

# Doing Deals in Japan: An Introductory Guide for U.S. Practitioners

BY STEPHEN D. BOHRER AND AKIO HOSHI

*Stephen D. Bohrer is a Counsel at Nishimura & Asahi and a leader of the firm's Cross-Border Transaction Group. Akio Hoshi is an associate at Nishimura & Asahi who is currently reading for a Master of Finance at Cambridge University. The authors wish to thank Nobuya Matsunami for his helpful comments. Contact: s\_bohrer@jurists.co.jp or ahoshi@post.harvard.edu.*

What do Millennium Pharmaceuticals, Sepracor, Bare Escentuals, and Buy.com have in common? All are U.S. companies that were recently acquired by Japanese purchasers. While the global economic crisis has negatively impacted M&A deal activity across the board in most economies, according to data published by MARR, from January 1, 2008 through December 31, 2009 Japanese outbound transactions numbered 676 (with a total value of approximately \$113.3 billion), of which 219 related to the acquisition of a U.S. company.<sup>1</sup> During this same period, approximately one-third of Japanese outbound targets were U.S. companies and the U.S. market represented the largest segment in terms of number of deals. With the continued appreciation of the Japanese yen, the historical friendly ties between the U.S. and Japanese governments, and corporate Japan's relatively strong balance sheets, large cash reserves, and eagerness to expand overseas in order to compensate for shrinking domestic demand, Japanese companies have become major buyers of U.S. assets and could be making an investment in your neighborhood soon!

Why should a U.S. practitioner place importance on Japanese M&A techniques and the basic issues to consider when conducting business in Japan? Outstanding client service and a desire to gain a competitive edge support such learning. A U.S. dealmaker's ability to understand the fundamental differences and nuances of deal making in Japan will prove useful not only when supporting a U.S. client's acquisition strategies in Japan, but such insights also should provide counsel with the ability to anticipate (and manage) the deal "blind spots" of Japanese clients as they enter the U.S. M&A market, and enable counsel to effectively respond to client questions by comparing U.S. and Japanese acquisition practices. With Japan's insatiable appetite for overseas growth and historical preference for the U.S. market, the development of this skill set should be invaluable.

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There are many stark differences in the methods to acquire a Japanese company and the ways to transact business in Japan when compared to U.S. laws and practices. This article does not purport to explain all of the variances between U.S. and Japanese M&A techniques and practices, but aims to highlight the principal differences in (1) corporate governance, (2) M&A acquisition methods, and (3) the application and enforcement of contractual rights.

## Corporate Governance

Understanding the corporate governance structure of a Japanese company has multiple benefits. At a minimum, it enables purchasers of Japanese assets to better understand with whom they should negotiate, the powers and limitations of the Japanese negotiating team, and the overall corporate decision making process. In addition, Japanese companies entering the U.S. market may use their corporate governance systems as the framework for analyzing the U.S. deal team and the level at which negotiations should take place, and U.S. counsel's prior understanding of these systems may prevent unnecessary confusion and time delays in completing the deal.

There are fundamental differences between the U.S. and Japanese corporate governance models. For example, the Revised Model Business Corporation Act and Delaware corporate law state that the business and affairs of every corporation shall be managed under the direction of its board of directors.<sup>2</sup> The Companies Act of Japan ("Japan Companies Act"), however, does not necessarily require a board-of-directors-centered supervisory structure. The Japan Companies Act allocates a portion of the supervisory function to the company's shareholders and statutory auditor (*kansayaku*).<sup>3</sup> Consequently, a board's traditional supervisory function and role as a check on executive abuse of power normally found in the U.S. corporate governance model is typically absent in Japan. This difference in supervisory approach is a contributing factor on how the rights and responsibilities of directors and shareholders are apportioned under the Japan Companies Act.

## Shareholder Rights

While shareholders in a Delaware company may cast their vote upon the election of directors, an amendment to the company's certificate of incorporation, the dissolution of the company, or a fundamental corporate change (such as a merger or a sale of all or substantially of the company's assets), the Japan Companies Act provides shareholders (depending on their percentage ownership level) with a panoply of rights above those afforded to shareholders in a Delaware company, including the right to determine dividend payments, approve the sale of shares at a discounted price, select the company's accounting firm, petition a court to dissolve the company, and establish the upper limit of the aggregate amount of compensation to be awarded to all directors.<sup>4</sup> Furthermore, the articles of incorporation of a Japanese company can be amended by only a shareholders' resolution (*i.e.*, the shareholders may propose an amendment to a company's articles without obtaining the board's approval).<sup>5</sup> Shareholders of Japanese companies, therefore, typically have vaster and deeper voting rights than shareholders in Delaware corporations, which can cause confusion to Japanese investors when first entering the U.S. M&A market.

