Linklaters

Steel Partners v Bull-Dog Sauce: analysis

On 7 August 2007 the Supreme Court rejected Steel Partners' appeal, clearing the way for Bull-Dog Sauce Co., Ltd (Bull-Dog) to issue a massive number of shares in order to defeat Steel Partners' tender offer bid.

This is the most significant judgment in this area since livedoor Co., Ltd (Livedoor) tried to take over Nippon Broadcasting System (NBS) in early 2005. We analyse the impact on corporations, funds, financial advisers and others.

Executive Summary

- Contrary to many people's perception, the Bull-Dog judgment is pro-shareholder and against management-determined defence.
- Of the three courts which gave judgments in this case, the middle one (the High Court) was the most anti-fund in tone and received the most publicity, mainly because it decided that Steel Partners was an "abusive acquirer". This has given rise to an impression that this case was bad for funds and for shareholder activism. We think this view is incorrect.
- The highest court (the Supreme Court) declined to follow the High Court's line of argument. It chose instead to base its decision primarily on the fact that the defence had been approved by the shareholders.
- The fact that Steel Partners lost the case does not mean that Japanese courts are anti-takeover. The result would most likely have been the same if Bull-Dog had been a US or UK company.
- The Supreme Court judgment has clarified some points of law which were necessary to decide this particular case. Unfortunately the court did not take the opportunity to clarify other points. The law in this area therefore remains uncertain. In particular we do not know how the courts view Advanced Warning Systems (AWSs) and other types of defensive measures which many Japanese companies have installed in the last few years. We give our view below but must wait for future court action to be certain.
- The Bull-Dog case has clarified the following:
  - a company can defend against a hostile bidder if there is likely to be damage to corporate value and thus damage to the interests of the shareholders as a whole;
  - the question of whether corporate value is likely to be damaged is ultimately to be decided by the shareholders. Therefore if there has been a shareholder vote on whether to defend the courts will respect the conclusion (absent procedural or other material defect, such as that the vote was based on materially incorrect information or, we believe, the court can find no basis for the shareholders to have reached the decision they did); however

  - that defence is only allowed if it is fair. In the Bull-Dog case the court identified payment of fair compensation to Steel Partners as a factor in satisfying this test. This suggests that the most common form of AWS, which provides for dilution without compensation, would generally not be upheld by the courts, although to date there has been no clear court guidance on this point.

- In the absence of a shareholder vote, we believe a company can defend against a hostile bid, but the courts will scrutinise the reasons much more closely. The target directors will need to prove there is a likelihood of damage to corporate value. As above, the defence must be fair.

- The legal status of AWSs and other defensive measures is still somewhat unclear. We believe that they continue to have some value, but that it is limited. Most defensive measures currently in operation do not seem consistent with the Bull-Dog ruling.

- In particular most defensive measures currently adopted permit directors to determine (with or without input from advisers) whether corporate value is likely to be damaged and to dilute a bidder without compensation. Both these run contrary to the logic underlying the Bull-Dog ruling.

- The primary purpose rule still applies. If a company genuinely needs to issue shares, say to raise cash for already-planned new development, then it may do so even if this happens to dilute a potential bidder. In practice a company with large free cash reserves which tries to argue after a hostile bidder has appeared that the primary purpose is to raise funds is likely to be treated sceptically by the courts. Companies may therefore want to reduce large cash balances by dividend, share buyback or investment.

- There has been a debate for the last couple of years whether defensive measures need to be approved by special resolution, ordinary resolution or simply board resolution. We believe that it is not legally critical whether a shareholder vote is structured as a special resolution or an ordinary resolution. However the higher the approval vote actually achieved in practice, the better for management. A large, vocal minority against the defensive measure increases the chance that the court considers the measure to be unreasonable. Board approval alone is much less likely to stand up in court if the defensive measure is challenged.

- Certain types of defensive measure purport to cover advisers as well as bidders. These pose particular issues for integrated financial institutions which have fund management as well as takeover advisory operations.

- In our view, squeeze-outs after a (friendly or hostile) bid can be done by a two-thirds vote, in the absence of special factors. Until recently the invariable practice was to obtain around 90 per cent. of the votes before attempting to squeeze out the minority.

Why is this case significant?

In the two and a half years since the NBS case, nearly 400 Japanese companies have officially adopted takeover defence plans, yet the courts have had little chance to say what steps companies can legally take to defend against hostile bidders. In 2005 the Tokyo District and High Courts struck down Nireco's defensive measure, but as that was in a highly unusual form and it was not in the course of a takeover battle the judgment provided only limited guidance on

allowable defence tactics. The Bull-Dog case is the first high profile takeover battle since then to go to the superior courts and the first ever to go to the Supreme Court.

