

M&A Rules in Japan

1. Structural changes in the corporate environment in Japan
2. Negative effects resulting from lack of rules on hostile takeovers
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4. Fair rules to enhance corporate value
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May 2005

Ministry of Economy, Trade and Industry

1. Structural changes in the corporate environment in Japan

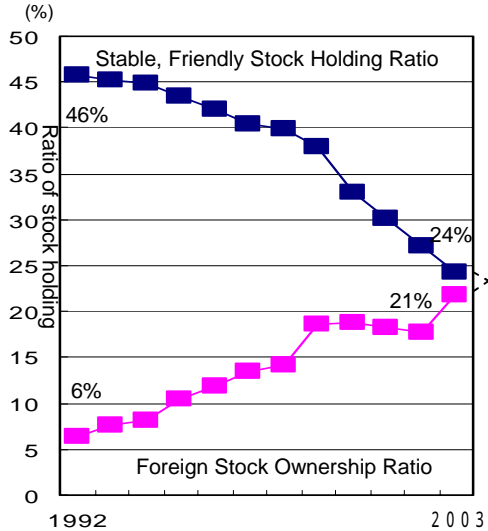
- During the last 10 years, the corporate environment in Japan has drastically changed due to the dissolution of cross-shareholdings and increased awareness of shareholder value
- The M&A era is now arriving in Japan with both friendly and hostile takeovers

[Structural changes in the corporate environment in Japan]

Dissolution of cross-shareholdings

Change in awareness of shareholder value

Change in attitude toward M&A



(survey in 1995)
97% of managers answered "It is the **stakeholders who own companies**"

(survey in 2005)
About 90% of managers answered "It is the **shareholders who own companies**"

(survey in 2004)
According to a survey of employees, 80% answered that they would accept an acquisition which would enhance corporate value, even if by a foreign company

Source: Prepared by METI based on the data from "Research on Cross-Shareholdings in 2003" (NLI Research Institute) and "FY2004 Share ownership Survey" (All domestic stock exchanges)



Structural changes in the corporate environment have increased concerns over hostile takeovers

2. Negative effects resulting from lack of rules on hostile takeovers

- There is no consensus as to what constitutes a fair offence or defense in hostile takeovers in Japan
- The situation allows coercive takeover tactics and excessive counter-measures; also results in possible destruction of corporate value by companies that have insufficient defensive measures

[Coercive Takeover]

Sotoh vs. Steel Partners (SPJ)

[Sotoh – Prior to hostile approach]
 - Manufactured and processed textiles
 - Had no debt and approx. JPY20bn liquid assets

Spring 2003 SPJ makes friendly proposal to the management of Sotoh



Rejection of SPJ's proposal by Sotoh



12/19/03 SPJ launches hostile TOB for Sotoh (offer price: JPY1,150)
Partial TOB without any term for back-end offer
 - NIF, as a white knight, launches a counter TOB for Sotoh
 - SPJ raises offer price to JPY1,550 and NIF withdraws its proposal

2/16/03 Sotoh announces plan to raise its dividend from JPY13 to JPY200
 - Its stock price surges to JPY2,000 and SPJ's TOB is unsuccessful



Substantial dividend boost was the only option but did not result in enhanced corporate value

[Excessive Defense]

Nippon Broadcasting vs. Livedoor

[Nippon Broadcasting description]
 - Radio broadcasting
 - Core business of Fujisankei Communication Group

2/8/05 Livedoor acquires more than 30% of total shares outstanding in Nippon Broadcasting through off-hours trading (surprise attack) (purchase price: JPY6,050)



2/23/05 Nippon Broadcasting announces its issuance of new share warrants to Fuji TV (more than 60% would be owned by Fuji TV when exercised)
 2/24/05 Livedoor seeks a court injunction in response to the plan by Nippon Broadcasting to issue a large number of share warrants to Fuji TV



3/23/05 Tokyo High Court upholds a lower court decision blocking Nippon Broadcasting's plan to issue equity warrants to Fuji TV