## Board of Directors

The lack of independence, the limitations on who is capable of lawfully binding a company and the absence of board committees are the principle corporate governance differences when comparing U.S. and Japanese boards of directors.

*Lack of independence.* While a majority of the directors in U.S. public companies are usually independent directors and many U.S. private companies have independent board members, most board members of Japanese public and private companies concurrently serve as senior executives of the company. According to the "Corporate Governance Study Group Report" published in June 2009 by a study group established under the auspices of Japan's Ministry of Economy, Trade and Industry, "outside directors" constituted approximately 9% of all directors sitting on the boards of companies trading on the Tokyo Stock Exchange.<sup>6</sup> With these overlapping roles and responsibilities, many Japanese boards of directors

may fail to objectively check and monitor the activities of the company's senior management, as they themselves are the persons whom they are supposed to monitor.<sup>7</sup>

*Limited binding authority.* The board of directors of a Japanese company must appoint one or more Representative Directors (*daihyō torishimari-yaku*) from among its directors to have the authority to represent the company (*i.e.*, execute contracts on behalf of the company). The name of each Representative Director is listed in the company's publicly available commercial registry in order to provide notice of such binding authority to third parties. U.S. practitioners may incorrectly assume that persons holding a title that appears equivalent to a senior executive position would have the authority to legally obligate a Japanese company.

This binding authority, however, is ordinarily non-existent. Many Japanese companies often refer to their highest level of employees as "executive officers" (*shikkō yakuin*), and unless a special delegation has been made to such persons, then they ordinarily will not have the authority to enter into contracts on behalf of the company.<sup>8</sup> When transacting with a Japanese company, therefore, the deal team should be sensitive to the divergence of title versus actual power, and U.S. practitioners should anticipate that Japanese clients may be skeptical if a vice president or line manager claims to have the authority to execute contracts on behalf of the company (and may seek a legal opinion to confirm such authority as opposed to relying on a secretary's certificate).

*Absence of board committees.* Unlike Delaware corporate law, the Japan Companies Act does not permit a Japanese board to fully delegate its power and authority to a committee (even if the committee consists entirely of directors). When facing matters that require board approval, a Japanese company is actually required to hold a full board meeting or, if its articles of incorporation permit, pass a board resolution by way of unanimous written consent of its directors. The establishment of a special committee to negotiate with a purchaser in the M&A context is also currently uncommon in Japan. However, Japanese companies since the mid-2000s have with greater frequency established special committees to review the terms and conditions of a management

buyout or to decide whether to implement anti-takeover defensive measures (primarily due to the recommendations made in reports published by study groups established by Japan's Ministry of Economy, Trade and Industry). Since these special committees do not have binding authority and typically cannot engage their own advisors, they are frequently viewed as simply an advisory committee to the board of directors.

## M&A Acquisition Methods

While Japanese acquisition techniques vary depending on whether the target is publicly-traded or privately-held, certain background principles cut across both public and private M&A transactions.

### Background Principles

*Formation of acquisition vehicle.* A company not organized under Japanese law cannot merge or enter into a statutory corporate combination with a Japanese company. Establishing a new Japanese company could have negative tax implications for a purchaser if assets must be transferred to the new Japanese subsidiary, and also may delay the deal's timetable and significantly raise transaction costs. In particular, unlike the ability to incorporate a Delaware company overnight, completing the registration of a newly-established Japanese company will normally take approximately one week after the necessary paperwork is submitted to the local registry. Using shelf companies is not common in Japan due to the inability to confirm that there are no prior "hidden" or contingent liabilities. Furthermore, although the stated capital of a Japanese company technically can be one Japanese yen, many operating companies have a stated capital of approximately one million Japanese yen (approximately \$110,000) or more due to the local bias to conduct business with financially strong and prestigious companies, and the stated capital is frequently viewed as an indicator of financial health. Japanese executives, therefore, may question in disbelief a U.S. transaction timetable that calls for the overnight formation of an acquisition vehicle (let alone with a very low stated capital).

*Choice of acquisition methods and tax considerations.* Similar to a U.S. target, a Japanese target can be acquired through an asset purchase,

stock acquisition or merger. While an asset acquisition may be the initial option if the purchaser wishes to acquire only a portion of the target's business or to potentially avoid the assumption of certain liabilities of the target, the choice of either a stock acquisition or a merger is the common acquisition method in Japan due to the seller being required to recognize the unrealized gain on

the transferred assets and the purchaser not being able to inherit net operating losses and losses carried forward from the seller.

