International Law Office

CAPITAL MARKETS - JAPAN

Kyoto District Court rules on raising of capital by third-party allotment

08 January 2019 | Contributed by Nagashima Ohno & Tsunematsu

What is third-party allotment?
Safeguarding existing shareholders against third-party allotment
Facts
Decision
Comment

AUTHOR

Sosuke Kimura

On 28 March 2018 the Kyoto District Court ruled in favour of a shareholder's petition that a listed issuer cease an offering of its new shares by third-party allotment on the grounds that the offering had been conducted through an 'extremely unfair method', despite having been approved by a resolution at the issuer's shareholders' meeting.

What is third-party allotment?

'Third-party allotment' is a method of offering shares in a joint stock company under which the board of directors determines the parties to whom the newly authorised shares will be allotted. Under the Companies Act, the issuer company's board of directors can issue new shares which are authorised in its articles of incorporation, but have yet to be issued, in accordance with the board's terms provided that authorisation at a shareholders' meeting is also necessary when the issue price of the offering is an 'especially favourable' price.

The distinguishing factor between a third-party allotment and a public offering under the Companies Act is that, in the former, the issuer determines the allottees who can purchase the offered shares. In comparison to a public offering, a third-party allotment offering is important for companies whose financial condition is unsound or whose share price is not attractive enough to make a public offering practically feasible. Historically, third-party allotment offerings in Japan have been conducted among business partners or with financial institutions as a tool to establish a capital relationship underlying a business collaboration or to rehabilitate the issuer company.

Safeguarding existing shareholders against third-party allotment

Under the Companies Act, shareholders may demand that an issuer cease the offering of its shares, regardless of whether they are being offered by way of a third-party allotment or a public offering, if the shareholders are likely to suffer a disadvantage because:

- the offering violates applicable laws and regulations or the company's articles of incorporation; or
- the offering is being conducted through an extremely unfair method.

In practice, existing shareholders typically seek such an injunction based on the fact that:

- the issue price of an offering is an especially favourable price; and
- the offering is being conducted through an extremely unfair method as its primary purpose is maintaining the management's control.

As described above, the Companies Act provides that the issuer's board of directors may issue new

shares on its own authority unless the issue price is especially favourable. However, the Companies Act does not define an 'especially favourable' price. If the issue price is especially favourable, the offering must be approved by a resolution at a shareholders' meeting where the directors should explain the "necessity of making the offering at a specially favorable price". In addition, such necessity must be provided in the convocation notice which must be sent to shareholders at least two weeks before the shareholders' meeting. As a result, if the offering of shares at an especially favourable price is conducted without a resolution at the shareholders' meeting, such offering would violate the Companies Act in relation to the procedure for offering shares.

Similarly, the Companies Act does not define an 'extremely unfair method'. However, the Japanese courts appear to have adopted the so-called 'main purpose rule', under which they will determine a share offering's primary purpose, including where this is capital raising or maintaining management's control. Previously, the courts have determined that an offering is not conducted through an extremely unfair method when its primary purpose is raising money, even where, as a result, the offering would maintain the management's control.

Facts

Before the issuer decided to offer new shares to certain affiliate individuals or corporations, the shareholder who eventually filed for the injunction invited the issuer to form a business collaboration with it. At the same time, the shareholder proceeded to purchase shares in the issuer in the secondary market and, as a result, became its second largest shareholder. The largest shareholder was the issuer's management.

The issuer rejected the offer from the shareholder regarding the business collaboration and requested that it stop raising its shareholding.

The issuer announced the planned offering, but the issue price was set far below the most recent market price of its shares. In addition, the issuer sent a convocation notice to its shareholders. However, the convocation notice did not include the shareholder's continued offer to collaborate with the shareholder for the issue price, which was considered to be especially favourable.

Immediately after the issuer announced the planned offering, the shareholder offered the issuer its proposal of equity financing, in which it proposed that the issue price would be equal to the recent market price. However, the issuer rejected this proposal, insisting, among other things, that the business collaboration with the shareholder would have a material adverse impact on the issuer's corporate value and that the planned offering would be more beneficial for the shareholders in the mid-to-long term despite the lower issue price.

In response to the issuer's rejection, the shareholder:

- distributed written material to other shareholders explaining the detail of its proposal; and
- requested that the other shareholders give it proxies with respect to the shareholders' meeting that was to be held to approve the planned offering.

Following the distribution of these materials, the issuer also sent written material to its shareholders explaining its position. However, this material was distributed less than two weeks before the shareholders' meeting.

The offering of the shares, as planned by the issuer, was eventually approved at the shareholders' meeting.

Decision

The Kyoto District Court adopted the main purpose rule in accordance with the previous court rulings. The court concluded that the main purpose of the offering planned by the issuer had been to reduce the petitioning shareholder's shareholding. The rationale behind this conclusion was that:

- the offering's issue price had been far below the market price; and
- there was no reason why the offering could not have been conducted with a more favourable

issue price.

The court pointed out that the fact that the issuer had rejected the shareholder's proposal of the equity offering with a higher issue price implied that it had intended to dilute the shareholder's shareholding. With respect to the approval at the shareholders' meeting, the court held that this approval could not validate the offering and emphasised the fact that the shareholder's counter-offer had not been disclosed to the shareholders before the shareholder had distributed its written material for proxies. Further, the issuer's eventual disclosure of the counter-offer had occurred less than two weeks before the shareholders' meeting, while the Companies Act requires the issuer's convocation notice to be issued at least two weeks before the meeting and include information relevant to the "necessity of making the offering at a specially favourable price".

Comment

This case is a lower-court ruling and, as such, will need to be tested in other similar cases before it can be generalised. However, while the *prima facie* position appears to remain that approval at a shareholders' meeting is valid justification for a proposed share offering, it is important to recognise that, depending on the factual circumstances of the case, an offering may be subject to an injunction order even where it has been approved by shareholders if it is conducted through an extremely unfair method.

For further information on this topic please contact Sosuke Kimura at Nagashima Ohno & Tsunematsu by telephone (+81 3 6889 7000) or email (sosuke_kimura@noandt.com). The Nagashima Ohno & Tsunematsu website can be accessed at www.noandt.com.

The materials contained on this website are for general information purposes only and are subject to the disclaimer.