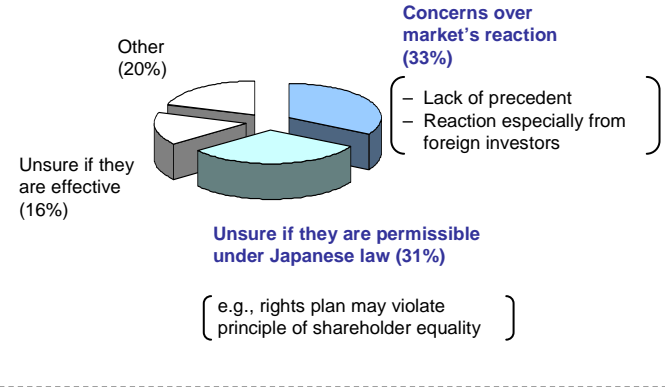
Excessive defenses could be judged illegal

[Insufficient Defense]

Most Japanese companies have been reluctant to adopt defensive measures out of fears that:
 - Adoption of defensive measures may not be permissible under Japanese law
 - Adoption of defensive measures may cause a negative share price reaction

Reasons for not adopting defensive measures

(Source: METI, September 2004)



Vulnerable to coercive takeovers which could result in destruction of corporate value

It is necessary to establish the fair and reasonable rules on hostile takeovers in Japan. The rules should stop coercive takeovers while allowing takeovers that enhance corporate value.

3. Global M&A market and the rules and regulations in the U.S., the EU and Japan

The U.S. (Since the 80's)

- During the M&A boom in the U.S. in the 80's, hostile takeovers also increased. Surprise attacks, often accompanied by accumulation of large blocks and coercive tactics, such as two-tiered offers, resulted in the forced rapid sales of companies under circumstances unlikely to achieve maximum results for shareholders
- In response, companies often pursued excessive defenses, although these were usually invalidated by judicial action
- The rights plan prevailed as the most effective means of providing time to management to pursue alternatives and leverage to negotiate a better deal, while leaving the ultimate outcome in shareholders' hands because they could replace the board

- The M&A framework in the U.S. today provides a fair balance between conflicting interests in takeover situations, with the shareholders generally retaining final control over whether a company is sold. Hostile bids continue to be made, and are often successful, but acquisitions occur at a more rational pace with more alternatives available

The EU (Since the 90's)

- Since integration of the market in the 90's, the EU began the process of establishing common rules for hostile takeovers
- In parallel with another M&A boom in the U.S., creation of Euro led to an M&A boom in the EU including hostile takeovers
- The "Takeover Directive", including the mandatory offer rule, was adopted in 2004. However, each country has flexibility regarding rules on defensive measures

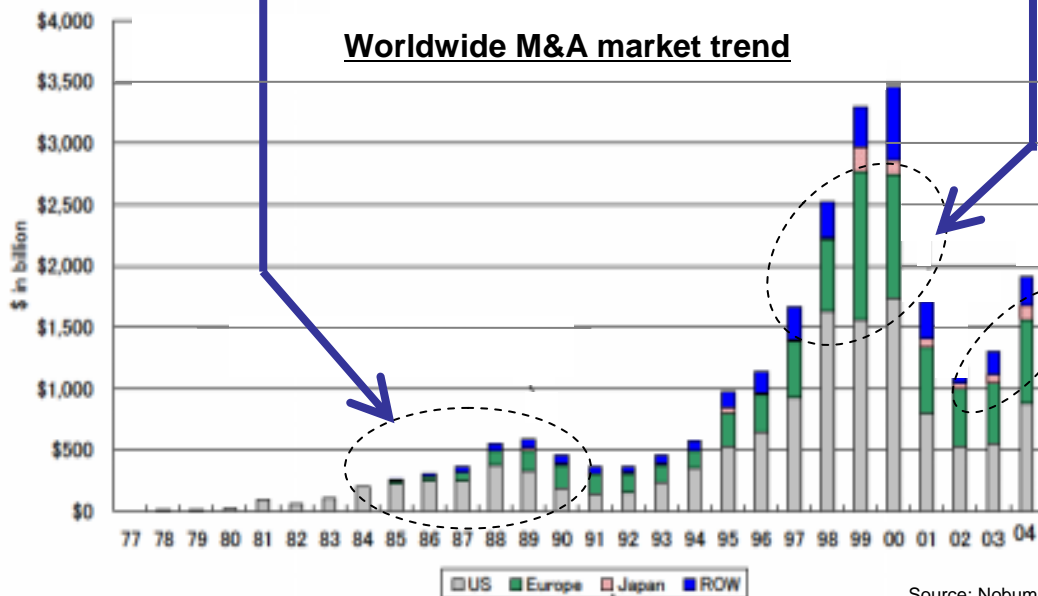
- EU has established rules on hostile takeovers during last 10 years
 - There are three types of defensive measures in EU; UK (frustrating action prohibited in principle), Germany (possible through supervisory board approval), Other Continental Europe (golden share and super voting stock)