For mergers and other corporate combinations involving Japanese companies, the target will be required to recognize a capital gain on its assets and goodwill, unless the several requirements outlined in the table below are met. The requirement

Requirements	Qualified Merger, Demerger, Share Exchange, Share Transfer or Contribution-in-Kind		
	100% Relationship <sup>a</sup>	<100% but >50% Relationship <sup>b</sup>	≤50% Relationship
Consideration	only purchaser shares or shares of purchaser's direct parent who owns (and is expected to continue to own) all of purchaser's shares		
Employment	None	approximately 80% of target's employees must be expected to continue to be employed ( <i>requirement applicable to the transferred business in a qualified demerger or contribution-in-kind</i> )	
Business Continuity	None	principal business of target must be expected to continue ( <i>requirement applicable to the transferred business in a qualified demerger or contribution-in-kind</i> )	
Other	None	principal assets and liabilities of the transferred business must be transferred to purchaser in a qualified demerger or contribution-in-kind	<ul style="list-style-type: none"> <li>• mutual connection between the principal business of target and any business of purchaser (<i>requirement applicable to the transferred business in a qualified demerger or contribution-in-kind</i>)</li> <li>• target shareholders who are expected after the transaction to hold shares of purchaser (or the shares of its parent if used as the consideration) must, before the transaction, hold at least 80% of target's shares unless target has 50 or more shareholders</li> <li>• principal assets and liabilities of the transferred business must be transferred to purchaser in a qualified demerger or contribution-in-kind</li> <li>• either of the following:                             <ul style="list-style-type: none"> <li>(i) sales amount, number of employees or other similar characteristics of target's principal business or a related business of purchaser is no more than approximately five times greater than the size of that of the other; or</li> <li>(ii) at least one senior manager of target and purchaser before the transaction will be appointed a senior manager of purchaser after the transaction (<i>and in the case of a qualified share exchange or share transfer, none of target's senior management resign upon the closing or shortly thereafter</i>)</li> </ul> </li> </ul>

a: Target or purchaser must own directly or indirectly all of the shares issued by the other party, or all of the shares of both the target and purchaser must be directly or indirectly owned by the same individual or company. Such capital relationship must be expected to continue.

b: Target or purchaser owns directly or indirectly less than 100% but more than 50% of the shares of the other party; or less than 100% but more than 50% of the shares of both the target and purchaser are directly or indirectly owned by the same individual or company. Such capital relationship must be expected to continue.

that the purchaser use its shares as the sole consideration in order to obtain Japanese capital gains tax deferral is likely the main reason why mixed consideration (cash plus stock) is rarely used in Japan in the corporate combination context.

In Japanese stock purchase transactions, the target shareholders frequently will be subject to Japan national and local income tax if the purchase price for their shares is greater than the book value. The target, on the other hand, is not required to recognize a capital gain on its assets or goodwill. In this respect, a stock purchase transaction offers tax advantages over a cash merger, and it is frequently used as the acquisition method for a cash deal.<sup>9</sup>

Capital gains or losses can be deferred at both the target and shareholder level in a qualifying merger or other qualifying form of corporate combination if the requirements below are satisfied:<sup>10</sup>

## Public M&A Transactions

Tender offer regulations and permissible defensive measures are the two principle areas of difference when comparing U.S. and Japanese public M&A techniques.

*Tender offer regulations.* U.S. and Japanese tender offer regulations are closely aligned.<sup>11</sup> Nonetheless, principal differences exist. For example, generally speaking, Japanese tender offer rules are automatically triggered when a purchaser increases its beneficial ownership<sup>12</sup> in a Japanese reporting company above one-third through one or more “off-market transactions” or above 5% through transactions conducted “outside the market” with more than 10 persons during a rolling 60-day period.<sup>13</sup>

In addition, if a purchaser acquires more than 5% of the voting rights in a Japanese reporting company in one or a series of “off-market transactions” during a rolling three-month period, then generally speaking the purchaser may not acquire additional shares in any manner whatsoever that would raise by more than 10% its aggregate voting ownership level in the target over a three-month period (which ownership increase includes the transaction that brought the purchaser over the foregoing 5% ownership threshold) if

as a result thereof its ownership level in the target would exceed one-third.<sup>14</sup>

Structuring the terms of a Japanese tender offer also can be more restrictive in comparison to options available under U.S. tender offer rules. For example, a purchaser can condition its tender offer only upon events specified by statute, such as the receipt of governmental approvals (but not the ability to obtain financing or the absence of a material adverse change), and a purchaser cannot withdraw its offer unless one of several events specified by Japanese securities laws occur.<sup>15</sup> Furthermore, after the commencement of a tender offer (which occurs after the publication of the tender offer commencement notice), a purchaser may not decrease the tender offer price, decrease the number of shares to be purchased, shorten the tender offer period, decrease the minimum number of shares to be purchased, change the consideration of the tender offer, or change the withdrawal conditions listed in the tender offer documents. Also, if a purchaser intends to become an owner of no less than two-thirds of the voting rights in a Japanese reporting company, then it cannot launch a partial tender offer.

