Expansion of M&As through Economic Reforms and Structural Change in the Business Community

By Sadamori Keisuke

INTERNET services provider livedoor acquired a controlling interest in Nippon Broadcasting System, a radio broadcaster, last spring. The move created a sensation in Japan because Nippon Broadcasting System was the parent company of Fuji Television Network, a major TV station, and because it was a hostile takeover that had been opposed by the managements of both Nippon Broadcasting System and Fuji TV. Debate has been raised a number of issues, including the ownership of companies, whether hostile takeovers are good or bad, and whether this type of merger and acquisition (M&A) has now become common in Japan. In politics, government, the media and the business community, people have started to debate the proper state of business in Japan.

The ferment has boiled over into the foreign business community in Japan, as well. Various amendments to the Corporate Act were under deliberation in the Diet, but opposition had come up over the question of triangular mergers, in which Japanese subsidiaries of foreign companies seeking to acquire Japanese enterprises would be allowed to use the shares of parent companies. Some politicians and members of the business community feared that this would pave the way for foreign investors to gobble up Japanese enterprises one after another. The Diet finally passed the bill after deciding to put off the implementation of triangular mergers for one year. The issue of M&A has made waves in this area as well.

The debates was revived last autumn in the wake of M&A moves involving another TV station and a professional baseball team.

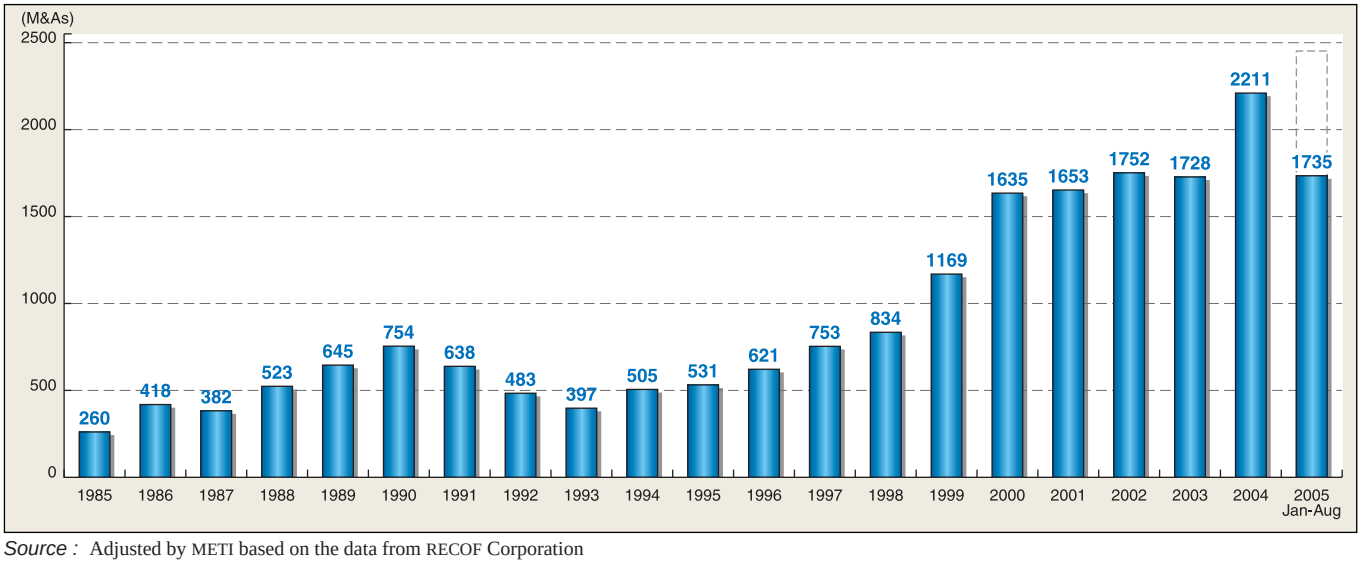
It sparked a premonition that perhaps Japan has entered a full-fledged era of M&As. How to handle hostile takeovers is one of the most pressing issues facing the business community today.

Major Changes in the Japanese Business Community

Japan's business community has undergone major structural changes over the past decade. First, the elimination of cross-shareholding has reduced the number of long-term shareholders, from 46% in 1992 to 24% in 2003. In the meantime, the holdings of foreign investors rose from 6% in 1992 to 21% in 2003. The second change has been the increasing prevalence of the idea that a company belongs to its shareholders. When it was asked in 1995, 97% of top-level executives responded, "a company belongs to all of its stakeholders," but roughly 90% responded that "a company belongs to its shareholders" in 2005. The third change has been a growing acceptance of hostile takeovers as well as M&As by foreign parties. A survey in early 2005 focusing on the attitudes of employees at Japanese companies toward M&As showed that some 80% have no objection to M&As, even if the acquiring firm is foreign, as long as they enhance the value of the enterprise, and another media survey found that 60% of the respondents think that "corporate M&As are a normal part of today's world."

