Case

Case in which the jurisdiction of the Japanese courts was denied based on the Unfair Competition Prevention Act and tort, because:

1. **The plaintiff did not prove on the facts that the alleged business damages arose from the use of information (including parent company trade secrets) by the defendant, a former employee of a foreign subsidiary of the Japanese corporation, after he was headhunted by a competitor company in the foreign country, and;**
2. **The plaintiff did not prove objective circumstances sufficient to constitute a duty under the good faith principle that the defendant ought to have cancelled or postponed the business trip.**

(Osaka District Court, February 5, 2004; LEX/DB 28090764)

Keywords : Unfair Competition, Trade Secrets, Tort, Headhunting, Jurisdiction of Japanese Courts, Proof of the Facts Constituting the Jurisdiction of Japanese Courts

[Facts]

The defendant 'Y', who lived in Australia, worked at 'A' Company, a wholly-owned subsidiary of the plaintiff 'X', a Japanese company. X Company produced electrical connector parts for export and import. While Y was working at A Company, Y went to Japan on business at X Company's expense from May 21-24, 2001. While in Japan, Y visited various departments of X Company receiving explanations about the company's business, including trade secrets. On May 17, 2001, the day before Y visited Japan, Y was headhunted by telephone by 'B' Company, an Australian company and business competitor of X Company. On May 29, Y received an offer in writing from B Company with specific details such as salary. On June 4, 2001, Y notified an X Company representative that Y had accepted an offer from B Company and would resign from A Company. Y then went to work at B Company.

Later, X Company entered a competitive bid at 'T' Company (not a party to the dispute), a Japanese automobile company, for automobile side airbag connector parts. As a result of the tender, 'C' Company, an affiliate of B Company in Japan, won the bid on December 10, 2001.

X Company brought a suit against Y, claiming: ① compensation reflecting part of X Company's damages arising from the loss of the tender, insisting that these were caused by Y disclosing X Company trade secrets to B Company, which Y fraudulently obtained in Japan by not divulging his plans to change companies, based on Article 2 (1) (iv) and (vii), and Article 4 of the Unfair Competition Prevention Act; and ② an action in tort for

damages reflecting X Company's losses from Y's travel expense account, which it paid for Y who had already decided to transfer to B Company.

Y challenged the jurisdiction of the Japanese courts and demanded that the case be dismissed.

[Judgment]

The case was dismissed on the grounds stated below:

1. "In order to exercise the jurisdiction of the Japanese courts in a case for damages in tort and the Unfair Competition Prevention Act against a defendant who has no domicile in Japan, the forum rule as the place of the tort in the Code of Civil Procedure (Article 5 (ix)) shall be applied. Under the circumstances, it is necessary to prove on the facts that the harm to the plaintiff's legal interests were in principle caused by the defendant's acts in Japan. Indeed, if there is a connection on the facts, there is normally a rational reason why the defendant should respond on the merits. In addition, there are sufficient legal reasons to justify the exercise of the jurisdiction of the Japanese courts from the perspective of sharing judicial functions throughout international society (See Supreme Court (P. B. 2), Judgment, June 8, 2001, *Min-shū* (Supreme Court Reports (Civil Cases)) Vol. 55, No. 4, p. 727)."

2. ". . . In this case, in order to affirm the exercise of the jurisdiction of Japanese courts with regard to ① [the claim for damages reflecting part of the loss of the tender], at the least it is necessary to prove on the facts that Y acquired technical or business information held by X Company which is kept secret and not publicly known, and that the business losses arose from the use of that information. With regard to ② [the claim in tort for damages for Y's expense account], at the least it is necessary to prove the objective circumstances sufficient to constitute a duty under the principle of good faith requiring that the defendant cancel or postpone the business trip, even if the plaintiff can prove that the defendant had considered or decided to resign at the time of the business trip. The reason for this is that a tort shall not normally be constituted. This is so even if it is a fact that an officer of the company, who worked at the foreign subsidiary of the Japanese corporation, visited Japan on business at the expense of the parent company despite the officer knowing of his/her resignation. There are therefore insufficient facts to exercise the jurisdiction of the Japanese courts, even if the facts are proven, except where the jurisdiction of Japanese courts is exercised as a joint claim with ①, where the Japanese courts do have jurisdiction."