Before the Bull-Dog judgment commentators thought it would be very significant whichever way it went: "it's the end of the Japanese capital market" if Bull-Dog won or "there won't be any hostile bidder that companies will be able to use [poison pills] against" if Steel Partners won.

In the end Bull-Dog has won, but we do not think at all it is the end of the Japanese capital market or, as another commentator put it, "Japan going back to the dark ages".

What were the brief facts?

On 18 May 2007 Steel Partners, a bid vehicle owned by a well-known US-managed investment fund, announced that it intended to make a Tender Offer Bid (TOB) at ¥1,584 per share for each share in Bull-Dog, a long-established Japanese company listed on the Second Section of the Tokyo Stock Exchange (TSE). Steel Partners already held 10.25 per cent. of Bull-Dog's voting shares. On 15 June Steel Partners raised its bid to ¥1,700 per share.

How did Bull-Dog defend?

On 7 June 2007 Bull-Dog announced a form of defence which was unique in Japan. Provided the shareholders approved at the Annual General Meeting (AGM) on Sunday 24 June, Bull-Dog would issue free of charge three stock acquisition rights (SARs) for each share. It could then:

(a) in respect of SARs held by Steel Partners, buy these back at ¥396 per SAR (being one-quarter of the original TOB offer price); and

(b) in respect of each other SAR, issue one share free of charge.

The effect would be that Steel Partners' shareholding would be effectively diluted from 10.25 per cent. to 2.86 per cent. Steel Partners would receive approximately ¥2.3 billion, a huge payment by Bull-Dog representing over four times its net profit in the year to 31 March 2007.

Isn't an AGM on a Sunday unusual?

Yes. Most Japanese companies hold their AGMs at around the same time, largely on the same day. Historically this was in order to hinder disruptive shareholders, specifically *sokaiya*, from attending the meeting. However Bull-Dog wanted its proposed SAR issue to be approved by shareholders, not just the board. The METI and MoJ Guidelines recommended that defensive measures should be approved by shareholders and it seems Bull-Dog thought, rightly as it turned out, that shareholder approval would increase its chance of success if the defence were challenged in court. Bull-Dog therefore decided that it needed to change its Articles of Incorporation so as to give to the shareholders the power to approve the issue of this particular type of defensive SARs. This change of Articles required a resolution to be passed by two-thirds of the votes of shareholders represented at the meeting. Steel Partners at least would no doubt vote its 10.25 per cent. against the resolution, so absences or abstentions would effectively count against Bull-Dog. For this reason Bull-Dog moved the AGM from Thursday 28 June to Sunday 24 June to try to ensure maximum turn-out.

The tactic was successful. The vote approving the SAR issue was carried by 83.4 per cent. of the total votes, being 88.7 per cent. of the votes represented at the AGM. Given that Steel Partners

held 10.25 per cent., this was a remarkably strong demonstration of shareholder support for management. This was despite the independent proxy advisory firm ISS reportedly recommending shareholders to vote against the defensive issue.

What were the grounds for Steel Partners' court challenge?

On 13 June 2007 Steel Partners asked the Tokyo District Court to grant an injunction to prevent Bull-Dog issuing the SARs, on the grounds that:

- it was contrary to the principle of shareholder equality (Article 109 of the Corporation Law); and
- the manner of issue was "manifestly unfair" (Article 247 of the Corporation Law).

Did Bull-Dog make use of the new Q&A rights?

Yes. Since December 2006 a target company has a statutory right to ask a bidder to provide information. The bidder is required by the Financial Instruments & Exchange Law to provide this information within five business days and to file it publicly with the Local Finance Bureau. On 25 May 2007 Bull-Dog filed its extensive list of questions and on 1 June Steel Partners responded in a 24-page report. This report is publicly available on EDINET.

This Q&A process is important, as we will see below. Bidders need to frame their answers carefully so as not to give ammunition inadvertently to the target board. For example Steel Partners had said in the Tender Offer Registration Statement that it "may" dispose of assets of Bull-Dog, and although it tried to clarify in the Q&A that this was a hypothetical possibility and it had no plans to do so, this mention of a plan to sell assets seems to have influenced the High Court as a factor in branding Steel Partners as an abusive acquirer.

Would the result in Bull-Dog have been any different had this been, say, the US or the UK?

Most likely not.

In the US, under the Unocal principles a Delaware company could almost certainly defend in this situation, where the defensive action had been approved by the shareholders.

In the UK, a target company cannot take "frustrating action" to defend against a hostile takeover bid, unless the action has been approved by shareholders. Again therefore, although the form of defence may have been somewhat different, the bid would have almost certainly failed in the UK.

So why is this decision controversial?