These surveys show that it is a mis-

Figure 1 Increasing M&As in Japan



Source : Adjusted by METI based on the data from RECOF Corporation

understanding to conclude that there are few M&A cases in Japan, or hostile takeovers have never happened at all, or corporate M&As have a bad image in Japan or there is discrimination against foreign companies.

Thanks to the structural changes, the once commonly held assumption that all M&A cases are friendly ones has given way to accept the idea that hostile takeovers are also possible. The Ministry of Economy, Trade and Industry (METI) thinks the threat of hostile takeovers as a good thing to keep top executives on their toes and enforce managerial discipline. Whether it is hostile or not, a corporate takeover by superior managerial skills enhances the value of a company through the acquisition of a controlling equity interest and management innovations.

Significant Progress in Economic Reforms over the Last 10 Years

Another factor behind the advent of hostile takeovers in Japan is the economic reforms carried out since the latter half of the 1990s. The reforms have sought to achieve three basic objectives. The first one is to enact legislation to provide enterprises and executives with a greater range of choices in the form of organization. The second is to promote corporate restructuring (M&As). The third is to enhance the functions of the "market," where such restructuring and efficiency measures play themselves out.

The reform effort has targeted such legislation as the Anti-Trust Act, as well as the Corporate Act, taxation and rehabilitation/bankruptcy legislation. M&A deregulatory measures include a series of amendments to the Corporate Act since the ban on holding companies was lifted in 1997. As a result, enterprises and executives are now able to respond to a changing environment by carrying out mergers and spinoffs, setting up holding companies and seeing through other structural changes without spending too much time or money.

There are other choices, as well, besides incorporating under the Corporate Act. Increasing flexibility is now becoming possible in deciding how a business is run and limited liability entities such as a limited liability company (LLC) and limited liability partnership (LLP) are now available.

However, we cannot allow this expanded range of choice to bring unbridled freedom. The role of the market is more urgently needed than ever before; players must be the subject to market discipline and the principle of survival of the fittest. This has triggered many changes: private enterprises are now embarking upon the provision of public services and various deregulation measures have been taken; the Anti-Trust Act has been amended, with stronger provisions against the formation of cartels; and corporate financing, which had been heavily dependent on loans from a main bank, has shifted toward a focus on profitability. Recently, moreover, as part of an effort to strengthen the role of the market, we have seen the implementation of measures designed to institute a greater variety of structures of corporate governance.

Expansion of M&A, and the Advent of Hostile Takeovers

With these economic reforms and structural changes, Japan has experienced a friendly M&A boom since the latter half of the 1990s aimed at industrial restructuring. In the auto industry since 1996, Western capital has taken equity stakes in Nissan, Mazda and Mitsubishi, leading to the formation of five major groups. In the distribution sector, Wal-Mart and other foreign enterprises have accelerated industrial restructuring since 2000. We are seeing an acceleration of restructuring in other sectors, as well.

Looking at global M&A transactions in terms of monetary amounts, the United States accounts for roughly 40% and Europe 30%, while Japan lags behind at a mere 5-6%. Hostile takeovers are starting to occur, and the former predominance of friendly mergers is changing, as evidenced by a rise in takeover bids (TOBs). Japan has seen an average of about 1600 to 2000 M&As a year since 2000, including many takeovers by foreign investors in such sectors as telecommunications, pharmaceuticals, chemicals and financial services.

The laying of a institutional framework conducive to M&As will be completed this year when the new Corporate Act comes into force, ushering in the possibility of triangular mergers. This factor, in conjunction with the structural change taking place in the business community, is expected to spur the growth of a robust M&A market in Japan as time goes by.

Foreign investments in Japan are on the rise, but remains at a low level (the balance of foreign direct investment in Japan was 1% of nominal GDP at the end of 2003). The Japanese government intends to double such investments over the five years from 2001 to 2006, therefore it will be important to build up an environment that stimulates M&A activity. An increasing number of foreign investors are also expected to bring various benefits, including strengthened shareholder control.

Importance of M&A Rule-Making

Reform of corporate governance has thus been advanced through the formulation of enterprise legislation and the strengthening of market mechanisms, however, the issue of rule-making for the M&A process has remained to be resolved. A series of reforms designed to facilitate friendly M&As have been implemented, but enterprises have blanched at the hostile takeovers, because there has been no discussion in Japan on the topic of fair M&A rules. The business community did not have a clue on a number of important questions, such as what sort of defenses would be allowed, and

where to draw the line that separates legitimate defense measures.