". . . With regard to . . . the improper acquisition of trade secrets . . . in this case, except with regards to whether the information provided to Y, including the information regarding connectors, was trade secrets of X Company . . . we cannot find that Y acquired that information and disclosed it to B Company . . . judging from the following facts, that is, the affinity of mechanics' connectors between X Company and C Company, the result

of the bid of T Company, and the circumstances of Y before and after the business trip to Japan . . ."

". . . With regard to . . . a tort caused by concealing resignation plans . . . there existed only a possibility that Y might resign. Y made up his mind and decided to resign after May 25, 2001, which was after the date on which Y returned from the business trip. Moreover, Y had only received the headhunting offer from B Company by telephone on May 17, 2001, which was before Y visited Japan on business on May 21, 2001. At that time, Y had not yet made a final decision to resign. There was therefore no reason to fulfill a duty under the principle of good faith requiring Y to cancel or postpone the business trip, where Y had just received the headhunting offer and there was only a possibility that Y might resign . . ."

3. "According to the above, as to the improper acquisition of trade secrets and the tort arising through the disclosure of trade secrets, which was asserted by X Company, the facts have not been sufficiently proven to show that Y acquired technical or business information, which was held and kept secret by X Company and not publicly known, and that the business losses arose from using that information. In addition, as to the allegation of a tort based on the fact that Y kept his resignation plans secret while visiting Japan on business, we cannot find that the plans to resign were settled at the time of business trip to Japan. Moreover, the objective circumstances have not been sufficiently proved to show that there was a duty under the principle of good faith requiring Y to have cancelled or postponed the business trip."

"Consequently, we cannot exercise the jurisdiction of the Japanese courts under the rule on forum of the place of the tort according to the Code of Civil Procedure (Article 5 (ix)), and there is no other basis for the exercise of the jurisdiction of the Japanese courts in this case."

[Commentary]

1. This is a case based on a provision in Japan specifying the forum as the place of the tort in determining the jurisdiction of Japanese courts, for a claim of damages based on unfair competition by a former employee living in foreign country. The court concluded that the facts constituting the jurisdiction of Japanese courts had not been proven, that is, that the losses of the Japanese company (the parent company) arose from the acquisition of information by the defendant. There are some former cases which concerned the jurisdiction of Japanese courts in unfair competition. The cases included seeking an injunction in an unfair competition case in the United States between competing Japanese companies. In addition, an action for declaratory relief for the non-existence of damages was brought against a Japanese company which infringed the know-how of an American company. However, there had yet to be a case published similar to the one in question, that is, determining the jurisdiction of Japanese courts for damages based on the improper

acquisition and disclosure of trade secrets by a former employee. This seems to be the first case of its kind in Japan.

In section 2, this commentary gives an overview of the argument about the jurisdiction of Japanese courts and applicable law for unfair competition; secondly, it discusses the standard of proof required in cases where the facts relevant to establishing the jurisdiction correspond with the facts of the claim for damages, in section 3. Some additional comments will be made at section 4. A claim based on tort for damages representing the expense account, by concealing an intention to leave the company, was also judged in this case. The court decided to deny the jurisdiction of the Japanese courts in this matter based on the issue of a duty under the principle of good faith. The reason was that the objective circumstances of the decision to leave the company at the time of business trip were not proven to the degree required in order to exercise the jurisdiction of Japanese courts. There are also some important issues with regards to this point, which cannot be considered in this commentary, such as the matters and extent of proof needed to exercise the forum of the place of tort in Japan, and whether the jurisdiction based on a joint claim is recognized where the Japanese court has jurisdiction over a claim for damages based on unfair competition issues.

