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
3. Global M&A market and the rules and regulations in the U.S., the EU and Japan
4. Fair rules to enhance corporate value
   (1) Legal issues to consider in adopting Western-style defensive measures in Japan
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5. Corporate Value Protection Guidelines – The Goal
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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**

![Graph showing changes](chart_image)

<table>
<thead>
<tr>
<th>Year</th>
<th>Stable, Friendly Stock Holding Ratio (%)</th>
<th>Foreign Stock Ownership Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>46%</td>
<td>24%</td>
</tr>
<tr>
<td>2003</td>
<td>6%</td>
<td>21%</td>
</tr>
</tbody>
</table>

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)

(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

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
- 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)

2/24/05  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)

- Concerns over market’s reaction (33%)
  - Lack of precedent
  - Reaction especially from foreign investors
- Unsure if they are effective (16%)
- Unsure if they are permissible under Japanese law (31%)
  - e.g., rights plan may violate principle of shareholder equality
- Other (20%)

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)

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

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

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 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 county has flexibility regarding rules on defensive measures.

**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**

Source: Nobumichi Hattori, Assistant professor, Graduate school of International corporate strategy, Hitotsubashi University
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.

[Comparison of legal framework]

- **Statute-Based Defense**
  - U.K.
    - Mandatory Offer Rule
  - Germany
    - Mandatory Offer Rule
  - Conti. Europe (France, etc.)
    - Mandatory Offer Rule
  - EU
    - Mandatory Offer Rule
  - U.S.
    - Mandatory Offer Rule
    - State Statutes
      - Business Combination Statutes: 33 states
      - Fair Price Statutes: 27 states
      - Control Share Acquisition Statutes: 27 states
      - Constituency Statutes: 33 states
  - Japan
    - No mandatory offer rule and no State Statutes

- **Company-Created Defense**
  - Prohibited in principle
  - Approval of supervisory board required
  - Golden shares, dual class capitalization
  - Rights plan, staggered boards

Problem 1: Coercive attacks are possible

Problem 2: 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. 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

- 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

- 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

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Adopt before an actual hostile approach with full disclosure</th>
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<tbody>
<tr>
<td></td>
<td>– May be adopted in conjunction with shareholder value enhancement measures or corporate governance improvement measures</td>
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<th>Step 2</th>
<th>Proxy out and no staggered boards</th>
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<td>– Ensure possible cancellation of the defensive measure if the acquiror takes control of the board of directors through a proxy fight</td>
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<tr>
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<td>Up to 2 year proxy contest in U.S.</td>
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<td>(3 year term, staggered boards, removal restrictions)</td>
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<tr>
<td></td>
<td>Up to 1 year proxy contest in Japan</td>
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<td></td>
<td>(1-2 year term, no staggered boards, no removal restrictions)</td>
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<th>Step 3</th>
<th>Add features to enhance transparency and avoid management entrenchment</th>
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<tr>
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<td>Adoption through board resolution</td>
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<td>Adoption through shareholder approval</td>
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<td></td>
<td>to judge whether to maintain or cancel in takeover contexts</td>
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<td>(Example of shareholder approval)</td>
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<td>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</td>
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<th>U.S. Mainstream</th>
<th>U.S. Variations</th>
<th>Preferred by Institutional Investors</th>
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<td>Condition 1</td>
<td>Disclosure Requirements</td>
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<td>Dead-Hand Rights Plan</td>
<td>Rights Plan + Staggered Board</td>
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<tr>
<th>Condition 2</th>
<th>Basic Requirements</th>
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<tbody>
<tr>
<td>(NA)</td>
<td>(2)</td>
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<table>
<thead>
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<th>Condition 3</th>
<th>Additional Requirements</th>
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<tbody>
<tr>
<td>Independent outsiders’ check</td>
<td>“Chewable pill” Shareholder approval</td>
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| (2) | (1) | (2) | (1) | (1) |

Dead-Hand Rights Plan
Rights Plan + Staggered Board
Basic Rights Plan
“Chewable” Rights Plan
Rights Plan w/ Shareholder Approval

Fair starting point for defensive measures in Japan
Start with a reasonable plan acceptable to investors

Independent outsiders’ check
“Chewable pill” Shareholder approval
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.

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

- Advice based on the guidelines
  - Establishment of voting guidelines
  - Accumulation of cases
  - Fair disclosure/limitation on use of excessive defense
  - Adoption of defensive measures
    - Independent outsiders check
    - Chewable pill
    - Shareholder approval
    - Emphasize the importance of shareholder value and facilitate dialogue with shareholders
    - Establish standards to properly investigate acquisition proposals
    - Accelerate shift to more “independent” boards
  - Stock exchange
  - Judicial
  - Administration
  - Professionals such as lawyers and bankers
  - Advice based on the guidelines
  - Possible revision of M&A rules

- Corporate Value Protection Guidelines
  - (METI / MOJ)
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