Recent Developments of Shareholder Activism in Japan

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- Introduction

The importance and influence of shareholder activism in the US is increasingly impacting corporate activities in Japan. According to research of IR Japan, approximately 28% of Nikkei 225 companies have at least one shareholder activist among their shareholder base as of the end of January 2019. The number of shareholder activists that are active in Japan has increased from 9 in 2014 to 27 in 2018. Of those 27, 16 are US or European activists, 5 are Asian activists and 6 are local activists. Since US or European shareholder activists that have investments in Japanese companies include prominent names such as Elliott, Third Point, TCI Fund, Value Act Capital and Greenlight, their investment styles for Japanese companies reflect current trends in shareholder activism in the US. Their activities also influence Asian shareholder activists such as Effissimo and Oasis and the local Japanese shareholder activists such as Reno and Strategic Capital.

In conjunction with increased shareholder activism in Japan, although Japanese institutional shareholders have traditionally been cautious or hesitant in providing support to shareholder activists, they are rapidly changing their stance towards shareholder activists. They have recently started to support shareholder activists more often and more openly to effect change in the directions, transactions or governance of companies.

This article provides a summary of the history of shareholder activism in Japan, current trends in shareholder activism, Japanese laws facilitating or discouraging shareholder activism and future developments of shareholder activism in Japan.

- History of Shareholder Activism in Japan

Shareholder activists began to appear in Japan early in the first decade of the 2000s. In that earlier period, activists such as Steel Partners and M&A Consulting tended to target Japanese companies with low PBR (Price Book-value Ratio) and focused on the maximization of their own profits without considering the interests of the target and the target's other shareholders. These activists were often criticized severely for their aggressive tactics and actions that were inconsistent with traditional Japanese corporate culture, but these activists took advantage of their "hostile" reputation to encourage target companies to use their retained earnings to fend off the activists.

In 2005, the Japanese government issued Guidelines Regarding Takeover Defense,

which clarified the requirements for Japanese companies to lawfully introduce takeover defense measures. Thereafter, Japanese companies started to introduce a Japanese version of shareholder rights plans, or so-called “advance warning type takeover defense measures”. The number of Japanese listed companies with defense measures reached 570 in 2008 (approximately 15% of all Japanese listed companies). The courts have also supported the validity of such measures. For example, in the course of Steel Partners’ hostile tender offer to acquire shares of BULL-DOG SAUCE in 2007, the Supreme Court ruled that the triggering of the takeover defense plan should be allowed because most of the shareholders (approximately 89% of votes cast) approved the plan and Steel Partners was cashed out with reasonable consideration. Japanese companies have also maintained cross-shareholdings to keep a stable shareholder base to protect them from shareholder activists.

In 2006, when Mr. Murakami, one of the most famous Japanese shareholder activists, was arrested for breach of insider trading regulations, the reputation of shareholders activists suffered and reached a low point which led to increased hesitance of Japanese institutional shareholders to support any proposals made by shareholder activists irrespective of the merits of such proposals. Institutional investors felt a need to keep their distance from shareholder activists and to avoid being labeled as being in the same shareholder category as the shareholder activists. As a result, most shareholder activist campaigns (such as proxy fights) during such period were unsuccessful. Since shareholder activists were shunned and were unable to persuade other shareholders to support their proposals, they needed to acquire significant stakes in a target on their own in order to gain influence in the target or resort to exercising their statutory shareholder rights, such as pursuing appraisal rights or claims of breach of fiduciary duties against directors.

- Current Trends

In 2013, Prime Minister Abe took office and began introducing a series of economic policies referred to as “Abenomics”. One of his core policies was corporate governance reform.

As part of such reform, the Stewardship Code of Japan entered effect in 2014, and such code has been adopted by 256 institutional shareholders as of August 1, 2019. The Stewardship Code encourages institutional shareholders to publicly disclose their voting guidelines, the results of their votes and the reasons for their votes. The Stewardship Code has substantially influenced the voting attitudes of institutional shareholders and has resulted in much greater emphasis by such shareholders on the objective merits of votes rather than on relationships with listed companies. As a result, institutional shareholders are

no longer hesitant in supporting proposals by shareholder activists if these institutional shareholders believe that such proposals are also beneficial to their own interests. Institutional shareholders and non-Japanese shareholders now on average constitute more than 55% of all shareholders of Japanese listed companies and often serve in the role of umpire in proxy fights between shareholder activists and the board.