For two reasons. First because of the way that this defence attacked a specific shareholder. Previous defences had consisted of raising dividends (Sotoh, Yushiro), issuing shares or SARs (NBS, Hokuetsu) or finding White Squires or White Knights (Myojo). So previously all shareholders have been affected equally, whether positively (Myojo) or negatively (Hokuetsu). However in this case the Bull-Dog shareholder resolution specifically named Steel Partners and its associates, which is why Steel Partners claimed in court that the defensive measure was discriminatory.

The decision was also controversial because of the finding by the High Court that Steel Partners was an abusive acquirer. This seemed to come as a shock to Steel Partners, particularly since the lower court (the District Court) had found more or less the opposite, which was that the evidence did not show that Steel Partners was a greenmailer.

To understand the current state of the law it is helpful to consider all three court judgments in turn, as the arguments in each were different and they give an insight into how each of the sets of judges think.

What happened in the lower court?

The Tokyo District Court decided in favour of Bull-Dog.

The lead judge was the same judge who had decided against NBS and in favour of Livedoor in 2005, so might have been assumed to be pro-shareholder.

The District court ruled that:

- the court could not characterise Steel Partners as a greenmailer, as there was no evidence that Steel Partners had requested Bull-Dog or its affiliates to buy the shares it held. However in this case in any event it was irrelevant whether Steel Partners was or was not a greenmailer; and
- as a matter of principle, where there is a question as to whether defensive measures should be taken when an acquirer aims to take a controlling interest in a company, the correct place to determine that question is the shareholder meeting (this is consistent with the High Court decision in the NBS case). Once the shareholders had approved a defensive measure, the court would not overturn this measure unless it was manifestly unreasonable.

So the lower court upheld the principle that shareholders, not directors, decide on a proposed change of corporate control?

Yes. The court said that “the shareholder meeting is the most important decision-making body of a stock company. Therefore the final decision for choosing whether to retain the current management or to appoint the management designated by the acquirer should ultimately be made by the shareholders”.

What happened in the appeal court?

The Tokyo High Court also decided in favour of Bull-Dog. However the basis of the judgment was very different.

The three judges were all different from the three judges who had decided against NBS and in favour of Livedoor in 2005.

The judges in the High Court ruled that:

- Steel Partners was an abusive acquirer;
- the TOB was against general principles of good faith and trust;
- the TOB was an act detrimental to the corporate value of the target company and the joint interests of its shareholders;

- any target company faced with an abusive acquirer may adopt defensive measures in order to protect its corporate value; however
- the defensive measure must be appropriate, i.e. only as much as is necessary to defend and reasonable in all other respects including as to damage to the respective interests of the acquirer and the other shareholders.

Although the judges took the fact of the shareholder vote into account in determining whether the defence was reasonable, the High Court, unlike the District Court, did not hold this to be a fundamental step in the analysis. In other words, the High Court judgment opened the way for companies to defend even where there has been no shareholder vote. More on this below.

Why did the High Court decide Steel Partners was an abusive acquirer?

Unfortunately the judges were not entirely clear. But they seem to have taken into account the following:

- relevant was not just how Steel Partners had behaved in relation to Bull-Dog, but also its previous behaviour in Japan and also in the US. The judges quoted from US press articles about Steel Partners;
- Steel Partners did not intend to manage Bull-Dog, rather it intended to leave the current management in place (it is ironic this counted against Steel Partners, which probably thought that its stated support of management was a positive factor);
- Steel Partners "by the very nature of its being an investment fund" ("*toushi fando to iu soshiki no seikaku jou*"):
  - is motivated by earning performance fees;
  - is not remotely interested or involved in the business management of an acquired company; and
  - once it has bought shares in a company, is committed to resorting suddenly to a variety of tactics, including launching a TOB while demanding that the management purchase the shares solely to make gains from the sale of the acquired shares back to the company or to a third party in the short to medium term, and to pursue strictly its own interests by ultimately seeking to dispose of the assets of the target company; and
- while a bidder for 100 per cent. of a company would normally be expected to consider how to manage the company, Steel Partners did not do so and consequently gave Bull-Dog unnecessary cause for concern.

It seems that the High Court did not approve of Steel Partners. Would the court see other funds the same way?

It is clear throughout the judgment that the High Court strongly preferred the business of Bull-Dog, a Meiji era-founded maker of "safe and exquisite sauce", to the business of Steel Partners, the purpose of whose TOB was "to gain profit from trading and nothing else".

