

# Japan's New Company Law

## Its Impact on Governance, M&A, and FDI

Presentation to JETRO Seminar:  
“Japan, Deregulated: Japan's Improved Corporate Governance”

Nicholas Benes

President, JTP Corporation  
Governor, The American Chamber of Commerce in Japan  
(Chair, Foreign Direct Investment Committee)  
Member, Expert Committee, Japan Investment Council

*(Note: these materials and all related comments by the author are personal opinions,  
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JTP Corporation

# The Big Picture

- Japan has done a good job of upgrading its laws for the next stage of development of economy and capital markets (inc. M&A). Things look more like the U.S. in many ways. The new Company Law allows:
  - Greater residual control by shareholders IF they choose to use it (Directors more accountable to shareholders). Better disclosure about internal controls and posture re takeovers
  - Greater diversity and flexibility of corporate structure and capital transactions
  - New transactions such as triangular mergers - useful for “squeeze-outs”, and can also be used for cross-border stock swaps
- More disclosure + more pressure on managers + more structural flexibility = meaningful proxy voting, healthy dialogue w/ shareholders
  - The most positive impact of the new Company Law comes from heightened tension and pressure to perform. Managers must raise corporate value if they fear targeting by activists Shareholders are starting to find a voice, and managers are starting to listen
  - The value of a shareholder’s vote has just went up a lot. The downside is, if shareholders do not responsibly vote, management can make more “mischief” than before
- Legally, now the “the cat is out of the bag” regarding unsolicited M&A activity,... as well as U.S.-style takeover defenses. However:
  - *Control* acquisitions by strategic players will occur more gradually than hype and activist arbitrage
  - There *still* has not been a single successful unsolicited (“hostile”) TOB proving it can be done
  - It will take years to sort out practical matters (related laws, regulations, attitudes, governance, best practices, optimal structures, and many logistical issues)
  - Most takeover defense plans do not make much sense – cannot work effectively - in the absence of independent outside directors comprising a majority of the board

# Key Legal Changes Affecting Governance

- **Increased “self-governance” by shareholders**
  - A simple majority vote (out of quorum) can now terminate directors
  - Very important for the M&A market; clarifies that 51% = de facto “control”
  - In Japan, 1% holders have access to the proxy ballot to nominate directors, make case
    - Some other countries do not allow this...
  - Can change Articles so shareholder approval not needed: e.g., dividends, director compensation
  - But note: “self-governance” could lead to permanent delegations of authority to management
- **Greater structural and transactional flexibility. Examples:**
  - More diverse alternatives for governance, and for audit functions
  - Greater simplicity, fewer administrative burdens for small private companies
  - Adoption of a structure allowing triangular mergers; creation of an LLC equivalent
  - Can have different classes of shares with different rights, including “golden shares”
  - Can limit liability of independent directors, statutory auditors, CPA firm via contract
- **Governance (improvements, generally):**
  - Now required: procedures for “internal controls, and disclosure of them
  - Disclosure of management’s policies re takeovers, and defensive measures
  - Maximum terms for directors: 1 year for “Committee”-style companies, 2 years for others
  - Audit (CPA) firms can now be the target of shareholder derivative suits
  - Companies must provide statutory auditors with support staff (but, should have done this for independent directors too)
  - Directors must be “negligent” to be liable for a conflict of interest
- **Takeover defenses have been “legitimized” and fortified in the law**
  - But director duties with regard to M&A transactions have not been fully clarified...
  - The system needs many more independent directors, and associated practices

# Responsible Voting and Some Systemic Improvements Are Still Needed

- **If allowed, public companies can now change their Articles so that:**
  - Golden shares will prevent almost any unsolicited takeover
  - Poison pill structures that allow internal boards very wide discretion are countenanced
  - Shareholder approval requirements for mergers are prohibitively high
  - The quorum is 1/3, *because* 25% of shareholders are in management's pocket
  - There is a higher hurdle than 51% to remove directors
  - Shareholders do not have the right to propose that a higher dividend be paid
- **Defense plans and TOB systems have never been tested in action**
  - Kinks and best practice must be worked out....but if all bids are warded off, will never happen
- **“Funny stuff” can occur behind the scenes; unclear how courts will react. Example: why does Nippon Steel’s defense plan use a “written ballot”?**
  - No legal substance or rules. In the extreme case, the company can manipulate, need not follow the result. A court-ordered inspector cannot be appointed. Not a shareholder vote, so fewer fiduciary duties; and less disclosure of who voted and how. The company can pressure key relationships more easily, with less embarrassment to them
- **The TOB system has logistical problems that make large-sized transactions very difficult and unlikely**
  - Very few large securities firms that are not conflicted as underwriters
  - Unreliable Chinese wall within securities firms, so must use direct contact TOB method
  - ...but, an accurate shareholder list is only produced every 6 months

# The Biggest Problem that Remains

- **More sophisticated thinking about directors' duties and "corporate value" is starting to emerge...but will take a few years to be refined**
  - Lots of talk about "Corporate Value"\* , and the need to *defend* it.....
  - But does this include the duty to *maximize* the value held by *shareholders*? Is this a legal duty?
  - A growing realization that "independent judgment" of directors is essential in unsolicited M&A deals
    - ....but, the concept needs to be expanded to *all* major transactions (i.e., anywhere where conflicts of interest or tendencies for managerial entrenchment are likely)
  - Growing awareness of the need for independent outside directors generally. The days of the naive assumption that Japanese management will always do the right thing, are numbered
- **Adopting the US model where many decisions can be delegated to the board, does not mean it will work well in Japan, where most companies have a totally different board composition (i.e, internal)**
  - One or two independent directors on a board is not *nearly* as meaningful as a majority. They will be outvoted, pressured by internal managers, do not have safety in numbers. For a sincere individual director, a "no-win" situation: make an unwanted pest of yourself, or bear great liability
  - Takeover defenses do not really "work" in Japan, for this reason. Most likely, they will function so as to kill *all* deals, rather than to negotiate better terms from the good transactions. Until some deals actually go ahead, we must assume this. The honest truth is that there is no past history here.