In many countries, TOB rules are established as standard for M&A markets. The initiator of an M&A deal must offer the same price to all shareholders under TOB rules. There are other rules to prevent surprise attacks and excessive defense measures in the West which regulate initiators and ensure that takeover targets can take reasonable defense measures.

Japan, on the other hand, lags behind in establishing the regulation of takeover initiators and the enforcement of fair defenses. We have few experience with hostile takeovers, and there is no market consensus on a fair defense. If we continue without any rules, excessive defense measures will be adopted again and again, and we will not reap the full benefits of M&As, which are supposed to enhance corporate value.

Japan's Corporate Act is being amended with reference to similar legislation in the United States, and Japanese legislation is now in a position to introduce defense measures on a par with Western standards. There is an urgent need to formulate rules to prevent excessive defense measures.

Fair Defense Measures

METI has been working since September 2004 to examine M&A defense measures in its Corporate Value Study Group. Hostile takeovers are an effective tool for spurring innovation by enterprises that are not making good use of their business resources; it would be a major loss to allow excessive defense measures to go unchecked and thwart hostile takeovers.

In a report[1] released last May, the Corporate Value Study Group focused on four basic principles – enhancement of corporate value and the prevention of rearguard action by management; alignment with global standards; equal treatment for domestic and foreign players; and the opening up of options. At the same time, METI and the Ministry of Justice have jointly drawn up the *Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests*.[2]

The goal of the Guidelines is to deter excessive defense measures and establish a basic set of rules for Japan's M&A market. The promotion of defense measure adoptions is certainly not its goal, and the Guidelines were drafted on the basis of judicial precedents in M&A cases in Japan, academic theories, rules adopted in the West, and institutional investors' views on M&As. They are designed to dovetail with the Japanese legislative system, and give full consideration to shareholders and prevent rearguard action by management when viewed from an international perspective.

The Guidelines state that defense measures should be effective against M&A proposals that would harm corporate value, but are not effective against the proposals that would enhance corporate value.

The term "corporate value" means company assets, profitability, growth potential and anything else that is beneficial to shareholders' earnings; the term "common shareholder interests" refers to the interests held in common by all shareholders. To safeguard corporate value and common shareholder interests, the Guidelines put forward three principles that M&A defensive measures should comply with.

Principle 1: The defense measures should not constitute rearguard actions by management. Rather, they should be designed to maintain and enhance corporate value and common shareholder interests.

Principle 2: Shareholders' reasonable views should be respected. The details of the defense measures should be made public ahead of time, and should incorporate the legitimate views of shareholders and investors, and should either be approved at a general shareholders' meeting before implementation or when such measures are adopted by a resolution of the board, a mechanism whereby the measures can be eliminated at the next general shareholders' meeting should be included.

Principle 3: Excessive defense measures must not be employed. In particular, to prevent the abuse of defense measures by management, the Guidelines emphasize the importance of establishing objective criteria and of respecting the judgment of independent outside parties, so that the enterprise can quickly eliminate the measures if a good offer is made.

These three principles apply to all steps that have the effect of defending against a takeover. The Guidelines pay special attention to rights plans in particular, calling for steps to ensure that such plans are both legal and reasonable. For example, unitholder rights plans that offer purchase options on new share issues are seen as quite legal and reasonable, and present a more shareholder-friendly defense model than those in the United States.

Depending on how it is designed, however, this type of defense measure can also thwart good takeover bids, so an effort is needed to gain market acceptance, which is why the Guidelines call for steps to ensure that a defense can be terminated at a meeting of the board if a good takeover bid is received. The Guidelines also recommend the adoption of a sunset clause to ensure that the latest shareholders views are taken into account.

When a resolution of the board alone is sufficient to adopt a takeover defense, there should be provisions allowing shareholders to cancel it. To prevent the board from making arbitrary decisions: (1) a specific time limit for the evaluation and negotiation of M&A offers should be set, and once the time limit has passed, the defense measures would automatically terminate; or (2) the judgment of a special committee composed of independent outsiders must be given due weight in considering the appropriateness of initiating defense measures, thereby ensuring better compliance with the law.

Notes : 1) English translation is available at <http://www.meti.go.jp/policy/economic_oganization/ma_rule.htm>
2) English translation is available at <http://www.meti.go.jp/policy/economic_oganization/shishin_sakutei.html>

Guidelines Well Received at Home and Abroad

The Guidelines are generally regarded as being quite fair and widely supported, both in Japan and by Western governments, businesses and market players.