Some funds have interpreted the judgment as meaning the courts will always allow companies to defend against hostile bids in general and those by funds in particular. But this interpretation

seems too strong. Although it will always turn on the facts, a fund would have a better chance of avoiding being characterised as an abusive acquirer under the High Court tests if:

- it shows an interest in the business, and in being involved in the management, rather than being a passive investor willing to leave management to the existing directors;
- it develops a strategy for the business, for example by bringing connections to new strategic partners or suggesting new business lines or markets where it could help facilitate entry;
- it communicates that strategy well (a good precedent is Ichigo Asset Management's use of the media to win the support of other shareholders in its proxy fight with Tokyo Kotetsu, in a way that the more media-shy Steel Partners did not manage to achieve); and
- it creates a dialogue with management to try to gain its support, only resorting to a hostile bid if this does not work.

What happened in the Supreme Court?

The Supreme Court also decided in favour of Bull-Dog. It did not follow the High Court reasoning, but adopted reasoning nearer to, though not identical with, the original District Court judgment. We believe this is significant, as the Supreme Court had the benefit of two very different bases of judgment from the lower courts and it decided to follow the "shareholder democracy" rather than the "abusive acquirer" approach.

The judges in the Supreme Court ruled that:

- the law requires that when a company issues SARs free of charge to all shareholders, the SARs should have identical terms and conditions (it had not previously been clear that this duty of equality applies to SARs as well as shares);
- however this duty of equality (i.e. non-discrimination) is not absolute. If the acquisition of a controlling interest would be likely to jeopardise the existence or development of the company and thus lower its corporate value and thus damage the interests of the company and the joint interests of its shareholders, then discriminatory treatment against that acquirer may be justified in order to prevent that damage, unless the discriminatory treatment contravenes a general principle of fairness (*kouhei no rinen*) and is thus unreasonable;
- the question of whether the acquisition is likely to lower the company's corporate value and thus damage the interests of the company and the joint interests of the shareholders should be ultimately determined by the shareholders themselves "because the interests of the company are those of the shareholders";
- approximately 83.4 per cent. of the votes approved the proposal, which means that most of the shareholders other than Steel Partners had concluded that the acquisition would lower Bull-Dog's corporate value and thus damage its interest and the joint interests of the shareholders (the court judgment specifically mentions the 83.4 per cent. figure and seems to put considerable weight on the overwhelmingly high vote; but nowhere does the court say that a special resolution is needed in preference to an ordinary resolution);
- the court did not find any procedural defect in the above vote (the court did not say why it made this finding, but did say elsewhere in the judgment that the vote was taken after discussion at the shareholder meeting and Steel Partners had the opportunity of speaking at

that meeting). The court also found no other material defect in the vote, and said that it thought the shareholders seemed to have voted the way they did in reliance on the fact that Steel Partners had not stated its intentions how to manage the company, indeed it had said it had no intention to manage the company, and had not disclosed how it intended to recover its invested capital even though it aimed to acquire 100 per cent. of the company (this shows the importance of the Q&A which had been publicly exchanged by Bull-Dog and Steel Partners earlier under the new statutory scheme);

- having found that the shareholders had determined that the acquisition would be likely to damage corporate value (and there was no procedural or other material defect in making that decision), the court considered whether the issue of SARs breached the principle of fairness and was therefore unreasonable. The court held that, even though Steel Partners suffered the adverse effect of substantial dilution, the issue of SARs did not breach the principle of fairness and so was not unreasonable, taking into account that:
  - Steel Partners had been allowed to make its case at the shareholder meeting;
  - Steel Partners would receive financial compensation for its SARs (although it had no legal right to compensation under the terms of the SARs issue); and
  - the compensation "correctly reflects the value of the SARs" (this might seem to suggest that the court would always require full compensation, however a better interpretation would be that in a different case a lower level of compensation might be justified, as the High Court had previously indicated, but since the Supreme Court did not have to consider this it left this question open);
- the court also noted that the payment of such a large sum of money by Bull-Dog to Steel Partners could lower Bull-Dog's corporate value and thus damage the joint interests of the shareholders. However the court decided to respect the view of most of the shareholders, who had decided to approve the payment in order to prevent the damage to corporate value that would be caused by the acquisition. In other words the court decided not to overturn the shareholders' decision that a damaging defence was better than a more damaging change of control;
- the question of whether Steel Partners was an abusive acquirer (as had previously been concluded by the High Court) was not relevant to the court's decision;
- given that the court had concluded that the issue of SARs did not breach the principle of equality (Article 109), the issue also was not made in a "manifestly unfair manner" (Article 247);
- the issue of SARs was not made in a manifestly unfair manner despite the fact that the defensive measure had not been installed in advance (this interestingly seems to be judicial support for the view that defensive measures, if installed, are better installed in advance rather than when a hostile bidder appears). The reasons were:
  - Bull-Dog was responding to an emergency situation as the bid was launched without warning; and
  - Steel Partners would receive compensation for its SARs; and

- finally the court reaffirmed the general principle that if a company issues SARs free of charge with discriminatory conditions, "solely" (this is the word the court used, although the usual test is "primarily") to maintain the directors' control or that of specific shareholders which support them, and not to maintain the company's corporate value or ultimately the joint interests of shareholders, then such an issue would in principle be deemed to be made in a manifestly unfair manner. (The court seemed to be keen to stress that this case had an extreme set of facts and it did not want its judgment to be seen as sanctioning defence against any hostile bid, in fact quite the opposite.)