2. There have been two main cases which have decided on the jurisdiction of Japanese courts in instances of unfair competition: Tokyo District Court, Judgment, October 16, 2003, *Hanji* No. 1764, p. 23 (the so-called "Coral Case") and Tokyo District Court, Interim Judgment, May 30, 1989, *Hanji* No. 1348, p. 91. The former case involved a Japanese company which sent letters of warning from Japan by email and post to the customer of a competing Japanese company in the United States, stating that patent rights were held in the United States by the Japanese company, and warning that these was being infringed by its competitor. The court upheld the jurisdiction of the Japanese courts without referring to jurisdiction in unfair competition. It characterized the law applicable to unfair competition as tort. However, it is not clear whether the court recognized the jurisdiction of the Japanese courts due to the forum being the place of tort (Japan), because the court initially recognized the international jurisdiction of the Japanese courts as the general forum for the defendant, for an action for declaratory relief for the non-existence of injunction based on patent rights held in a foreign country.

The second case involved a Japanese company which claimed an action for declaratory relief regarding the non-existence of damages and an injunction. Both claims were brought before a court in the United States against the Japanese company by the American company. The reasons were that the Japanese company illegally acquired trade secrets from the American company through a company which was not a party to the dispute, but which was established by a former employee of the American company, and that Japanese company subsequently infringed the know-how of the American company. The Japanese court characterized the damages mentioned above as a tort, and exercised the jurisdiction

of the Japanese courts because some of the essential tortious acts in this case were performed in Japan. The jurisdiction of the Japanese courts for the injunction was recognized based on the grounds that the injunction was sought as part of a joint claim.

With regard to the international jurisdiction of the Japanese courts in unfair competition cases, such as in the current case, there might be a question as to whether jurisdiction should be recognized according to the forum of the place of the tort (Article 5 (ix) of the Code of Civil Procedure) or another forum, for example, a special forum for unfair competition. Similar problems arise in deciding the applicable law for unfair competition. There are four theories regarding the applicable law. First, unfair competition is characterized as a tort and the law of the place where the relevant event occurred should be applied under Article 11 of the *Hōrei* ("Act Concerning the Application of Laws"). Secondly, unfair competition is characterized as a special tort and the applicable law should be decided according to *naturalis ratio*. Thirdly, unfair business competition is classified as "market-related unfair competition" and "business related unfair competition", and Article 11 of the *Hōrei* should be applied to both. However, in the former, the place of the tort should be interpreted as the place of the market, while in the latter, it should be the place of act; alternatively, though unfair business competition can also be classified into two types, the law of the market place shall be applied in the former and the law of the place of the act should be applied in the latter, based on Article 11 of the *Hōrei*.

There are also some cases in which unfair competition is characterized as a tort and Article 11 of the *Hōrei* is applied (for example, the "Coral Case", Tokyo District Court, Judgment, September 24, 1991, *Hanji* No. 1429, p. 80), in which the law of the most closely connected jurisdiction is applied based on *naturalis ratio*, as well as emphasizing the point that an injunction was sought in this case (Intellectual Property High Court, Judgment, December 27, 2006). The theories and case law do not agree.

In the current case, X Company alleged that the business losses arose from the loss of the bid to T Company, which was caused by Y disclosing trade secrets of X Company. Therefore, the issue in this case is not the direct connection between the act and the market but rather the mutual relationship between the parties. It is therefore preferable that unfair competition, such as in this case, is qualified as a tort. For this reason, it is possible to maintain the argument that the court's decision was based on the forum of the place of the tort.

Incidentally, in the current case, the place where the trade secrets were acquired improperly was Japan, but the place where the trade secrets were disclosed and used improperly was likely to have been Australia. Furthermore, the place where the resulting damages occurred was Japan. In cases such as this where a tort occurs in places which are in different jurisdictions, it is debatable whether the place of the tort is interpreted as the place in which the event occurred which caused the tort or the place where the effects of

the infringement occurred. The international jurisdiction of the courts can generally be exercised in both forums in Japan. In contrast, there is debate over applicable law. If we consider previous case law, both Japan and Australia could have been recognized as the place of the tort in this case.

The *Hō no Tekiyō ni kansuru Tsūsokuhō* ("Act on General Rules concerning the Application of Law") was enforced from January 1, 2007, in place of the *Hōrei*. There is no special provision applicable to unfair competition. However, the law applicable to torts will change such that, as a general rule, the governing law shall be that of the place in which the effects of the infringement occurred (Article 17, paragraph 1), and in certain exceptions shall be that of the place of the tortious acts (Article 17, paragraph 2). Furthermore, notwithstanding Article 17, the law of the more closely connected jurisdiction, including the case where the parties had common habitual residence at the time of the tort, shall apply (Article 20). Moreover, the parties may change the applicable law after the occurrence of a tort (Article 21). These new provisions are likely to have a major influence in the future on the process of the determination of the applicable law for unfair competition.