Japan (Since 2000)

- Since the late 90's, friendly M&A bringing about industrial reorganization has increased
- Threat of hostile takeovers has also increased due to dissolution of cross-shareholdings and widening gap of market capitalization

- Despite the M&A boom, there is lack of fair rules on hostile takeovers
 - A lack of rules allows coercive takeovers, excessive defenses

Worldwide M&A market trend



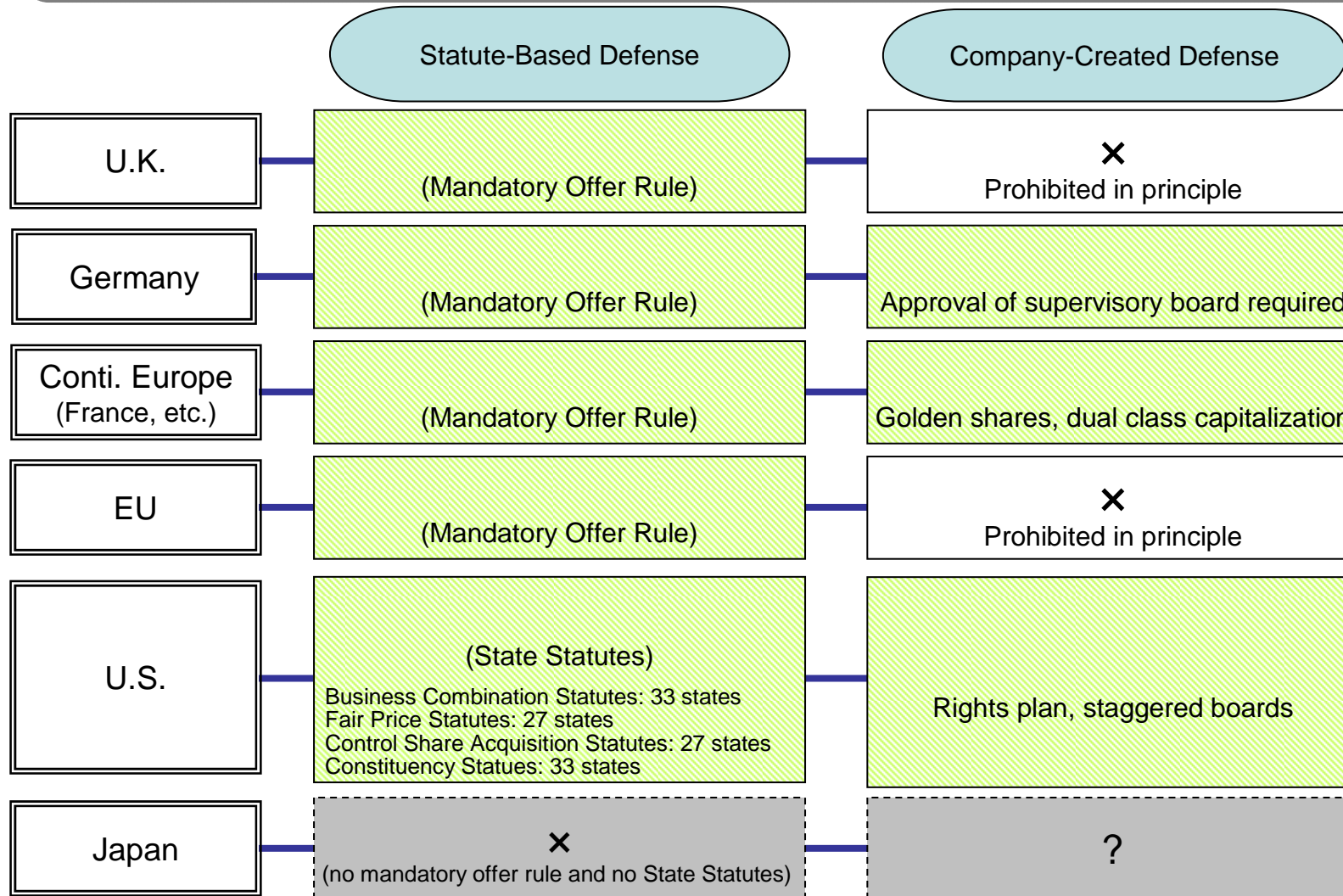
[Comparison of legal framework]