Is this the end of hostile bids in Japan?

Probably not. All three of the Bull-Dog court judgments built on the principles set out in the NBS judgment, which said that once a company is in play (i.e. there is competition for control), the directors of the company cannot take action if the primary purpose of the action is defence, except in certain circumstances where corporate value is threatened. The courts in the Bull-Dog case have further developed the rules as to how to determine when corporate value is threatened but have not undermined the basic principle that defence by a company in play is generally prohibited.

Was the judgment anti-fund or anti-foreigner?

There were some strong anti-fund comments in the High Court judgment as noted above but the Supreme Court chose not to repeat these and not to follow the "abusive acquirer" line of argument.

As to foreigners, there was absolutely nothing in the judgments which suggested that foreign bidders could be legally treated more suspiciously by target boards. Indeed, the anti-Steel Partners comments by the High Court were similar in tone to the anti-Murakami Fund comments by the judge in the recent criminal trial of Mr Murakami (currently on appeal), which suggests that the Japanese courts do not automatically treat foreign funds any better or worse than Japanese funds.

Where does Japanese law stand after the Bull-Dog case?

This involves some speculation as to how Japanese courts will decide future cases, but we suggest the following principles emerge from the Bull-Dog case and previous cases.

(1) A company can take defensive action against a hostile bidder if there is likelihood of damage to its corporate value.

(2) If at the time of a particular threat the shareholders vote in favour of defensive action (and the vote is not tainted by procedural or other material defects), the courts will assume that there was a likelihood of damage to corporate value and so allow the proposed defensive action.

(3) Without shareholder approval the directors may (indeed we think must) take defensive action if failure to do so is likely to lead to damage to corporate value. The onus of proof is on the company and the courts will require the company to show strong evidence of the likelihood of damage.

(4) Approval of defensive action by the shareholders in advance (e.g. an AWS installed at the AGM) rather than when a bidder appears is, we believe, more like the principle in (3) above than that in (2) above. This is because the Supreme Court appears to approve of

shareholders deciding whether a bidder is likely to cause damage to corporate value on the basis of full information, which the shareholders do not have when approving an AWS at an AGM. This view is speculative as the courts have not yet ruled generally on the effectiveness of AWSs and other defensive measures. If the courts decide to follow this line of reasoning, then AWSs have only a limited value as:

(i) any company, even if it does not have an AWS, can take defensive measures if at the time it needs to do so to protect corporate value; and

(ii) no company, even if it has an AWS, can take defensive measures if at the time it does not need to do so to protect corporate value.

In any event, AWSs do still have some limited value, as we explore below.

(5) Any defensive action taken must be reasonable taking into account all relevant factors, including compensation.

Can a company always defend as long as it obtains shareholder approval?

No, there are limits. We believe that defensive action would be invalid if, for example:

- the shareholder vote had a procedural defect, such as that it was based on the presentation of materially inaccurate information at the meeting;
- the shareholder vote had some other material defect. We speculate, based on the somewhat shorthand Supreme Court reasoning, that a material defect would include the situation where there was no rational basis for the decision. This might indicate to a court that, rather than the shareholders' decision being based on concern about corporate value, the true purpose of the vote was to maintain control in the hands of the directors or specific shareholders supporting those directors; or
- insufficient compensation is paid to the bidder.

Do the target directors have to hold a general meeting in the event of a bid to find out the shareholders' views, or can they just defend?

Although the Supreme Court said that the correct body to determine whether corporate value is likely to be damaged is the shareholder meeting, we do not believe that the directors must always call a meeting to establish this.

For example:

- there may not be time to hold a meeting. A hostile bid can be over in 20 business days which is insufficient time to set a record date and call a shareholder meeting. The Supreme Court appears to approve of shareholders deciding on the basis of full information. If the likely effect of the bid on corporate value is unclear and the directors reasonably believe that longer time is needed to give the shareholders full information then this suggests that the directors should be allowed to request the bidder to pause and provide further information, with the only practical sanction for non-compliance being that the company will defend; or
- the threat to corporate value may be clear, for example a competitor may intend to buy the company simply in order to take its know-how or other assets. This example was used by the

High Court in the NBS case as a situation where directors could take defensive action (without a shareholder vote). If it is obvious that a bid will harm corporate value we do not think directors are required to put the company to the expense of holding a shareholder meeting, particularly if in fact the views of most shareholders are known to be against the bid.