Other differences include:

- pre-commencement tender offer communications by the parties are not required to be filed with Japanese regulators;
- the purchaser is required to provide the local regulator with evidence that it has ample funds to complete the offer at the proposed tender offer price (such as a bank statement that denotes it has sufficient funds);
- the equivalent of the “best price rule” under Japanese tender offer rules requires the consideration offered to tendering shareholders be the same in form and amount, but such criteria does not require an examination of the arrangements entered into between the purchaser and the target’s shareholders outside the tender offer (dispensing with the specific U.S. substantive standards applicable to employment compensation, severance, and other employee benefit arrangements with security holders of the target, and reducing the uncertainty that may exist with respect to commercial arrangements entered into be-

tween the purchaser and certain target shareholders at the time of the tender offer); and

- the initial and any subsequent tender offer period cannot in the aggregate extend beyond 60 business days from the commencement date.

*Defensive measures.* While unsolicited transactions are becoming more prevalent in Japan, the number of hostile acquisitions of Japanese companies pales in comparison to the United States.<sup>16</sup> Nonetheless, the July 2010 issue of *MARR* reports that as of May 31, 2010, 551 publicly-traded Japanese companies have adopted anti-takeover mechanisms, principally in the form of publishing notices that detail (1) the procedures that a purchaser should follow in order for the board (or shareholders) to consider an acquisition proposal, and (2) the potential defensive measures the company may take. This practice is called “advance warning” (*jizen keikoku*).<sup>17</sup> The use of U.S.-style “poison pills” in Japan remains rare.<sup>18</sup>

A series of case law decided in 2005 promoted the use of “advance warning” by Japanese publicly-traded companies. In the *Nippon Broadcasting* case, the Tokyo High Court articulated that, in the context of disputes over corporate control, unless the target succeeds in proving that the acquiror is an “abusive acquiror,” then the court should award injunctive relief to stop the target from effecting anti-takeover mechanisms.<sup>19</sup> The Tokyo District Court, which had suggested in the *Nireco* case that the court will make a rebuttable presumption that a purchaser who violates the procedural provisions stipulated in the target’s “advance warning” notice is an “abusive acquiror,” held the following month in the *Japan Engineering Consultants* case that the target’s board may require a hostile purchaser to present a business plan and allow the board sufficient time to examine its proposal in order for the target’s shareholders to have sufficient time to decide whether the hostile purchaser or the current directors should manage the target.<sup>20</sup> If the purchaser declines to comply with these reasonable requests, then the court held that the board, to the extent permitted by law, may take reasonable anti-takeover measures against the purchaser.

Staggered boards rarely appear as a Japanese anti-takeover tactic because this mechanism nor-

mally is not helpful. While Delaware corporate law allows shareholders to remove directors sitting on a staggered board only for cause, Japanese corporate law allows the majority shareholders (or two-thirds majority, if the target’s articles of incorporation so provides) to remove any director with or without cause at any time. Accordingly, a purchaser who acquires more than a majority of the outstanding voting interests in a Japanese target can gain control over the target’s board. A raiding purchaser, however, may not be able to swiftly remove incumbent directors because the Japan Companies Act requires a company to actually hold a shareholders’ meeting to adopt shareholder resolutions, unless all shareholders unanimously agree in writing to the matters being resolved (which unanimity requirement cannot be altered by the target’s articles of incorporation).

## Private M&A Transactions

The practices adopted by Japanese parties to undertake a local private business combination differ significantly from U.S. norms. It wouldn’t be unprecedented in Japan for a large domestic transaction to be documented in a 30-page or less acquisition agreement. Although listing all of the differences between a U.S.-style versus a Japanese style private acquisition agreement would extend beyond the scope of this article, the following are some of the notable differences:<sup>21</sup>

- Similar to U.S. practices, representations and warranties covering the basic business operations of the target are common in domestic private transactions, as well as specially-tailored representations and warranties addressing matters uncovered during the due diligence process. However, detailed representations and warranties are normally not seen for matters concerning employee benefits, environmental liabilities, specific items from the financial statements (*e.g.*, accounts payable, inventory, backlog, etc.), accounting practices, tax, or real property. However, the inclusion of a “full-disclosure” representation and warranty remains a current market practice.