As part of the corporate governance reform, a Corporate Governance Code entered effect in Japan in 2015; such code implemented principles that strongly encouraged Japanese listed companies to reform their corporate governance. The adoption of such code by many companies resulted in an increase in the number of independent outside directors and movement by boards and management toward engagement with shareholders. The ratio of Japanese listed companies on the Tokyo Stock Exchange (1st division) with independent outside director(s) increased from 46.7% in 2013 to 99.7% in 2019.

The foregoing corporate governance reforms have resulted in a reduction of cross-shareholdings in Japanese listed companies which were traditionally popular in Japan[1], and a reduction in the number of Japanese listed companies with approved defense plans, with such number down to 329 (approximately 8.8% of all Japanese listed companies). Such developments have significantly changed the investment environment for shareholder activists.

The investment styles and activities of shareholder activists in Japan have also changed with the influence of shareholder activism abroad and the activities of international shareholder activists in the Japanese markets. The strong negative reputation of shareholder activists in Japan has lessened since the earlier period of their engagement in the Japanese markets; and public campaigns by shareholder activists now sometimes find support in Japan. The number of Japanese companies facing shareholder proposals increased from 52 (8 of which were made by shareholder activists) in the period from July 2016 to June 2017[2] to 56 (17 of which were made by shareholder activists) in the period from July 2017 to June 2018[3]. Although the number of shareholder proposals approved at shareholders meetings is still small, with two in 2017 (Fukui Computer Holdings and Kuroda Electric) and three in 2018 (Ahkun, JP-Holdings and 21 LADY), the ratios of votes for shareholder proposals (particularly for proposals to strengthen corporate governance and shareholder return) are increasing. Even without activist public campaigns, some listed companies such as Olympus and “K” LINE gave board seats to directors appointed by

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[1] According to a September 5, 2019 Nikkei article, cross-shareholding decreased by approximately 12% from 2013 to 2018, with approximately 10% of public shares now being held by shareholders for reasons other than pure investment purposes.

[2] Commercial Law Review no. 2151, p.19-p.23 (*Shojihomu*, 2017)

[3] Commercial Law Review no. 2184, p.17-p.22 (*Shojihomu*, 2018)

shareholder activists in 2019.

In June 2019, METI issued two important guidelines, which are the Group Governance System Guidelines and the Fair M&A Guidelines. The Group Governance System Guidelines encourage parent companies to consider whether holding subsidiaries as listed companies is appropriate with respect to capital efficiency and enhancement of corporate value considered from a company group basis. The Fair M&A Guidelines describe in detail various considerations for procedures to ensure the fairness of transactions involving a conflict of interest, including going private transactions initiated by parent companies with respect to their listed subsidiaries and management buyouts. As of December 2018 in Japan, there were 628 listed companies that had controlling shareholder(s) (17.2% of all Japanese listed companies), which is substantially higher than in other major countries. While these listed subsidiaries or their parent companies have often been typical targets of M&A activism or balance sheet or business strategy activism in Japan, shareholder activists are starting to take advantage of these newly issued guidelines to support their arguments, campaigns and proposals against actions by these companies or their management that are contrary to or not in the best interests of the non-controlling shareholders. The treatment of or actions involving listed subsidiaries will become an increasingly pressing topic in Japan going forward.

Shareholder activists typically target going-private transactions involving listed subsidiaries initiated by their parent companies or contested transactions, or often address issues relating to the balance sheet, shareholder returns, business strategies, governance and compliance in Japan. Some recent examples reflecting the actions and influence of shareholder activism are set forth below.

