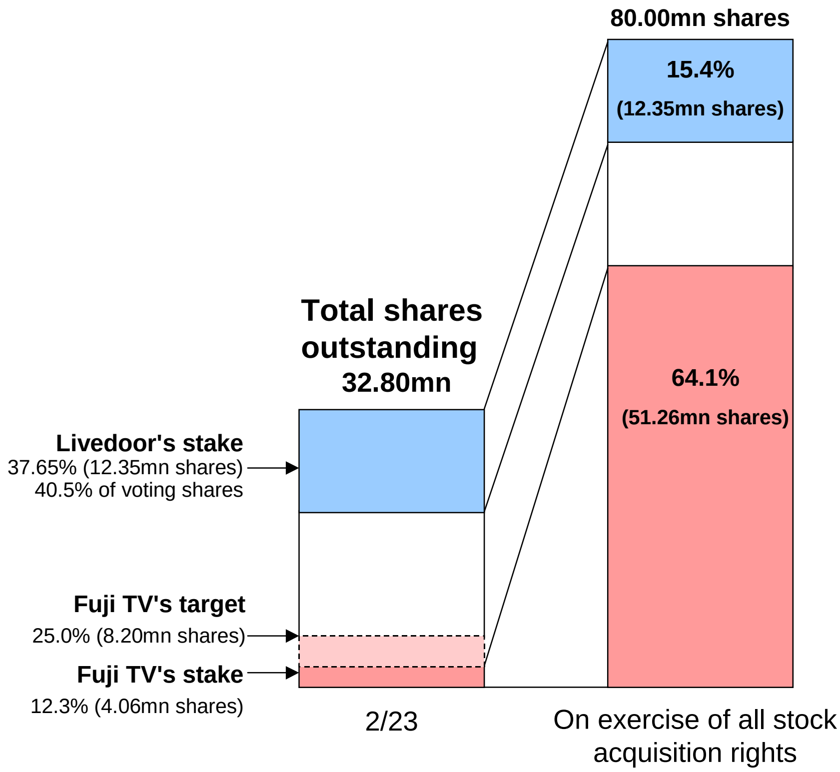
The court considered whether Nippon Broadcasting's planned issue of stock acquisition rights to Fuji TV (1) would have been at the kind of "specially favorable price" that would have required approval by a special resolution of a general meeting of shareholders and (2) would have amounted to the kind of "egregiously unfair way" that would have justified an injunction in the same way as a violation of the law or the company's articles of incorporation. Its conclusion was that, although the actual issue would not have been at a "specially favorable price," the way in which the issue would have been conducted would have been "egregiously unfair." It therefore decided to grant Livedoor's application for an injunction.

2) The court's decision on the issue price

The court indicated that it interpreted "specially favorable price" to refer to a situation where the issue price of the stock acquisition rights was significantly lower than their theoretical price (i.e., their value calculated using option pricing theory and based on the current share price, strike price, exercise period, interest rates and share price volatility).

When the court checked whether Nippon Broadcasting had calculated the issue price (¥336.2731 per share) correctly, using a trinomial tree model,[5] it was unable to find fault with the calculation. Moreover, when the court considered whether the combined issue and strike prices were specially favorable (given that the purpose of the issue was to enable Nippon Broadcasting to become a subsidiary of Fuji TV), it found that the figure (¥6,286.2731) was equivalent to roughly 97% of the average share price for the four weeks preceding the day on which the board of directors decided to issue the stock acquisition rights. As this is in accordance with the Japan Securities Dealers Association's self-regulatory rules for third-party share issues, the court concluded that the issue price was not specially favorable.

Figure 2 Impact of Stock Acquisition Rights Issue on Ownership of Nippon Broadcasting



Source: Sankei Shimbun, 24 February 2005.

5 This is a type of option pricing model.

3) The court's decision on the fairness of the issue

The court indicated that its decision on whether the way in which the stock acquisition rights would have been issued was fair was based on the view that, when there is a contest for control of a company, its board of directors, which is merely an executive organ of the company, should not normally take upon itself the responsibility of deciding who should control the company by issuing new shares in order to reduce the share of a particular group of shareholders and ensure that the current management retains control. The only circumstances in which issuing new shares could be justified was if the company and, by extension, the interests of the shareholders as a whole were threatened.

In its decision the court went on to say that, while Nippon Broadcasting's board of directors' decision to issue stock acquisition rights to Fuji TV might not have been motivated principally by a desire to safeguard its own position, it was motivated by the desire to ensure that the company remained under the control of the Fuji Sankei Group and preferably that of the current management.