- Escrow agreements to hold-back a portion of the purchase price to settle indemnification claims and other post-closing obligations of the sellers are rarely seen in Japan due to the lack of financially stable escrow agents that can offer the traditional services of an escrow agent at a reasonable price. The use of an offshore escrow agent, while technically possible, is frequently viewed with great concern by Japanese sellers. Purchase price holdbacks and earn-outs are possible alternatives in the private acquisition context, but neither is currently widely used in Japan.
- While indemnification provisions with baskets and caps are common features of Japanese private acquisition agreements, it is uncommon for agreements to contain (1) indemnification eligibility thresholds, (2) carve-outs from the baskets and caps for certain representations and warranties and breaches of covenants, (3) double materiality scraps, (4) pro- or anti-“sandbagging” clauses, (5) a tax gross-up for indemnification payments (or claim off-sets for tax benefits resulting from the indemnification claim or insurance proceeds received), or (6) detailed procedures on how claims made by third-parties should be handled and controlled.
- Private acquisition agreements normally do not contain a separate section detailing how taxes of the target incurred prior to the closing should be handled.
- The inclusion of a definition for “material adverse effect” is uncommon and, when provided, the use of numerous exceptions is even less common.

Japanese legal principles and cultural patterns may play a role in the differences between U.S. and Japanese contract drafting conventions. In particular, Japanese law does not contain the equivalent of the parole evidence rule. As a result, the parties to a dispute normally can submit all applicable evidence to a court, even if a contract contains an integration clause that states the contract represents the entire understanding of the parties and supersedes all prior communications regarding the subject matter of the agreement.<sup>22</sup>

Parties to an agreement in Japan, therefore, may naturally tend to feel that it is not important to memorialize all of the deal terms in a definitive set of transaction documents since external communications typically can be submitted to explain and supplement the provisions of a contract.

Japanese parties also may prefer to defer upfront detailed discussions over controversial and sensitive deal points because the parties frequently place great importance on preserving initial goodwill, and each side normally expects that post-closing differences will be reasonably resolved (regardless of what rights and privileges appear in the deal documentation). To support such sentiments, Japanese commercial agreements frequently contain a covenant that the parties shall decide through mutual consultation and good faith negotiations any matter that is not expressly provided in the agreement. Consequently, Japanese parties may not feel that it is necessary for deal documentation to contain lengthy provisions delineating the various intricacies of the commercial arrangement and numerous deal-breaking scenarios because such sensitive matters can be subsequently worked out upon an analysis of the actual facts and the totality of the circumstances.

### Squeezing Out Minority Shareholders

Similar to prevailing U.S. practices, a controlling shareholder of a Japanese company technically can utilize a cash-out merger to squeeze out the minority shareholders of the target. As discussed above, however, a cash-out merger would cause the target to incur a capital gains tax on its assets and goodwill. In order to avoid unnecessary tax leakage at the target level, squeezing out minority shareholders in Japan entails a relatively time consuming and unusual process. Currently, the most common method used to squeeze out minority shareholders is the use of a “shares subject to call” process (*zenbu-shutoku-jókótsuki-syurui-kabushiki*), which warrants special attention due to its somewhat bizarre steps.

A “shares subject to call” squeeze-out is ordinarily effected as follows: (1) the common shares of the target are re-characterized as shares that can be called/redeemed by the target (*ergo* the name “shares subject to call”), which re-characterization requires the approval of at least two-

thirds of the target's shareholders duly present at a shareholders meeting (which vote can include the target shares owned by the purchaser) in order to amend the target's articles of incorporation to provide for the re-characterization, (2) the target obtains shareholder approval to redeem the "shares subject to call" and instead of paying cash, the target uses another class of its shares as consideration for the redemption, (3) the exchange ratio for the number of the target's other class of shares that can be received in exchange for the target's "shares subject to call" is set so the minority shareholders are entitled to receive only a fractional share (*i.e.*, less than a whole share), and (4) upon receiving court permission, the target sells the total fractional shares to the purchaser and distributes the cash proceeds to the minority shareholders on a *pro rata* basis (if a tender offer precedes the squeeze-out, the tender offer price ordinarily would be the sales prices), thereby eliminating the share ownership of the minority shareholders in the target.

Apart from the above procedural aspects of a squeeze-out, the biggest difference between squeeze-out practices in Delaware and Japan is the remedies that Japanese courts award to dissenting shareholders. Unlike the Delaware courts, which may apply an "entire fairness" review depending on the structure of the squeeze-out transaction and enjoin the transaction if it does not satisfy this exacting standard of review, Japanese courts are able to award injunctive relief only if such remedy is provided under the relevant Japanese statute. Although the Japan Companies Act allows the court to reverse a "shares subject to call" squeeze-out process by invalidating the relevant shareholder resolutions, Japanese courts are traditionally reluctant to invalidate shareholder resolutions after-the-fact in the absence of extremely egregious facts, so such reversal is normally a theoretical risk. As a result, exercising appraisal rights is typically the sole remedy available to dissenting shareholders in a "shares subject to call" squeeze-out process.