3. In cases such as the present, where the forum of the place of tort is disputed, the facts constituting the cause of the jurisdiction correspond with the facts which go toward the merits. It is unjust for parties to have a burden of proof the same as that for the merits of the case, which require a high standard of proof. In this respect, the Supreme Court in P. B. 2, Judgment, June 8, 2001, *Min-shū* (Supreme Court Reports (Civil Cases)) Vol. 55, No. 4, p. 727 (the so-called "Tsuburaya Production Case"; see *Ritsumeikan Law Review* No. 20, pp. 246) adopted a doctrine demanding proof of the facts constituting the jurisdiction of the Japanese courts as follows: "In order to exercise the jurisdiction of Japanese courts in a case which claims damages based on a tort against a defendant who was not domiciled in Japan, the rule regarding the forum of the place of the tort in the Code of Civil Procedure shall be applied. Under the circumstances, in principle it is necessary to prove on the facts that the damages to the plaintiff's legal benefits were caused by the defendant's act in Japan." The present case follows the "Tsuburaya Production Case". Three opinions emerge from doctrine and case-law. First, the doctrine that the facts alleged to support the claim by the plaintiff are assumed to exist in Japan (rationality doctrine). Secondly, the doctrine that complete proof of the facts which support the jurisdiction is not required, but that it is insufficient to assume these based on mere allegation by the plaintiff. Thirdly, the doctrine adopted in the "Tsuburaya Production Case".

The present case considered in detail what specific objective facts ought to be proven in a case concerning the jurisdiction of Japanese courts based on unfair competition. These are clear from the grounds of this case as mentioned above. However, this case seems to presume the application of the Japanese Unfair Competition Prevention Act in

discussing the facts which ought to be proven. Normally, the proceedings with regard to the applicable law commence after it is decided which courts have jurisdiction. This case seems to be a similar to a decision made on the merits of the case. Indeed, it can not be denied that a legal norm must be presumed in order to judge the facts constituting the jurisdiction of Japanese courts in unfair competition, but the facts ought not to be proven in every case. The court would have been able to exercise the jurisdiction of Japanese courts in this case, if the facts supporting the plaintiff's claim were assumed to exist in Japan.

4. On one hand, the methods of regulation for unfair competition differ in each country based on the industrial and cultural policies in that country. On the other hand, the importance of trade secrets in economic activities is increasing in today's so-called information age. Moreover, the headhunting of employees by competing companies is not unusual in the context of increasing globalization. In light of this, the present decision merits attention for business practices.

As mentioned above, this case adopts the doctrine requiring proof of facts constituting the jurisdiction of Japanese courts, as in the "Tsuburaya Production Case", and seems to presume the application of the Japanese Unfair Competition Prevention Act in deciding the jurisdiction of Japanese courts based on unfair competition. There are some countries (for example, Germany) where the Unfair Competition Prevention Act is considered a "mandatory rule". In those countries, the Unfair Competition Prevention Act is applicable to the extent that it has an effect on the domestic market, regardless of the governing law. It is not clear whether the court thought of the Japanese Unfair Competition Prevention Act in the same way. However, it is not necessary to think of the Unfair Competition Prevention Act as a mandatory rule if unfair competition is understood as a special type of tort.

In addition, it seems possible that the company could have prevented the improper acquisition of trade secrets and have prohibited the disclosure of information after the employee's resignation by concluding another contract. In doing so, the company could have sought an injunction suspending or preventing unfair business competition as the performance of an obligation under contract, or have claimed for damages in default. However, the jurisdiction of Japanese courts based on the claim for damages in default would be based on the general forum for the defendant (Article 4 of the Code of Civil Procedure) or the forum of the place of performance of the obligation (Article 5 (i) of the Code of Civil Procedure). With regards to the jurisdiction of Japanese courts based on the place of performance of the obligation, there is a case (Tokyo District Court, Judgment, October 25, 2004, *Hanta* No. 1185, p. 310) which follows the "Tsuburaya Production Case" with regards to the standard of proof necessary for invoking the jurisdiction of Japanese courts.