So can the target directors always defend without a shareholder vote if one of the four NBS categories applies, such as a leveraged bid?

We do not believe that directors can simply point to one of the four categories which the High Court gave as examples in the NBS case and assume defence is therefore permitted. They must show a likely threat to corporate value on the actual facts.

For example one of the categories in the NBS case was where the bidder intends to use the target's assets to fund or secure the financing for the bid. This has understandably given rise to concern amongst some funds that companies can always defend against leveraged buy-outs (LBOs). (Incidentally this was not discussed in the Bull-Dog case, as Steel Partners had an all-equity financing commitment.) However the court in NBS did not give general approval to defend against LBOs but rather only approved defensive action "subject to the defence being necessary and appropriate, because a purchaser with such an abusive intention is not entitled to be protected as a shareholder and leaving such a purchaser obviously damages the shareholders' interest". We believe this means that even in a typical LBO the target directors (without shareholder approval) could not defend unless they could prove to a court that securing the financing on the target assets would be likely to damage corporate value, for example that the interest payments would make it impossible to make necessary investment in maintenance and new developments and therefore would hurt the company's competitive position.

Shareholder approval helps the defence considerably. Does it need to be by special resolution?

No, there is nothing in the Supreme Court judgment which suggests that approval must be structured as a special resolution. But the higher the percentage of shareholders who actually vote in favour of defence, the more likely is the court to find in favour of the defence. The Supreme Court in the Bull-Dog case was clearly influenced by the fact that nearly all the shareholders other than Steel Partners approved the defensive measure. If conversely, say, only 51 per cent. had approved the defence, and a substantial minority objected on the basis that (i) the Steel Partners bid would not harm corporate value and (ii) the payment of over four times annual profits to Steel Partners could harm corporate value, then the court would probably have looked more closely at the merits of the bid and might have come to a different conclusion by deciding either that the bid would not harm corporate value or that the form of defence was unreasonable, and therefore that the defence should be prohibited.

What level of compensation is required?

We think every case will turn on its particular facts. A bidder which bought shares at a very low value then acts particularly unconscionably might legally be paid below the market value at the time of the bid. However this is speculative as the courts have not provided consistent guidance.

The High Court, in keeping with its general anti-Steel Partners stance, stated that the compensation paid by Bull-Dog to Steel Partners would still have been legal even if it had been of a lower amount. That court seemed to dislike the idea of an abusive acquirer (as it had deemed Steel Partners to be) profiting from this situation. The Supreme Court did not follow this line of argument but rather took into account in deciding that the defence was reasonable the fact that the compensation level was set at the TOB price which "correctly reflects the value of the SARs". This was a relatively high level of compensation given that it included the bid premium and was a figure which had originally been set by Steel Partners.

We believe that in the absence of special factors a good starting point for fair compensation would be the undisturbed market price, i.e. the price before the bid was announced and, if relevant, before the share price started moving upwards in anticipation of the bid.

What should companies wishing to defend do?

The best form of defence is: have a sound commercial strategy; have a regular dialogue with key shareholders to obtain buy-in to the strategy; and thereby keep both profits and the share price up.

A company concerned about takeover should watch the share register (e.g. by monitoring large shareholding reports) and be aware that a large percentage of shares held by financial investors (private equity, hedge funds, etc.) may mean the company is vulnerable. Such a company should have a defence manual and a plan to gather brokers, financial advisers, lawyers and PR advisers at short notice.

If a company insists on installing an AWS or other defensive measure, it would be better as a matter of good corporate governance and shareholder relations to have it approved by shareholders. We believe a defensive measure pre-approved by shareholders at an AGM without knowledge of the facts of a particular bidder does not of itself permit the directors to fight off all future bidders without further shareholder approval. However the court in the Bull-Dog case has not conclusively determined this point.

Is there any point installing defensive measures? Bull-Dog did not have an AWS but still fought off Steel Partners

It is a fair point. After the Bull-Dog case companies may decide not to install defensive measures in advance but instead to wait until a hostile bidder arrives then take Bull-Dog-style targeted defensive action.