The limitation of available remedies in a "shares subject to call" squeeze-out is not necessarily good news for the majority shareholder of a Japanese company. In recent appraisal proceedings invoked in connection with management buyouts, both the Tokyo High Court and

the Osaka High Court awarded the dissenting shareholder an amount higher than the tender offer price that preceded the "shares subject to call" squeeze-out process.<sup>23</sup> This possible trend of Japanese courts to award dissenting shareholders with an appraisal price higher than the tender offer price may give minority shareholders a distorted incentive to object to a proposed transaction in order to secure their appraisal rights.

## Application and Enforcement of Contractual Rights

The inability to terminate certain contracts and the proclivity to resolve disputes outside of court are distinguishing factors for how contractual rights are honored and enforced in Japan.

### Terminating Contracts

The principle of "freedom of contract" generally governs the interpretation of termination clauses under Japanese law, so the parties to an agreement generally have the right to end their contractual relationship in accordance with the terms of the arrangement. However, in the employment context or if a commercial agreement is characterized as a "continuous contract," then the ability to unilaterally terminate such arrangement in Japan is restricted.

The foregoing could have a critical impact on the valuation of a target if the purchaser mistakenly assumes that after the acquisition it can readily reduce the target's workforce and terminate all unfavorable "continuous contracts" simply by complying with an agreement's termination provisions.

*Employment arrangements.* Unlike many jurisdictions in the United States, an employer in Japan cannot terminate an employee without good cause. Even if an employment contract stipulates that an employer may terminate the employment relationship for any reason or no reason, such provision normally will be held unenforceable as an unlawful attempt to bypass Japanese labor laws. The threshold for "good cause" in Japan is extremely high in comparison to most U.S. standards. Article 16 of Japan's Employment Contract Act stipulates that the termination of an employee in Japan is invalid unless there is "objective good reason" for the termination and it is "accept-

able in light of socially accepted standards.” The foregoing standard is not defined or explained by Japanese statutes, which has left Japanese courts with the task of interpreting when this standard can be satisfied.

Japanese courts, taking into consideration the lifetime employment system established in the Japanese business community, require employers to meet extremely high burdens of proof to support the existence of “objective good reason,” even if the employment agreement or the company’s work rules permit a lower threshold. To demonstrate an “objective good reason,” an employer normally would need to show that (1) the employee committed a severe breach of the company’s work rules or other rules relating to employment, (2) the employee lacks competence or the necessary business skills, or (3) the survival of the subject company’s business requires that headcount be reduced.<sup>24</sup> Even if the employer succeeds in showing an “objective good reason,” the court will not permit the termination unless it is persuaded that the termination is “acceptable in light of socially accepted standards.”<sup>25</sup> In each instance, direct and substantial evidence must be submitted to convince a judge to accept the dismissal, and it is often especially difficult to convince a Japanese court that poor performance alone should warrant employment termination. Accordingly, a company in Japan will normally negotiate a severance package with the affected employees, which calls for the employer to pay several months’ wages (or more) as a separation payment in exchange for the employee’s voluntary resignation. A company’s Representative Director and most likely its directors who hold executive authority will not benefit from the pro-employment provisions of Japanese labor laws.

*Distribution, franchise and supply agreements.* A “continuous contract” is generally understood in Japan as a contract under which a party is required to perform a duty continuously by virtue of the nature of the duty (*i.e.*, the duration of the agreement does not directly dictate whether an agreement is considered continuous, but the underlying type of obligation and whether such obligation by its nature should be performed continuously are the determining factors). Many Japanese lower court precedents treat distribution agreements, franchise agreements and sup-

ply contracts as a “continuous contract” due to the ongoing and long-term requirements of one party to supply and the other party to purchase the subject matter of the particular contract. If a commercial agreement is characterized as a “continuous contract,” a Japanese court is likely to require a “justifiable and unavoidable reason” in order to allow the unilateral termination of such agreement.<sup>26</sup> Japanese courts place a high burden on a party seeking to terminate a “continuous contract” (even if the agreement permits unilateral termination) because the non-terminating party typically will make business decisions relying on the expected long duration of the agreement (and Japanese courts believe that such reasonable expectations should be protected). Accordingly, a one-sided cancellation right is normally voided. If a “continuous contract” is terminated without a justifiable and unavoidable reason, then the terminating party may be required to pay damages to the non-terminating party (the type and calculation of which is determined by a Japanese court on a case by case basis, but is rarely *de minimis*), or the termination can be enjoined.

## Enforcing Contractual Rights

In comparison to the United States, civil litigation is not frequently used as a method to settle disputes in Japan. A U.S. purchaser entering the Japanese market that hastily uses or threatens the use of litigation to settle disputes may find its reputation tarnished and blacklisted from the local deal community.