(KATAOKA Masayo)

Case in which the transaction which used the foreign tax credit margin as provided for by the Corporation Tax Act was judged to be an abuse of the foreign tax credit system

(Supreme Court, P. B. 2; December 19, 2005; *Hanrei-jiho*, No. 1918, p. 3)

Keywords : Foreign Tax Credit

[Facts]

Company A, incorporated in New Zealand, planned the purchase of New Zealand dollar-denominated bonds to manage the funds it collected from an investor. Company A established a wholly-owned subsidiary, Company B, in the Cook Islands where the corporation tax rate was lower than that of New Zealand in order to reduce the corporation tax imposed on investment profits. In reality, it was Company B that purchased the relevant bonds. Furthermore, as withholding tax would not imposed on Company C for funds received from the investor, Company A allowed Company C (incorporated in the Cook Islands), of which it held 28% of outstanding stock, to acquire the relevant funds in order to evade the withholding tax imposed in the Cook Islands for investments made by an investor. In other words, Company A diverted the relevant funds to Company B from the investor via Company C. However, in such a case, when Company C loaned the funds directly to Company B, according to the taxation system of the Cook Islands, a withholding tax of 15% was imposed for the interest paid from Company B to Company C.

Therefore, on March 31, 1998, Company B concluded a loan contract with X (a bank incorporated in Japan) for the amount of US$50,000,000 at an annual interest rate of 10.85%. In addition, Company C concluded the following deposit contracts with X on the same day:

- Company C deposited in X money equivalent to the amount with which X financed Company B based on the above loan contract.
- X's payment of the deposit capital in Company C was completed to the extent of repayments that X received from Company B from the above loan capital.
- When X received the above loan interest (after withholding tax deductions) from Company B, X paid an amount of money as interest on the deposit after subtracting its fees from the loan interest (before withholding tax deductions) to Company C for interest on deposit.

Company C could avoid payment of the withholding tax in the Cook Islands through the contract-based transaction. On the other hand, X incurred a loss as a result of the transaction. This was because X bore an amount of withholding tax in the Cook Islands which exceeded the fees received by X. Ultimately, however, X was able to profit due to foreign tax credits in Japan. In other words, they conducted this transaction in order to

reduce the tax burden of the Company A group by using X's foreign tax credit margin.

In filing X's tax return, X reduced the amount of money of the withholding tax paid in the Cook Islands from the amount of its payable tax.

However, the Superintendent of the Taxation Office, 'Y', did not accept this credit for foreign tax for the following reasons:

(1) Company C must pay the original withholding tax because X disguised the transaction with Company B and Company C.

(2) In this case, it defeats the purpose of the system to apply the system of foreign tax credits.

Y, therefore, decided to reassess X's taxes and levied a penalty for underpayment. X then filed a claim against Y for the cancellation of the levy.

In the first instance, the Osaka District Court accepted X's claim for the following reasons:

- Contracting parties decide in principle what kind of legal relations they use.
- X is a bank with a financial intermediary function, and receiving deposits and loaning funds constitutes its original business.
- X provides financing through reduced costs by using the foreign tax credit margin as a part of its business as a financial institution.

The Court concluded that such actions constituted normal practice. In the second instance, the Osaka High Court dismissed Y's appeal for the same reasons. Y appealed this decision to the Supreme Court.

[Judgment]

The Supreme Court overruled the Osaka High Court's judgment and accepted Y's claim for the following reasons:

"In a foreign tax credit system, where a domestic corporation is to pay a foreign corporation tax, the amount of the foreign corporation tax shall, to a certain degree, be credited against the amount of corporation tax payable. This system based on a policy designed to remove international double taxation on a single source of income and to secure neutrality of taxation for business.

However, considering this transaction overall, X (incorporated in Japan) paid foreign corporation tax that a foreign corporation must originally bear through the receipt of fees and escaped liability by reducing the amount of tax payable in Japan by using X's foreign tax credit margin, resulting in a profit to X. That is, X avoided tax payments by using foreign tax credit system in such a way that was contrary to its original purpose and attempted to execute a transaction in which, although X would incur a loss, that loss would ultimately be offset by placing the burden on the Japanese taxpayer, and thus, would allow X's business associates to profit. Therefore, in this case, X abused the system and significantly damaged the fairness of the tax base."