While legal approach may vary, all countries have ways to address coercive or abusive hostile takeovers

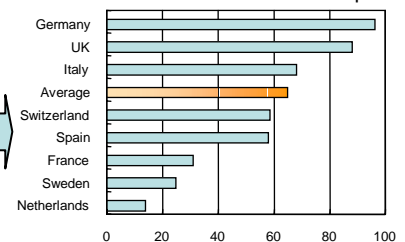
- Broadly speaking, there are two types of defensive measures:

- (1) Statute-based defense (e.g., mandatory offer rule, business combination statute)
- (2) Company-created defense (e.g., rights plan, staggered board)

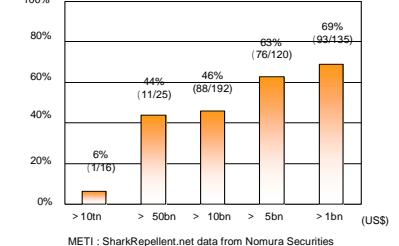
Japan is the only country without any protection



Percentage of companies adopting "One Share-One Vote" in Europe



Percentage of companies adopting Rights Plans (by market cap)



METI : SharkRepellent.net data from Nomura Securities

Problem1=coercive attacks are possible

Problem2=excessive defenses are possible

4 . Fair and reasonable rules to enhance corporate value

3 key factors in establishing reasonable defensive measures

Legal issues to consider in adopting Western-style defensive measures

It is possible to adopt Western-style defensive measures under the existing legal framework

It is necessary to establish proper rules

Rule 1 = Disclose rule Corporate Law / Tokyo Stock Exchange (TSE) rule

Rule 2 = Limitation on use of excessive defensive measures

METI and MOJ's Guideline / TSE's Listed Company rule

Standard to judge the reasonableness of defensive measures

Reasonableness should be judged based on the "Corporate Value Standard"

The "Corporate Value Standard" to be modeled after the U.S. standards (e.g., Unocal, Revlon)

Companies may consider three different approaches to enhance reasonableness

Adopt and **disclose** before an actual hostile approach

Proxy out and **no staggered board**

To avoid entrenching management in the face of an actual hostile takeover

1. **Independent outside directors/ auditors' oversight**
2. Qualified offer exemption ("**Chewable pill**")
3. **Shareholder approval**

}
- METI and MOJ's Guideline
- TSE's Listed Company rule

(1) Legal issues to consider in adopting Western-style defensive measures in Japan

Western-style defensive measures are already permissible under the existing legal framework. Also, with the new Corporate Law, options for defensive measures will be broadened
However, disclosure rules in Japan are not yet properly established. As disclosure of relevant defensive measures will provide a basis for shareholders and investors or acquirors to make appropriate investment decisions, the proper rules must be established as soon as possible

[Legal framework]

1. Defensive measures are permissible under the existing Commercial Code of Japan

Rights plan can be adopted utilizing Shinkabu Yoyakuken (warrants to subscribe for new shares)

Golden shares can be introduced, utilizing different classes of stocks

Super voting stock can be introduced, utilizing different classes of stocks

2. Options for defensive measures will be broadened with the introduction of new Corporate Law

[Establishment of proper rules]