However, defensive measures do still have some purposes:

- installing a defensive measure has a deterrent effect;
- a defensive measure in practice often slows up an acquirer while it goes through the mandatory information procedure. For example, Rakuten for a long time capped its acquisition of TBS at below 20 per cent. and complied with the time-consuming AWS procedure, whereas Steel Partners felt free to launch a TOB without notice for Bull-Dog which had no such measure;
- it is possible that a defensive measure may have some legal effect, especially if approved by a large majority of shareholders in a situation where the company had been noted as a potential takeover target for a particular bidder. The Supreme Court in the Bull-Dog case also appeared

to endorse AWSs when it said that an AWS has the advantage that it gives relevant parties, including shareholders, investors and acquirers, a higher level of predictability as to whether and what type of defences the company would take in the event of a possible future takeover attempt. The court noted that an increasing number of companies were making such advanced plans. As long as the courts' attitude to AWSs and other defensive measures is unclear, it is rational for a company concerned about takeover to have a defensive measure even if there is considerable uncertainly as to its legal effect.

Will companies now need to change their defensive measures?

After the Bull-Dog case we think most defensive measures cannot legally be fully exercised in accordance with their terms. This does not make their existence illegal, and they may have some deterrent effect as the law is not completely clear. However the following features would appear to need changing to make a typical defensive measure comply with the principles in Bull-Dog:

- the provisions which require a bidder to provide (i) information and (ii) time for shareholders to consider rival proposals from the bidder and from management are acceptable. We believe management can take defensive action to enforce these provisions if a bidder moves too quickly without having provided reasonable information. However the provisions which allow the directors to decide whether a bidder would damage corporate value, then take defensive action, do not seem to us to be entirely consistent with the Bull-Dog case, where the Supreme Court said that this question should ultimately be decided by the shareholders;
- to provide a greater chance of being upheld if challenged in court, a defensive measure could build in a mechanism whereby the directors would delay the bidder (by threat of defence action) for long enough for the defence to be put to a shareholder vote. We imagine directors will not be keen to give away their powers in this way, but it is consistent with the logic of the Bull-Dog case; and
- if the defensive measure is triggered, the bidder being diluted should receive fair compensation. The High Court and Supreme Court seem to have had different philosophies on this, with the High Court strongly indicating that a lower payment would have been fair, but neither suggested that zero compensation would have been appropriate. We would suggest that the defensive measure should ideally have some mechanism for determining fair compensation and that an appropriate starting point would be the undisturbed market price (i.e. pre-bid and pre-rumour of bid). Including this express authority to the directors to pay compensation may give them some protection (although it would not be absolute) from liability for breach of fiduciary duty if in the future they approve a payment to a bidder.

Are advisers at risk?

There is a certain category of defensive measure which, explicitly or implicitly, counts a wide category of entities as associates of a bidder. If such a defensive measure were triggered it would dilute the shareholdings of not just the bidder and its group companies but also potentially others such as its financial adviser and its associates. This could cause particular problems for integrated financial institutions where there is a risk that, for example, the fund management arm could find its clients' holdings in its nominee account diluted. In practice there may be solutions such as transferring holdings to a different nominee before the record date for the triggering of the

defensive measure, but advisers should be aware of the wide wording of some of the defensive measures currently in existence.

Why was Bull-Dog's share price so volatile on 5 July?

This was a strange side story in the three-month takeover battle. It shows how other players in Japan, like the TSE, are also feeling their way in a new world of hostile takeovers.

Bull-Dog's market capitalisation nearly quadrupled on Thursday 5 July, which was the day the shares went ex-rights. Normally this is impossible as the TSE rules set maximum and minimum limits by which share prices can rise or fall in a single day. However the TSE had issued a bulletin on 26 June stating that on 5 July only there would be an extraordinarily wide permitted trading range. The minimum was set at ¥290, which was the usual minimum on a 4 for 1 split. The maximum was left at ¥1,679, as if no split had occurred. The reason for this was not entirely clear but did not seem to be based on the possibility that the SARs issue would be struck down by the High Court on appeal.

On the day, the share price opened significantly down, as economic theory would predict since the shares had gone ex-rights. It then climbed from ¥500 to end the day at ¥1,365. Assuming all the SARs were issued and exercised, this means the equity value of the company had jumped from approximately ¥26.8 billion on 4 July to ¥103 billion only a day later. Clearly something strange was going on. Over the next several days the price fell by 60 per cent. to nearer its theoretical value.

A possible explanation is that day traders who had followed the story were bidding up the price. It is even possible some of them had not understood the significance of the shares going ex-rights. If so, that was an expensive error. Trading was much heavier than normal so substantial gains and losses must have been made.

If this situation arose again the TSE would do better to set the usual lower maximum and keep the trading range tight. There does not seem to be a useful purpose in allowing the higher maximum, other than to allow for the possibility of a legal challenge, and if there is a real risk of the challenge succeeding (so that shares would suddenly quadruple in value) then a suspension of trading pending the legal challenge would be a better solution.