[Commentary]

The "Foreign Tax Credit System" (Corporation Tax Act, Article 69) is a system that entitles a domestic corporation to subtract the amount of foreign corporation tax which it paid for income earned overseas from the amount of corporation tax payable in Japan. However, there is a limit to the amount in the Japanese Corporation Tax Act in this foreign tax credit system. The limit of foreign tax credit against corporation tax is the amount calculated according to the following formula (Corporation Tax Act Cabinet Order, Article 142, paragraph 1):

> "Amount of domestic corporation tax on income in the said fiscal year × Amount of income from sources abroad in the said fiscal year ÷ Total amount of global income in the said fiscal year"

Therefore, when a tax rate of a foreign corporation tax is higher than the Japanese corporation tax rate, the full amount of foreign corporation tax cannot be credited against the amount of corporation tax. However, on the other hand, if a corporation pays a foreign corporation tax rate lower than the Japanese corporation tax rate, the amount of foreign corporation tax that could not originally be credited can then be credited against the amount of corporation tax. For this reason, there has been an increase in the number of cases in which a corporation creates a foreign tax credit margin and uses it by intentionally conducting transactions which are subject to a foreign corporation tax in areas with low tax rates, and paying the relevant foreign corporation tax.

In this case, in addition to a loan contract that X concluded with Company B (incorporated in the Cook Islands), X also concluded a deposit contract for same amount as the above loan contract with Company C (incorporated in the Cook Islands). Considering this in terms of economics, Company C lends the funds to Company B; and Company C lends funds to Company B via X to reduce the withholding tax burden of the Company A group in the Cook Islands by using X's foreign tax credit margin.

Therefore, Y rejected X's tax return for the above two reasons.

Each of the above contracts was concluded between X and Company B and Company C respectively, and X actually paid the withholding tax in the Cook Islands. The Court in this case determined that the transactions had not been disguised. Therefore, the question in this case was whether the court could adopt a restrictive interpretation of Article 69 of the Corporation Tax Act.

The Osaka District Court and the Osaka High Court make it clear in referring to the history of reform of Article 69 of the Corporation Tax Act that the misuse of the foreign tax credit margin was not necessarily rejected at the legislative stage. The courts declared that the use of a foreign tax credit system will not be permitted if each of the parties used the foreign tax credit margin for reasons outside the scope of their company objectives.

Furthermore, they determined that the company objectives qualify in this instance as X conducts such transactions as a part of its business as a financial institution and that X's earnings before tax fall within a reasonable range. Therefore they affirmed the use of credit for foreign taxes of X. However, after explaining the general meaning of Article 69 of the Corporation Tax Act, the Supreme Court held that as X's use of foreign tax credits constituted an abuse of the system, Y's appeal would succeed.

(YASUI Eiji)

Prohibition of Nireco Corporation's Issuance of Stock Purchase Warrants

(Tokyo High Court, June 15, 2006; *Hanrei-jihō*, No. 1900, p. 156)

Keywords : Stock Purchase Warrants, Takeover Defensive Measure, Corporate Value

[Facts]

Nireco Co. (Y), an industrial machinery control device manufacturer, is listed on the JASDAQ market. SFP Value Realization Master Fund Ltd. (X), which is registered in the Cayman Islands, holds 2.85% of Y's issued stock. At its Board of Directors' meeting on March 14, 2005, Y decided to issue free of charge two stock purchase warrants for each share held to all stockholders of record as listed on March 31 of the relevant fiscal year. The particulars of this issuance were as follows:

(i) Purpose: To defend corporate value from hostile purchasers in advance, and in the instance of an acquisition proposal, to secure rational means for achieving maximization of corporate value.

(ii) Details: The period for exercising the right extends three years from June 16, 2005 to June 16, 2008. Stockholders will be allowed to exercise their right only when the board of directors becomes aware of a hostile purchaser who has a stake of 20% or more, and the board makes a public announcement accordingly. When exercised, the warrants will allow stockholders to receive one new share for each warrant for 1 yen. Y can retire all stock purchase warrants in order to maximize corporate value based on the board's decision. In doing so, the board of directors will pay due respect to the advice of a special committee consisting of professionals with no vested interests. The board will not permit the transfer of stock purchase warrants.