1. Disclosure rules

Disclosure obligation in regulatory filings (Corporate Law requirement)
METI/ MOJ to establish rules in May

Establishment of TSE disclosure rule
TSE issued guideline in April and will establish rule before this year end

2. Limitation on use of excessive defensive measures

Establish the Guideline
METI/ MOJ – May

Establishment TSE Listed Company rule
TSE issued guideline in April and will establish rule before this year end

However, proper rules must be established to avoid misuse

(2) Standard to judge the reasonableness of defensive measures

Reasonableness of defensive measures should be judged based on the Corporate Value Standard

– The “Corporate Value Standard” to be modeled after the U.S. standards (e.g. Unocal, Revlon)

Judge by the degree of threat to corporate value and the proportionality of the defensive measure

1. There exists a threat of hostile takeover that may result in destruction of corporate value
 - Greenmailer; two-step, front-end loaded offer
 - Offer which allows little time for the management to seek a white knight or to develop a stand-alone counter proposal
 - Offer without adequate disclosure in which shareholders may tender due to incorrect understanding or insufficient information
2. The defensive measure is not excessive but instead proportionate to the threat
 - Does not treat specific shareholders favorably
 - Does not deprive shareholders of the right to choose
3. The decision to adopt defensive measures is taken by the Board on an independent and informed basis
 - Whether or not sufficient time is spent by the Board in discussing and analyzing the acquisition proposal
 - Whether or not the Board has obtained advice of outside professionals (such as investment banks and lawyers)
 - Whether or not outside directors or auditors were actively involved

(3) Three conditions to enhance reasonableness of defensive measures and to obtain support from investors

Adoption

[Step 1] Adopt before an actual hostile approach with full disclosure

– May be adopted in conjunction with shareholder value enhancement measures or corporate governance improvement measures

Basic Structure

[Step 2] Proxy out and **no staggered boards**

– Ensure possible cancellation of the defensive measure if the acquiror takes control of the board of directors through a proxy fight

Up to 2 year proxy contest in U.S.
(3 year term, staggered boards, removal restrictions)

Up to 1 year proxy contest in Japan
(1-2 year term, no staggered boards, no removal restrictions)

[Step 3] Add features to enhance transparency and avoid management entrenchment

Adoption through board resolution

Independent outside directors and auditors
to judge whether to maintain or cancel in takeover contexts

(Example of third party check)

Independent outside directors (outside auditors) to take part in the decision for the cancellation or continuation of the defensive measures based on analysis and advice of third party experts (bankers and lawyers)

U.S. Mainstream

Adoption through board resolution

Automatically terminate the defensive measures in the event of a **“qualified offer”**
[Chewable pill]

(Example of qualified offer)

1. Offer in which the acquiror provides sufficient information to the shareholders and gives management enough time to propose alternative plan
2. Offer in which the acquiror makes an all cash offer for all shares, and the price is determined to be fair and adequate

U.S. Variations

Adoption through shareholder approval

Obtain **shareholder approval** on adoption as well as application in takeover contexts