There are a number of cultural, structural and procedural reasons that support the lack of civil litigation in the commercial context in Japan, including:

- Japanese hold a cultural preference for informal mechanisms to resolve disputes as opposed to formal litigation, as witnessed above with respect to the proclivity to include covenants in commercial agreements that the parties should consult and undergo good faith negotiations to resolve matters not contained in the agreement.
- Japan has relatively few lawyers per capita in comparison to the United States. For every 279 Americans there is one lawyer, while

in Japan there is one lawyer for every 4,423 Japanese.<sup>27</sup> The dearth of lawyers in Japan inherently limits the amount of litigation that can be brought and may even discourage parties to initiate litigation due to the perceived lack of adequate resources.

- Commercial parties may view Japanese judges with skepticism (jury trials do not exist in civil trials in Japan) because (1) most judges turn to this profession immediately after graduating from Japan's Legal Training and Research Institute, so commercial parties may be reluctant to have matters decided by a judge who has little (or no) business experience, and (2) some judges apply their own concept of fairness when deciding matters without particular reliance on the facts at hand or court precedents (other than decisions by the Supreme Court of Japan) and since it is difficult for plaintiffs to "forum shop" under the Japanese judicial system, commercial parties may prefer to settle matters pursuant to their own framework of justice.
- There is little "discovery" prior to the commencement of a trial (so pre-trial maneuvering through costly depositions or document demands should not exist). In addition, damages are normally prescribed by statute and Japanese courts are not allowed to grant punitive damages (so adversaries may be more inclined to settle their disputes before trial since damage awards can be more accurately estimated, thereby allowing the parties to better gauge their exposure when crafting settlements terms).

The lack of civil litigation in Japan is not due to arbitration or mediation serving as the preferred dispute resolution method. In comparison to civil litigation, commercial arbitration and mediation are actually even less frequently used in Japan as a way to settle either domestic or international disputes. During the fiscal year ended March 31, 2010, the Japan Commercial Arbitration Association (the Japanese counterpart of the American Arbitration Association) handled only 38 arbitration cases (19 new cases and 19 cases carried

forward), and two mediation cases (one new case and one case carried forward).

## Conclusion

The pace of overseas acquisitions by Japanese companies has accelerated during 2010 and there are concrete signs that Japan's outbound appetite will not abate for the foreseeable future. According to data published by Thomson Reuters, through August 2010 Japanese companies had spent approximately \$49 billion buying overseas rivals (already more than the approximate \$43 billion spent on overseas acquisitions during 2009), and Japanese government data indicated that as of March 31, 2010, non-financial Japanese firms were holding \$1.67 trillion in cash and deposits (up 8.5% from the prior year).

If the current expansion plans for Japanese companies continues, then developing a Japanese client base should pay long-term dividends to a counsel's M&A practice.

### NOTES

1. All U.S. dollar references in this article have been converted from Japanese yen at an exchange rate of USD1 equals JPY90.
2. See Section 8.01(b) of the Revised Model Business Corporation Act and Section 141(a) of the Delaware General Corporation Law.
3. There are approximately 40 permissible corporate governance structures available under the Japan Companies Act. In practice, however, an overwhelming majority of Japanese companies have adopted a single corporate governance form of a *kabushiki kaisha* (the practical equivalent of a corporation in the United States) that has a board of directors and a statutory auditor. Generally speaking, a statutory auditor is tasked with the responsibility of (i) monitoring the performance of directors to confirm that they are in compliance with applicable laws, regulations and the company's articles of incorporation, and properly executing their duties owed to the company, and (ii) overseeing and reviewing the audit of the company's financial statements by its external accounting firm (a privately-held company, if it does not appoint an external accounting firm, can limit the responsibility of its statutory auditor to an audit of the company's financial statements). In comparison to the U.S. corporate governance

model, the function of a statutory auditor is similar to that of an independent director who also serves on the company's audit committee. For ease of comprehension, in this article we focus on the predominant Japanese corporate governance structure of a *kabushiki kaisha* with a board of directors and a statutory auditor.