The question facing us now is whether the Guidelines are being adequately respected by Japan's business community. Some commentators argue that there ought to be a statutory basis for the Guidelines. Nevertheless, they are already being used as a guidepost by many Japanese corporations. The Guidelines are also spurring corporations to carry out corporate governance reform. Some are beginning to rethink shareholder returns, business strategies and other factors contributing to corporate value, and we are seeing corporations take a "total package approach" in discharging their responsibility to keep shareholders informed. Securities exchanges and institutional investors are also bearing the Guidelines in mind when they formulate rules for M&A defense measures to protect investors and maximize shareholder interests, and draft guidelines governing the exercise of voting rights.

In the final analysis, the defense measures are a continuously changing organism. M&A fairness, too, changes as time goes by. It is best to obtain maximum participation from businesses and market players in the formulation of rules that will be complied with. The Guidelines and the Corporate Value Report have made a powerful statement about the code of conduct that we should apply in the Japanese business community. We hope that Japan's business community will build on this fine start by making further efforts to enhance corporate value.

Future Tasks

Japan has now almost completed the first step in formulating fair M&A rules, which is one of the most important tasks that should be addressed over the next 10 years. A consensus on the need to prevent excessive defense measures is being formulated, and the business community has begun working on the problem.

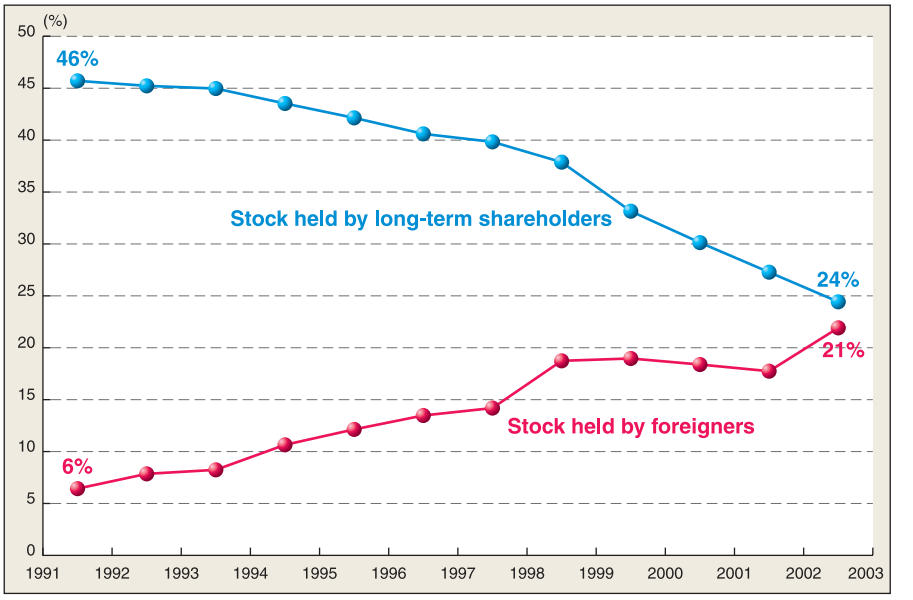
However, while the Guidelines have indeed included certain main aspects of M&A rules, the whole structure has not been completed yet. A number of problems relating to systems and procedures remain to be resolved to make it possible for shareholders and investors to exercise informed judgment.

Specifically, the first thing we must do is to ensure that shareholders and investors are provided with better information regarding the defense measures. Toward that end, in addition to formulating disclosure rules on the basis of the Corporate Act, in order to prevent excessive defense measures, securities exchange listing rules and disclosure rules are planned to be established based on the Guidelines. Second, we must reform the TOB rules. While promoting better disclosure by both the offerer and the target in a TOB, we need to reform the system so that shareholders can make better informed decisions by longer periods of the TOB. Third, in order to bring about more dialog between companies and their shareholders, we will carry out discussions on how to strengthen the role of general shareholders' meetings by making it easier to exercise voting rights, make proposals and participate in proxy contests.

Only 20 out of Japan's 3,800 listed companies adopted rights plans in 2005. Debate over M&A defense measures is expected to heat up considerably at this year's general shareholders' meetings. METI is confident that the systemic and procedural reforms will be implemented, and vigorous communication between shareholders and companies will give birth to a new system of corporate governance in Japan.

With that goal in mind, METI will seek to push ahead as quickly as possible with discussions regarding the unresolved issues, and will work for the expansion of M&As both in quality and quantity. We will also make more efforts to formulate fair rules in Japan's business community. JS

Figure 2 Decreasing Cross-Shareholding and Increasing Foreign Ownership



Source : Adjusted by METI based on the data from RECOF Corporation

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