Accordingly, if the board resolves not to retire the warrants upon the appearance of a hostile purchaser, and the stock purchase warrants are exercised and two new shares are issued for every existing share, the number of total issued stock increases threefold to dilute the stake of a hostile purchaser.

X sought a provisional injunction in the Tokyo District Court on the grounds that this issuance of the warrants operates in a "significantly unfair manner" and, as such, violates

both the principle that an executive director may not act in contravention of the intention of principal stockholders (*kikan-kengen-no-bunpai-chitsujo*) as provided for by the then applicable Commercial Code, and the director's duties of care and of loyalty (Article 254 (3) and Article 254-3 of the Commercial Code).

The Tokyo District Court issued a provisional injunction prohibiting the issuance of stock purchase warrants. Y applied for a preservation objection (*hozen-igi*), though this was also rejected in the second instance. Y then filed an objection and appealed to the Tokyo High Court.

[Judgment]

On June 15, the Tokyo High Court dismissed the appeal from the second instance judgment. The Court declared that the issuance of the stock purchase warrants might inflict unexpected losses on stockholders, and as such, constituted an issuance operating in a "significantly unfair manner". Specifically, the decision to dismiss was made for the following reasons:

(1) The issuance of stock purchase warrants

"The Board of Directors has authority to issue stock purchase warrants by allotment to stockholders (Article 280-20 (2)-12 of the Commercial Code; Article 241 of the now applicable Company Law), and to impose restrictions on the transfer of the stock purchase warrants (Article 280-20 (2)-8 of the Commercial Code; Article 265 of the Company Law). As such, the use of stock purchase warrants can be thought of as a defensive measure against hostile takeovers."

(2) The purpose of this plan

"It can tentatively be acknowledged, as stated by Y, that this plan has a preventative function as a mechanism for suspending an acquisition, through a system of granting stock purchase warrants in order to secure an opportunity to negotiate with the purchaser, and by motivating the purchaser to enter into serious negotiations with the Board of Directors as to conditions for the acquisition. However, it cannot be denied that the main purpose of this plan is to entrench the existing Board of Directors and maintain the controlling positions of cooperative stockholders, rather than to defend the company from unwanted takeovers."

(3) The problem with this plan

"Due to the existence of a fiduciary relationship between them, the directors are understood to have undertaken a duty not to needlessly disadvantage stockholders in the exercise of its abovementioned authority. However, these stock purchase warrants were issued for free on a large scale with an exercise price of 1 yen. It is therefore possible that stockholders unrelated to the hostile takeover may be disadvantaged by this plan."

(4) The ensuing damage to stockholders unrelated to hostile takeovers

"For stockholders who acquired Y's stock after the date of the ex-right (March 28,

2005) of the stock purchase warrants, if the stock purchase warrants were not retired and were exercised to issue new stock before June 16, 2008, they would bear the risk of Y's stock ratio being diluted by about one third, irrespective of whether the purchaser was a hostile purchaser or not. Furthermore, we cannot take lightly the possibility that due to the execution of the warrants at some point in the future the stock price would plummet as a result of the almost one-third dilution of Y's stock. Moreover, it cannot be denied that such circumstances will exert downward pressure on the price of Y's stock in the marketplace over the next three years.

Accordingly, given the destabilizing factors outlined above, Y's stock would be an unattractive investment target, it would not be able to garner interest from buyers, and acquisitions of its stock would likely be reduced. As a result, it is feasible to assume that it is highly possible that the stock price would remain in free-fall over a long period of time. As for the existing stockholders, in addition to the possibility of a lower stock price and having to bear the risk of losing the opportunity to receive capital gains, it can be said that were it not for the issuance of these stock purchase warrants, these unexpected losses would not have occurred."