Furthermore, the court considered Nippon Broadcasting's claim that the planned issue of stock acquisition rights to Fuji TV was a justified means of preserving and enhancing shareholder value, and of ensuring that the company would be able to continue to fulfill its public obligations as a broadcaster. It also considered the likely impact on the company if it had no longer been able to do business with the Fuji Sankei Group and analyzed in detail whether Livedoor's plans for the company made good business sense. It then concluded that it was by no means obvious that Livedoor's acquisition of the company would seriously impair its shareholder value.

4) The court's decision on Livedoor's acquisition of Nippon Broadcasting's shares

For its part, Nippon Broadcasting claimed that the way in which Livedoor had acquired a substantial stake in it (i.e., by means of after-hours trading) was illegal and that the planned issue of stock acquisition rights was intended as a defense against a hostile takeover bid.

In response, the court rejected Nippon Broadcasting's claim, saying that, although it appreciated some of the problems presented by Livedoor's use of after-hours trading to effect a change of control of the company (e.g., the fact that ordinary investors would not receive details of the transaction), under the current law a purchase order executed on ToSTNeT-1 could not be considered to have been executed outside a stock exchange-operated securities market and therefore subject to tender offer rules.

2. Previous court decisions and the significance of this decision

The court's decision on whether the planned issue of acquisition rights would have been at a specially favorable price was in line with previous court decisions in that it was based on the Japan Securities Dealers Association's self-regulatory rules, while its decision on whether the issue would have been unfair was based largely on the so-called "primary purpose rule," used to decide whether issues to third parties during contests for control of a company are illegal. Both decisions were reasonable.

1) Previous court decisions on the price of third-party issues during bidding wars

During battles for control of a company, the management may seek to issue shares to a friendly third party such as a shareholder or business partner. However, gaining the approval of a general meeting of shareholders for such a proposal is no easy matter.

There is, of course, no need for such approval if the proposed issue is to be at a price higher than the market price. However, share prices are often bid up sharply during such battles, while third parties will want to acquire as many shares as possible for their money. Companies therefore often seek to make third-party issues at a price that is lower than the most recent market price and, if possible, without having to obtain approval at a general meeting of shareholders.

One example of a recent case where shareholders obtained a court injunction against a company because it tried to make a third-party issue at a specially favorable price without seeking their approval was the decision by the Osaka District Court against Carolina in June 1990.[6]

The court decided that, although Carolina's attempt to buy up shares in Zeneral had contributed to the sharp rise in their price, the gap between the proposed third-party issue price and the market price (calculated, for example, using the average price for the preceding seven months) was such that this constituted a specially favorable price.

Similarly, in June 2004 the Tokyo District Court decided to grant an injunction stopping Miyairi Valve from making a third-party issue on the grounds that the gap between the issue price and the market price would have been excessive.[i] In reaching its decision, the court considered two of the Japan Securities Dealers Association's self-regulatory rules on capital increases at market prices. According to these rules, (1) the price of such an issue should normally be at least 90% of the price of the shares on the day immediately preceding the decision to issue the new shares or (2) at least 90% of the average price of the shares during a period of not more than six

[6] Osaka District Court, 22 June 1990, Hanrei Jiho [Case Law Report], No. 1364, p. 100.

months preceding the day immediately preceding the decision to issue the new shares if the share price has risen sharply. Otherwise, the issue price could not be considered equitable.

2) Previous court decisions on the fairness of third-party issues during bidding wars

As was mentioned above, a third-party share issue that is conducted in an egregiously unfair way may find itself subject to an injunction even if the actual issue price is not unfair. It is common for bidders in a bidding war to claim that a share issue that is intended to reduce their ownership ratio violates this fairness requirement.[7]

In its decision on the case involving the supermarket chains Chujitsuya and Inageya in July 1989, the Tokyo District Court found that the two companies, which had been buying up each other's shares and tried to make third-party share issues to each other on the pretext that they wanted to form an alliance, had tried to reduce the ownership ratio of a particular shareholder, mainly in order to keep control in their own hands.[8] It also found that, even though the two companies knew that the share issue would drastically reduce the ownership ratio of a particular shareholder, they could not justify it on purely economic grounds and that it was therefore egregiously unfair.[9]

The principle on which the court based its decision on this case is known as the "primary purpose rule" and has become a recognized approach for a court to reach a decision. In spite of the fact, however, that in reaching its decision on the case involving Bell System 24 in July 2004, the Tokyo District Court adopted certain aspects of this approach, it found that, although the company knew that its decision to go ahead with a third-party issue would considerably reduce the ownership ratio of a particular shareholder, it would be wrong to conclude without further ado that the issue was unfair because the Commercial Code does not normally safeguard the benefits to a shareholder from maintaining its share in a company.[10] Moreover, it found that the third-party capital increase was based on a detailed business cooperation plan and could be expected to result in higher net earnings per share while maintaining the same return on equity. Taking all this and more into account, the court therefore decided to reject the application for a temporary injunction.