- In 2016, Panasonic initiated a transaction to acquire a 100% stake of its listed subsidiary PanaHome (currently, Panasonic Homes) by share exchange. Oasis started to acquire up to approximately 9% of all shares in Panasonic Homes and launched a campaign to the effect that the consideration for such transaction was insufficient. Panasonic and PanaHome subsequently changed the transaction structure from a share exchange to a cash tender offer and substantially increased the offer price to successfully close the transaction. Oasis exercised its appraisal rights and the case is under consideration of the court.
- Reno and other affiliated activists led by Mr. Murakami collectively accumulated up to 35% of all shares in Kuroda Elecrtrics on the market. In 2017, Reno launched a campaign to improve the balance sheet of Kuroda and obtained a board seat at Kuroda. The shareholder proposal to elect an outside director appointed by Reno was approved with approximately 58.6% of all votes. Subsequently, Kuroda

considered a management buyout with support from the private equity fund MBK and successfully went private.

- In 2017, KKR launched a tender offer to acquire shares in Hitachi Kokusai Electric from its controlling shareholder Hitachi. Elliott then commenced purchase of up to approximately 8.6% of all outstanding shares in Hitachi Kokusai on the market in order to cause KKR to increase the tender offer price. KKR successfully closed the transaction after it increased the tender offer price by approximately 25%.
- Toshiba Plant Systems, a listed subsidiary of Toshiba, deposited approximately US$ 800 million to Toshiba as part of Toshiba group's cash management system. Oasis brought a lawsuit against the directors of Toshiba Plant to enjoin such deposit claiming that it was a breach of their fiduciary duties. The directors of Toshiba Plant voluntarily teminated such deposit considering the then financial situation of Toshiba.

- Relevant Regulations and Features in Japanese Law Facilitating or Discouraging Activism

• Companies Act

The Japanese Companies Act provides that directors owe duties of care and loyalty to the company in which they hold directorships, which is generally interpreted to mean that directors have a duty to enhance the corporate value of the company. In addition, such duties of directors include the duty to protect the common interests of shareholders. Therefore, in the context in which Revlon duties would apply in the US, directors of Japanese companies are required to make reasonable efforts to conduct change of control transactions on the best possible transaction terms for general shareholders, while also increasing corporate value. This requirement of considering corporate value is somewhat unique as compared to Revlon duties in the US.

• Takeover Defense Plans

Japanese law generally limits defensive measures available to target companies to those exceptional circumstances in which the hostile takeover would harm the corporate value and the common interests of the shareholders of the target company. In Japan, takeover defense plans such as shareholder rights plans can be adopted if they satisfy the requirements under the Takeover Defense Guidelines, which include the requirement that defense plans be based on shareholders' reasonable intent and the requirement that such plans are publicly disclosed. As a result, if a Japanese listed company wants to adopt a

defense plan, it would usually prefer to obtain shareholder approval at a shareholders meeting, which is different from the US where defense plans can be adopted by board resolution at any time, which enables the possibility of “shadow pills”. Because of this shareholder intent requirement, Japanese defense plans are designed to be shareholder friendly and only limited use of these plans is allowed.

- Minority Shareholder Rights

Minority shareholders have a variety of statutory rights in Japan. For example, a shareholder that has held at least 1% of the voting rights of all shareholders or a total of at least three hundred (300) voting rights, in each case for at least six (6) consecutive months, is able to demand that certain agenda items be included in the matters to be resolved at a shareholders’ meeting by giving at least eight (8) weeks’ prior written notice. In Japan, a shareholder seeking to elect its designated director(s) will often exercise such demand rights, and then try to obtain proxies from other shareholders or otherwise solicit other shareholders to vote for its proposal (and vote against the issuer’s proposal).

A shareholder holding at least 3% of the voting rights of all shareholders for at least a six (6) consecutive month period may also call a shareholders’ meeting on its own by obtaining consent of the court (if the directors do not call a shareholders meeting without delay after being requested to do so by such shareholder).

- Large Shareholding Report

Under the Financial Instruments and Exchange Act of Japan (the “FIEA”), a large shareholding report generally must be filed with the local finance bureau if a person, together with its joint holders, comes to hold more than 5% of the total number of the issued shares of a company. A large shareholding report generally must be filed within five business days from the day immediately following the day on which a shareholder crosses the 5% ownership threshold. Once a large shareholding report is filed, if there is any change in the information included in such report, except for minimal changes, a report of such change generally must be filed via the electronic EDINET system within five business days. For example, a report of change will usually be required for (i) any decrease or increase of one percent or more in the ratio of the voting rights held by a large holder and its joint holders to the total voting rights in the company or (ii) any change in the purpose of the holding of the shares by the large holder and its joint holders.