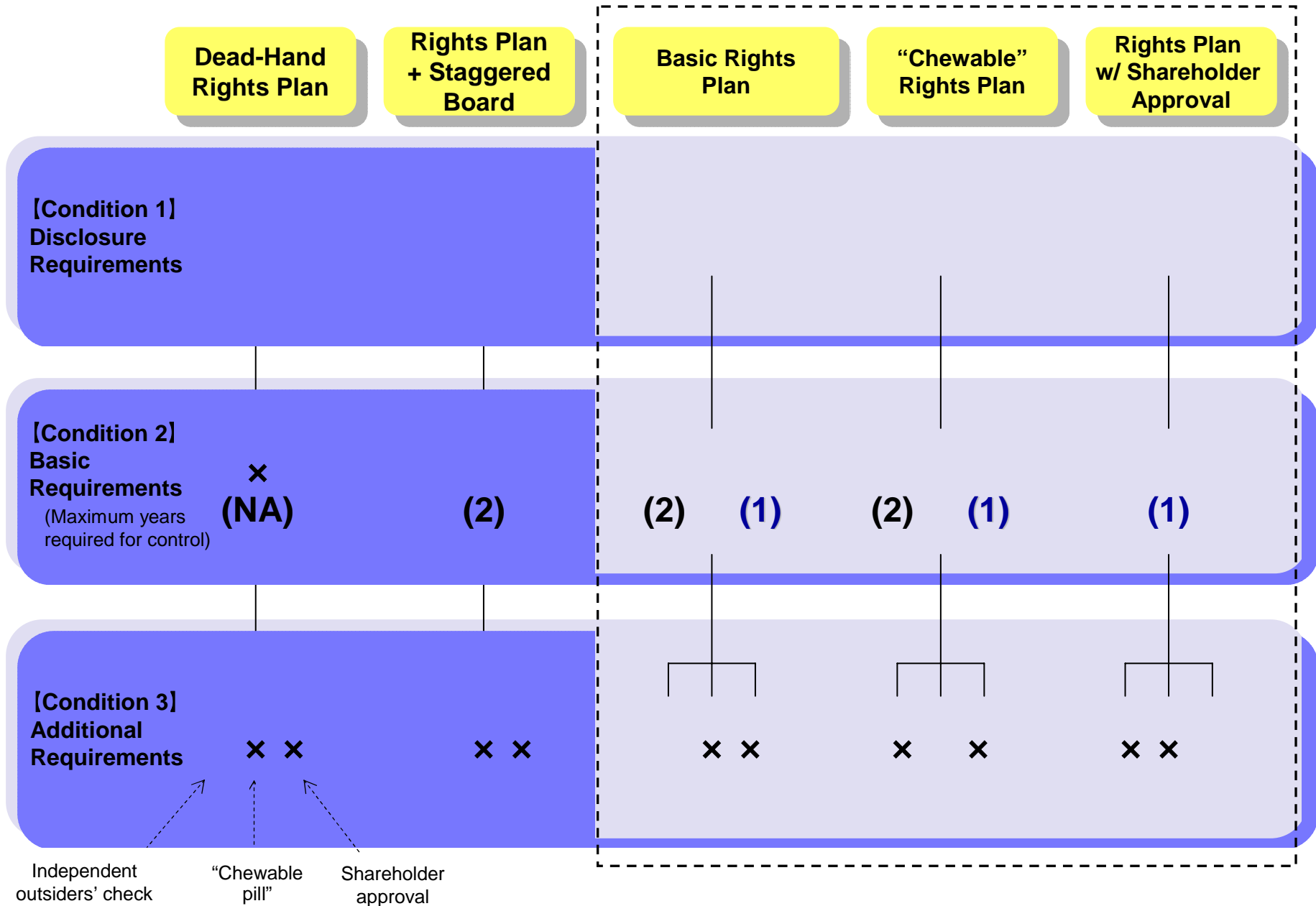
(Example of shareholder approval)

In takeover contexts, determine whether to cancel based on the standard (such as judgment standard, process) provided for in the Articles of Incorporation approved by shareholders