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7 There are some who argue that, theoretically, the use of a third-party issue in the course of a battle for control of a company will normally be egregiously unfair. See Kenjiro Egashira, Kabushiki Gaisha/Yugen Gaisha Ho [Corporation/Limited Liability Company Law], fourth edition, p. 625, Note 4 (2005).

8 Tokyo District Court, 25 July 1989, Hanrei Jiho [Case Law Report], No. 1317, p. 28.

9 In this case, the court also found that the third-party issue had been made at a specially favorable price.

10 Tokyo District Court, 30 July 2004, Hanrei Jiho [Case Law Report], No. 1874, p. 143.

This decision can be understood to have amended the primary purpose rule inasmuch as it recognized that a company should not automatically be subject to an injunction, even if it has decided to go ahead with a third-party issue in order to reduce the ownership ratio of a particular shareholder, and that factors other than the company's intentions also need to be taken into account.

3) Evaluation of the court's decision in the Bell System 24 case

The court's decision in the Bell System 24 case was controversial in that it allowed for third-party issues, even when their aim was to retain control of a company, provided they were based on a sound business plan. For example, the lawyer Hideaki Kubori, while refusing to take sides because he had been a legal representative in the case, said that he did not think that many businessmen would agree with the court's view that the business plan that was supposed to have been the reason for the third-party issue made "business sense" and that the decision indicated just how little judges knew about business.

Leaving aside the question whether Kubori was right in everything he said, it would seem inappropriate for courts, whose job it is to interpret and apply the law, to become closely involved in judging the merits of business plans. Moreover, if the court's decision means that a business plan is legally justified so long as it makes business sense, it would seem to leave too much to the discretion of company management and pay too little attention to the rights of shareholders.

In contrast, in the Nippon Broadcasting case, the Tokyo District Court refrained from analyzing in any detail whether the company's business plans and earnings forecasts made business sense on the grounds that any decision about the merits of either the company's or the acquirer's business plans should be made by shareholders—free from any illegal attempts by the board of directors to determine who should control the company. In the words of Hideaki Kubori, the court's decision made it clear that it was for businessmen to decide what makes "business sense."

Furthermore, the court's decision allows a company to make a third-party issue by drastically reducing the ownership ratio of particular shareholders in exceptional circumstances (e.g., where transferring control of the company might severely impair its shareholder value). In other words, a third-party issue will not be considered illegal, even if it is not needed to raise capital, provided it can be shown to be an effective and proportionate defense against a hostile takeover.

Many cases, both in Japan and elsewhere, where corporate raiders or greenmailers[11] have acquired large shares in a company without really wanting to take control of that company or without having any concrete business plans, have eventually ended in a battle for control of that company. In such cases, courts in Japan would presumably be obliged to allow a board of directors to take defensive action.

The well balanced decision of the court in the Nippon Broadcasting case leaves enough room for such an interpretation. It is probably fair to say that, whereas the decision in the Bell System 24 case prohibited third-party share issues that would drastically reduce the ownership ratio of particular shareholders unless they were based on a business plan that made good business sense, the decision in the Nippon Broadcasting case prohibited such issues unless they were the only way to prevent a company's shareholder value from being impaired.

The decision even entertains the use of third-party issues as a deterrent against hostile takeover bids and calls for fair and transparent rules to enable this. However, once a battle for control of a company has begun, the decision requires directors to remain neutral except in exceptional circumstances (e.g., where the company's shareholder value might be severely impaired). Given the premise that companies are owned by their shareholders, the court's ruling was an extremely wise one.

3. Subsequent court decisions

Unwilling to accept the Tokyo District Court's temporary injunction, Nippon Broadcasting immediately filed a protest. In its response, the court adduced much the same arguments as in its original decision, which it upheld on the grounds that there was no prima facie evidence of the kind of exceptional circumstances that might justify reducing the ownership ratio of a particular shareholder trying to gain control of the company.

The response of Nippon Broadcasting was to appeal to the Tokyo High Court. However, the high court rejected the appeal—adducing much the same arguments as the district court in its original decision.

The most interesting aspect of the high court's decision was the fact that it gave some examples of the kind of exceptional circumstances it considered would justify the use of a third-party issue to protect the interests of all the shareholders.

[11] Greenmail is the purchase of a large block of shares in a company, which are then sold back to the company at a premium over the market price in return for a promise not to bid for the company.