- Tender Offer Regulations

On-market purchases of shares are often attractive to shareholder activists seeking to

buy shares because on-market purchases are generally not subject to tender offer requirements, with certain exceptions. However, the FIEA generally requires that a person who wishes to acquire a large number of public shares of a company to conduct a tender offer through off-market purchases.

A tender offer is not required in connection with any off-market purchase of shares, as long as the voting rights of the company held by the purchaser and its "Special Interested Parties" (as defined in the FIEA) following such purchase do not exceed 5% of the total voting rights of the Company (the "5% Threshold").

If the 5% Threshold is exceeded, an off-market purchase generally must be made by way of a tender offer except where (i) the number of sellers in the relevant off-market purchase and the previous off-market purchases within the preceding 60 days is 10 or fewer; and (ii) after such purchase, the purchaser, together with its Special Interested Parties, hold no more than 1/3 of the total voting rights of the company (the "1/3 Threshold"). Furthermore, if the 1/3 Threshold is exceeded, a mandatory tender offer will generally be triggered by any off-market purchase, regardless of the number of sellers from whom purchases have been made in the last 61 days.

Therefore, shareholder activists usually prefer to purchase shares on the open market because, in principle, Japanese tender offer rules regulate off-market transactions and do not apply to open market transactions (in each case with certain exceptions).

- Recent Amendments to the Foreign Exchange and Foreign Trade Act

The Japanese government recently amended the Foreign Exchange and Foreign Trade Act (the "Foreign Exchange Act"). Under the Foreign Exchange Act, an acquisition by a foreign investor of shares of a Japanese company will constitute an "Inward Direct Investment" (as defined in the Foreign Exchange Act), if as a result of such acquisition, the foreign investor, together with its "Specially Related Parties" (as defined in the Foreign Exchange Act), comes to hold 10% or more of the total voting rights of the company. The government is currently considering lowering this 10% threshold to a smaller number.

In connection with an Inward Direct Investment, a prior notice generally must be submitted to the Minister of Finance and other ministers in charge of the relevant industry via the Bank of Japan within six months before the date of such acquisition, if the Company is engaged in such businesses that are concerned with national security, public order or safety and certain other businesses (e.g., manufacturing of arms, aircraft, leather and leather goods; manufacturing related to nuclear energy and space development; electricity, gas and heat supply; telecommunications and broadcasting; waterworks and sewage; railway, aviation, maritime and other forms of transportation; security services; agriculture,

forestry and fisheries; oil refining and other oil-related businesses). Effective as of August 1, 2019, the scope of such businesses (for which a prior notice in respect of an Inward Direct Investment is required) was expanded. Under the revised regulations, certain businesses relating to (i) manufacturing IT devices or their electronic components, (ii) developing IT-related software (outsourced software development, embedded software development, and packaged software development), and (iii) ICT-related services have been added to the list.

- Thoughts About Future Developments

While Japanese laws historically tend to respect decisions of shareholders in regard to the companies in which they hold shares, the current trend to improve corporate governance is expected to continue under the Abe administration so that shareholders are expected to continue to increase their power and influence in the companies. In parallel, shareholder activists are expected to be more active at least in the near future.

Some boards of Japanese listed companies are recognizing the increasing need for them to be prepared to deal with situations involving or caused by shareholder activists. If a shareholder activist starts a campaign in opposition to the board or management of a target company, both the shareholder activist and the target company's board will respectively try to obtain support from institutional shareholders and other shareholders by appealing to the respective merits of their position.

Accordingly, Japanese listed companies are appreciating the importance of engaging and maintaining good relationships with institutional shareholders, to garner support against the campaigns or proposals of shareholder activists or to blunt the influence of the shareholder activists. Of course, the fact that shareholder activists have a tendency to focus on short-term returns is generally acknowledged in Japan. Governmental authorities are carefully watching what harms such short-term focus may create. In the meantime, boards of Japanese companies are focusing on increasing their corporate value over the mid-term while also seeking to appease short-term shareholders as necessary or appropriate.

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