Preferred by Institutional Investors

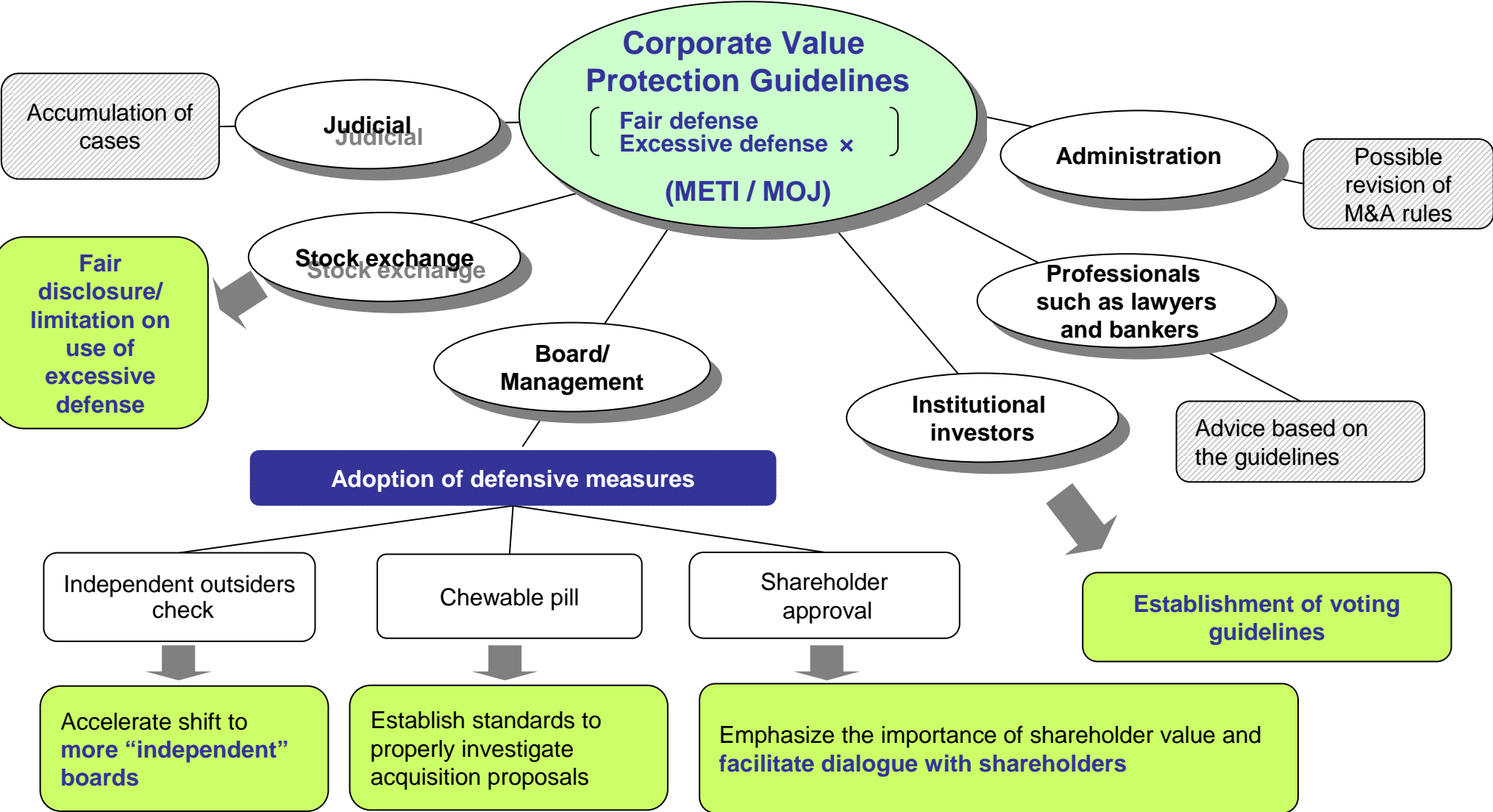
[Fair starting point for defensive measures in Japan]

[Start with a reasonable plan acceptable to investors]



5. "Corporate Value Protection Guidelines" – The Goal

Properly understood and respected Corporate Value Protection Guidelines will accelerate the further development of the Japanese M&A market in line with global standards



6. Structural and regulatory reforms – Next steps

Step 1: Permit reasonable defensive measures while preventing excessive defenses

1. Disclosure rules

Disclosure obligation in regulatory filings
(Corporate Law requirement)
METI/ MOJ – May

Establishment of TSE disclosure rule
TSE issued guideline in April and will establish
rule before this year end

2. Limitation on use of excessive defensive measures

Establish the Corporate Value Guideline
METI MOJ-May

Establishment of TSE Listed Company rule
TSE issued guideline in April and will establish
rule before this year end

 **Established in May**



Step 2: Additional reviews and possible revisions (main point of LDP Study Group)

1. Should Japan adopt mandatory
offer rule? (similar to EU/ UK)

2. Should Japan adopt business
combination statute?
(similar to Delaware 203)

 **Conclusion in June or July**