According to the decision, the shareholder rights of a hostile bidder are not worth protecting if the bidder tries to exploit the company by, for example, (1) using greenmail, (2) taking temporary control of it in order to gain control of its intellectual property rights, know-how, secrets and principal customers, (3) taking control of it in order to use its assets as collateral for loans or to repay existing debt, or (4) taking temporary control of it in order to dispose of its assets and pay a large one-off dividend or sell out before the share price drops again. In such cases, taking no action would, according to the decision, result in damage to the interests of other shareholders. The use of a third-party issue as a defensive tactic with the principle purpose of retaining control of the company would therefore be justified provided it was necessary and proportionate.

Moreover, there was no evidence, according to the court, that Livedoor simply wanted to strip Nippon Broadcasting of its assets and sell them off one by one. Similarly, it was for Nippon Broadcasting's shareholders and the stock market—not the court—to decide whether becoming a subsidiary of Livedoor would affect Nippon Broadcasting's shareholder value. The court therefore rejected Nippon Broadcasting's claim.

IV. Other Related Issues

In addition to the two main issues dealt with above (namely, (1) the status of after-hours trading within the rules for tender offers and (2) how to reconcile third-party issues with the principle of shareholder equality), the battle for control of Nippon Broadcasting raises a number of related issues concerning, for example, the Commercial Code and the Securities and Exchange Law. I should like to mention these briefly before concluding.

First, there is the question whether Livedoor's use of moving strike price convertible bonds [12] to finance its bid was justified. Although many other such convertible bonds have been issued, their use is questioned by some observers, who raise the following issues: (1) the fact that their conversion price can be adjusted downwards could lay their issuers open to the charge that they have been issued at a specially favorable price; (2) their sale (e.g., to hedge funds) could destabilize the market; and (3) the securities companies that underwrite the bonds could manipulate the share price in order to trigger the downward adjustment clause.

[12] Moving strike convertible bonds are convertible bonds whose conversion price may be adjusted upwards (downwards) if the share price is trading above (below) the conversion price after a certain period of time has elapsed since they were issued.

Second, there is the fact that Fuji TV altered the terms of its tender offer. According to the Securities and Exchange Law, a bidder may not reduce the number of shares for which it has made an offer once the process has started (Securities and Exchange Law, Article 27-6(3)). Some would claim that Fuji TV broke this rule by reducing its offer from 50% to 25% of the shares outstanding.

While some would say that investor protection is not at issue since Fuji TV simply reduced the minimum number of shares it was prepared to bid for and would have bought any additional shares tendered, others would disagree.

Third, there is the issue of how filings under the 5%-rule should be conducted. During the battle for control of Nippon Broadcasting considerable attention has been paid to some of its major institutional shareholders. However, some observers feel that confusion was caused by the fact that some of these shareholders failed to file before the deadline while others were exempted from filing within five days.

Fourth, there is the related issue of how institutions and non-financial corporations in a position to influence the outcome should behave. On the one hand, there has been criticism of those which accepted Fuji TV's tender offer even though a gap opened up between the offer price and the market price of Nippon Broadcasting's shares when Livedoor appeared on the scene and the share price soared. On the other hand, the argument that shareholders should always seek to dispose of their shares at the highest price possible may be simplistic.

Fifth, there is the issue of how companies should defend themselves against a hostile bid. As a result of this particular bidding war there has been a sharp increase in the number of those who say that the Company Bill, which will soon become law, should include provisions that would allow companies to mount an effective defense against hostile bids. Growing concern that allowing triangular mergers[13] would make it easier for foreign companies to take over Japanese companies has led to the inclusion in the Bill of a provision to postpone by one year the implementation of a measure to allow companies to use shares to pay for takeovers.

[13] A triangular merger allows a Japanese company to merge with a foreign one with a subsidiary in Japan. The foreign company's subsidiary in Japan is the acquiring company and merges with the Japanese target, while the subsidiary's equity merges with the target's stock. As a result of the merger, the target is owned by the subsidiary of the acquirer, and the shareholders of the target receive shares in the acquirer. At present, the payment to the shareholders of the acquired company is limited to the stock of the subsidiary in Japan, but the government is planning to promote foreign investment in Japan by allowing the shares of the foreign parent company to be used as well.

Events have moved quickly. At one stage, it looked as though the battle for control of Nippon Broadcasting would develop into a proxy fight in the run-up to the annual general meeting of shareholders in June. However, since mid-April where the deadline for shareholder proposals draws near, both sides have shown a willingness to compromise. As a result, they have finally reached agreement that Fuji TV will purchase Livedoor's entire stake in Nippon Broadcasting and itself take a stake in Livedoor.

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[i] Tokyo District Court, 1 June 2004, Hanrei Jiho [Case Law Report], No. 1873, p. 159.