\* Note that this is the same thing as "shareholder value".

# New Triangular Merger Structure Will Facilitate Foreign Direct Investment

- **Triangular mergers are “friendly” transactions that can be used by both domestic and foreign firms. The acquirer can use stock as consideration in making an acquisition**
  - Hence, a triangular merger can approximate a cross-border merger
  - Both the Japanese board, and shareholders, must approve the deal
  - Attractive for fast-growing foreign acquirers because cash can be conserved to be used on operations. Japanese shareholders receive stock with upside
  - Triangular mergers are expected to stimulate foreign direct investment
    - ...that is, ***IF*** the tax laws are changed so that tax is deferred until the foreign shares are sold
      - In that case, the structure may be particularly attractive for owners facing succession and inheritance tax issues
      - Some public companies appear to be afraid that the synergies and merits of such combinations could be so good that they will be “embarrassed” into “having” to accept and approve proposals
      - Because of this, the false assertion that triangular mergers are hostile is often used to justify the adoption of takeover defenses! For the same reason, business organizations may attempt to block the adoption of tax deferral

# The Tax System and Legal Infrastructure Require Improvement

- **The tax system for M&A transactions should be modernized**
  - Tax logic is based on continuity of *asset control*, not of shareholders. Logic is inconsistently applied and can result in unfair treatment
  - Tax deferral available for qualifying mergers and domestic stock swaps **only**. The conditions to qualify make diversification deals difficult
  - At present, ***no tax deferral at all is available for:***
    - New system of triangular mergers (whether cross-border or domestic)
    - Spin-offs to shareholders (stock of spun-off company distributed as a dividend)
    - Exchange offers (TOBs using stock). Exchange offer plus triangular merger combination results in differing treatment depending on when a holder sold
- **There is no legal system for class action lawsuits**
  - No securities class action lawsuits
  - Only derivative actions where the award is paid to the company
- **No system of “discovery” that can be used to uncover evidence of director malfeasance, violations of fiduciary duty**

# But Overall, Solid Progress.

## Positive Impact on FDI is Expected

- **Japanese executives who feel pressure from shareholders and are more responsive to corporate value are increasing in number**
  - More “rational”, speedy, structurally flexible. Overdone panic about potential “hostile M&A” has actually helped accelerate these changes
- **Many executives will have a more open mind to global tie-ups that are value-building and synergistic, than in the past**
  - In some industries, Japanese companies have not built global scale. At the same time, growing distaste for activists makes strategic acquirers look more respectable by comparison
  - The new law, and economic recovery, will spur creation of more young businesses, which tend to be more open to foreign investment or alliances
- **Expect to see a pickup in M&A activity inbound to Japan, including more transactions by strategic acquirers using triangular mergers**

(Note)

# *JTP Corporation*

- Leading boutique M&A advisor in Japan for more than 10 years
- A completely independent, “pure” advisor with no conflicts
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Shinagawa-ku, Tokyo 141-0031 JAPAN


Phone+81-3-5434-9680


Fax+81-3-5434-9681

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(Note)

# Representative Transactions




**CLARIANT INTERNATIONAL Ltd.**  
*has sold*  
**CLARIANT POLYMERS K.K.**  
*to*  
  
**NIPPON GOHSEI**  
**NIPPON SYNTHETIC CHEMICAL INDUSTRY Co., Ltd.**

*The undersigned initiated the above transaction and served as financial advisor to CLARIANT INTERNATIONAL Ltd.*




**JTP Corporation**  
November 2004

**Nihon Micom Co., Ltd.**  
*has been acquired by*



**Intuit Inc.**

*The undersigned initiated the above transaction and served as financial advisor to Nihon Micom Co., Ltd.*



**Japan Transaction Partners, Inc.**



**Cadence Design Systems, Japan**  
*Cadence Design Systems, Japan has acquired the major assets of the Cadence Technology Division of Innotech Corporation through a business transfer*



**INNOTECH CORPORATION**

*The undersigned served as financial advisor to Cadence Design Systems, Japan*



**JTP Corporation**  
July 2003



**Johnson Controls, Inc.**  
*has acquired*




**Tokyo Biso Kogyo Corporation**


*The undersigned initiated the above transaction and served as financial advisor to Johnson Controls, Inc.*




**Japan Transaction Partners, Inc.**



**ITOCHU Corporation**  
*ITOCHU Corporation has made a strategic investment in and entered into a business alliance with Myster Engineering Corp.*



**MYSTAR ENGINEERING CORP.**  
*The undersigned initiated the above transaction and served as financial advisor to ITOCHU Corporation.*



**JTP Corporation**  
February 2003



**Advantest Corporation**  
*Advantest Corporation has acquired the principal assets of the Semiconductor Testor Division of*

**Asia Electronics Co., Ltd.**  
*from*  
**TOSHIBA**  
**Toshiba Corporation**  
*The undersigned advised MapInfo Corporation*



**JTP Corporation**  
June 2000