[Commentary]

As a result of the recent dispute between Internet service provider Livedoor Co. and Fuji Television Network Inc. for control of Nippon Broadcasting System Inc. (NBS), the expression, "poison pill", has become a household term in Japan. A poison pill is a defensive measure adopted by a company in order to make acquisition less attractive during a hostile takeover attempt. When a hostile takeover occurs, the measure includes issuing new stock to existing stockholders to dilute the accumulated stake of a hostile purchaser. If stockholders exercise stock purchase warrants, the total number of authorized stock increases, and the hostile takeover becomes increasingly difficult as additional funding becomes necessary. A growing number of Japanese companies have been introducing measures to defend themselves against possible hostile takeovers following the dispute between Livedoor and Fuji TV. The takeover defensive measure announced by Nireco is similar to the poison pill mechanism used in the US to dilute the voting rights ratio of a company attempting a takeover.

The present case is the first judicial decision made in Japan with respect to a poison pill takeover defense being introduced as a preventive measure. This case also serves as a precedent for instances involving defensive measures wherein the target company opposes a hostile takeover after a dispute over corporate control has arisen. For example, as demonstrated by the NBS case, the Board of Directors of a target company cannot adopt defensive measures given the principle that an executive director may not act in contravention of the intention of principal stockholders (*kikan-kengen-no-bunpai-chitsujo*). However, when there are special circumstances that justify the Board of Directors adopting defensive measures for the protection of the stockholders' interests as a whole, it may

approve them if they are rational and suitable.

Both the first- and second-instance judgments seem to be premised on the proposition that a defensive measure may be acceptable in urgent circumstances when a company finds itself in a dispute over control. On the other hand, in order to adopt a defensive measure in preparation for a dispute against a possible hostile purchaser, in principle, it is necessary to consider the intentions of a general meeting of stockholders. If the adoption of the defensive measure does not reflect the stockholders' intentions, then the company will have violated the principle that an executive director may not act in contravention of the intention of principal stockholders (*kikan-kengen-no-bunpai-chitsujo*) as provided for by the then applicable Commercial Code. Such a defensive measure risks becoming an arbitrary judgment by the Board of Directors, and as there is a possibility of inflicting unexpected damage on existing stockholders, the measure is declared to have operated in a "significantly unfair manner".

However, as expressed in **[Judgment] point (1)** summarized above, this case does not adopt the principle that an executive director may not act in contravention of the intention of principal shareholders (*kikan-kengen-no-bunpai-chitsujo*) relied upon in the judgments of the first- and second-instance. The decision as to whether the issuance of the new stock warrants operates in a "significantly unfair manner" is based on whether unexpected losses were inflicted on the existing stockholders (see **[Judgment] point (4)**). If so, then it shall be deemed to operate in a "significantly unfair manner". This is consistent with the "Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Stockholders' Common Interests" (published by the Ministry of Economy, Trade and Industry and the Ministry of Justice on May 27, 2005). This states that "while it is not consistent with the division of corporate authority envisioned by Japanese law for directors, who are elected at a general meeting of stockholders, to change the composition of stockholders by adopting a takeover defense measure, since it is difficult to convene a general meeting of stockholders in a timely manner, it is not appropriate to reject outright the adoption of defensive measures by the Board of Directors when such measures enhance stockholder interests". Although the Guidelines are not legally binding, they present legally valid and reasonable criteria for the adoption of defensive measures against hostile takeovers under the following three principles: (1) protecting and enhancing corporate value and the interests of stockholders as a whole, (2) prior public disclosure and stockholders' consent, and (3) ensuring the necessity and reasonableness of defensive measures.

With this in mind, politicians from the ruling Liberal Democratic Party decided to delay moves to permit cross-border stock-for-stock transactions (which are also referred to as "triangular mergers") for one year, which would have made it easier for foreign companies to purchase Japanese companies. On the other hand, in today's economy, hostile takeovers within the same industry (for example, Oji Paper Co. and Hokuetsu

Paper Mills, Ltd.) are becoming increasingly common, and there is increasing activity in M&A transactions (as part of corporate strategy). Various plans under the new Company Law seem to be possible defensive measures. It is important that takeover defensive measures should not be used as tools to maintain the interest of existing board members and block constructive M&A transactions. Although this is a very difficult problem in terms of company objectives, there needs to be greater debate about hostile takeovers and defensive measures.

(KOJI Murakami)