Finally on squeeze-outs

The Bull-Dog case approved the forced reduction in the shareholding of a minority shareholder, after a vote passed by a large majority of the shareholders. In another context, squeeze-outs, there have also been legal developments recently which we believe give greater power to the majority shareholders.

As background, there had always been some concern that minority shareholders could challenge a squeeze-out as depriving them of their legitimate rights as shareholders (e.g. to vote) even though fair economic compensation was paid to them. The practice therefore grew up to squeeze out only after an overwhelming majority, generally taken as 90 per cent., of the shares had been acquired, even though only a two-thirds vote was needed. This 90 per cent. figure was not based on any law or regulation, but nevertheless became standard practice.

On 1 May 2007 new corporate methods of reorganisation, such as the cash-out merger, became available. This increased people's confidence in squeezing out using only a two-thirds vote, but still some residual concern remained.

In the Bull-Dog case the court accepted that, at least in certain circumstances, the majority shareholders can in effect squeeze out (or massively dilute) a minority shareholder in exchange for fair compensation. Similarly we believe, in the context of a squeeze-out following either a hostile or a friendly bid, that it would be very difficult, absent special circumstances, for a minority shareholder to challenge the squeeze-out achieved through a special resolution passed by two-thirds of the shareholders. In that case the minority's remedy is to apply to the court for a fair level of compensation to be paid, but not to halt the squeeze-out itself.

What next?

The Supreme Court has opened the way for Japan to have a functioning market for corporate control and management in the same way as it already has a functioning market for capital. However the picture is still developing. Different institutions argue either for less or for more protection from hostile takeovers. On the same day as the Supreme Court ruled in the Bull-Dog case, the Government's annual economic report took a somewhat anti-defence position by stating that:

- "Some consider in regard to hostile takeovers that they have the effect of increasing productivity and corporate value through the elimination of inefficient managers and the implementation of management reforms (as a result of imposing discipline on managers)."
- "At the same time, it is necessary to note that the introduction of takeover defences aimed at the self-protection of inefficient management and the implementation of restructuring plans designed to produce short-term profit increases have no connection to long-term business efficiency, and may even exert a negative influence on productivity."

We expect to see a few more hostile bids, but they will never be more than a tiny percentage of Japanese M&A. Defensive measures are likely to develop further and may start to incorporate compensation and possibly shareholder meetings in the procedure. The courts will need to clarify the circumstances in which shareholders can delegate to directors the ability to take defensive action: can this be done at the AGM or must the bidder have emerged before the vote is taken? Some consensus on what compensation is reasonable needs to emerge: not so high as to attract and reward greenmailers but not so low as to tempt the majority effectively to vote themselves a transfer of value from the diluted minority.

Now that the Supreme Court has confirmed the importance of the shareholder meeting, we may see more shareholder-proposed resolutions in the context of takeover battles. A hostile bidder with a three per cent. stake held for six months can call a shareholder meeting to obtain the shareholders' view on whether directors should take defensive action. We may see more proxy fights.

Perhaps the best lesson to learn from the Bull-Dog case is that, in Japan as in other countries, a hostile bid cannot succeed if the shareholders are against it. We expect both investment funds and strategic investors will increasingly use the media to sway the opinion of shareholders and others in future contests for corporate control. Japanese shareholders have in the Bull-Dog case once again shown themselves willing to place emotional distaste for a hostile bidder above their own

economic self-interest, but the successful proxy fight in the proposed Tokyo Kotetsu acquisition shows that shareholders can be won over with well-reasoned argument. The hearts of the shareholders, and target management, would be a better starting point for future would-be bidders than the courts.

If you would like further information please contact:

Casper Lawson
Partner
phone: +813 6212 1226
casper.lawson@linklaters.com

Hiroya Yamazaki
Partner
phone: +813 6212 1435
hiroya.yamazaki@linklaters.com

Paul McNicholl
Partner
phone: +813 6212 1210
paul.mcnicholl@linklaters.com

Mamiko Nagai
Associate
phone: +813 6212 1232
mamiko.nagai@linklaters.com

Mieko Hosaka
Professional Support Lawyer
phone: +813 6212 1231
mieko.hosaka@linklaters.com

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts at Linklaters.

© Linklaters. All Rights reserved 2007

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at marketing.database@linklaters.com

Gaikokuho Kyodo-Jigyo Horitsu Jimusho Linklaters is a firm organised under the Japanese Civil Code. It is affiliated with Linklaters LLP, a limited liability partnership registered in England and Wales with registered number OC326345. The term partner in relation to Linklaters LLP is used to refer to a member of the LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP and of the non members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ, England or on www.linklaters.com.

Please refer to www.linklaters.com/regulation for important information on our regulatory position.