4. We note, however, that the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the resulting legislation may substantially provide shareholders of U.S. public companies with greater power over executive compensation matters in comparison to those afforded to shareholders of Japanese publicly-traded companies.
5. Unlike U.S. corporations, Japanese companies only have articles of incorporation, which is often a relatively short document in length. The provisions that would typically appear in a U.S. company's bylaws can be found in a Japanese company's board regulations or statutorily prescribed under the Japan Companies Act.
6. An "outside director" is any person, other than a present or former executive or employee of the subject company and its subsidiaries. As a result, the qualifications for an outside director in Japan are substantially less stringent than the requirements for an "independent director" under the New York Stock Exchange and Nasdaq rules (as there is no inquiry into financial dependence outside the employment context, and even an executive of the subject company's parent can qualify as an "outside director" in Japan).
7. In response to this gaping corporate governance hole, the Tokyo Stock Exchange amended its listing rules to require all listed companies to have at least one "independent" director or one "independent" statutory auditor (defined as not likely to have a conflict of interest with the company's shareholders). The new rules are effective from the day following the annual shareholders meeting relating to the fiscal year ending March 1, 2010 or later. At present, it is difficult to predict whether this amendment will lead to Japanese boards demonstrating greater independence.
8. We note that in the case of a *kabushiki kaisha* that has a board of directors and statutory committees (*iinkai secchi kaisha*), the authority of executive officers is essentially equivalent to that of executive officers in U.S. corporations, and they directly owe fiduciary duties to the company. They are called *shikkó-yaku* (not *shikkó yakuin*) in Japanese and are distinguished from employees. Even in an *iinkai secchi kaisha*, however, corporate binding authority is normally reserved to the Representative Officer(s). Only approximately one hundred companies, including unlisted companies, currently use this corporate governance structure in Japan.
9. We are aware of only a few transactions where non-Japanese purchasers chose a tender offer as an acquisition method in a stock deal, but those transactions were made prior to the introduction of a triangular merger to Japanese corporate law (which became effective in 2007). A non-Japanese purchaser, nevertheless, may consider a stock tender offer as an acquisition method if the home jurisdiction of the purchaser prohibits the purchaser from performing a triangular merger under Japanese law or the purchaser wishes to make a hostile takeover bid with stock as the consideration.
10. A demerger (*kaisha bunkatsu*), share exchange (*kabushiki kókan*), and share transfer (*kabushiki-iten*) are forms of business combinations prescribed under the Japan Companies Act. Under a (i) demerger, the assets and liabilities of a contributor's business are assumed by either a newly established company (in exchange for its shares) or an existing company (in exchange for its shares, cash and/or other property) by operation of law, (ii) share exchange, the target is converted into a wholly-owned subsidiary of the acquiring company by operation of law and remains a separate legal entity (in this respect, it is identical to a reverse triangular merger under Delaware corporate law), and (iii) share transfer, all outstanding shares of the subject company (or companies) are transferred to a newly incorporated company, and such newco issues shares on a proportional basis to the shareholders of the subject company (or companies). Tax and the ultimate ownership structure frequently drive the selection of the form of business combination.
11. Japanese tender offer rules are applicable to a company that is subject to the periodic reporting requirement under the Financial Instruments and Exchange Act of Japan (which is substantially identical to the periodic reporting requirement under the U.S. Securities Exchange Act of 1934 ("U.S. Exchange Act")). As an initial step, a prudent purchaser should examine whether Japanese mandatory tender offer rules will apply before acquiring shares in a Japanese reporting company.
12. Ownership level is calculated on a diluted voting power basis and includes the voting interests held by "specially-related persons" (*tokubetsu*

*kankeisha*) of the purchaser (similar to the “group” concept under Section 13(d) of the U.S. Exchange Act).

13. A transaction conducted “outside the market” means a purchase and sale that does not clear through a stock exchange (*i.e.*, a transaction privately negotiated directly between the purchaser and the seller of the shares). An “off-market transaction” means a purchase and sale that (i) is conducted “outside the market,” or (ii) clears through a non-auction trading system run by a stock exchange, such as the Tokyo Stock Exchange Trading Network System (commonly referred to as “ToSTNeT”).
14. The intention behind this extremely complicated rule is to require a purchaser who has acquired more than 5% of the outstanding voting rights of a Japanese reporting company in “off-market transactions” to wait three months before commencing further target share acquisitions. The Japanese government enacted this “speed bump” requirement in 2006 in response to public outcries against the rapid accumulation by M&A Consulting (also known as the Murakami Fund) of shares in Hanshin Electric Railway in “off-market transactions.” Except for the ten-day cooling off period under Section 13d-1(f)(1) of the U.S. Exchange Act, U.S. tender offer rules do not have a similar stop-and-wait rule.
15. Pursuant to Article 14, Paragraph 1 of the Enforcement Order of the Financial Instruments and Exchange Act, a purchaser can withdraw its offer if the target or its subsidiary determines to undertake certain actions or experiences certain events, including: (i) a statutory corporate combination, (ii) a corporate dissolution, (iii) the filing of a petition for bankruptcy, (iv) a decrease in its stated capital, (v) the sale or discontinuance of all or part of its business, (vi) the delisting of its shares, (vii) a stock split, (viii) the allotment of shares or share purchase warrants without consideration, (ix) a sale or other disposal of material assets, (x) the incurrence of a significant amount of indebtedness; (xi) the issuance of an injunctive order to stop its principal business; (xii) the revocation of a principal business license; (xiii) the discontinuity of business with a major customer or supplier; or (xiv) the loss of a material asset due to a *force majeure* event. Most of the foregoing events and actions are subject to numerical thresholds. Noticeably absent is a general “catch-all” provision (*e.g.*, the occurrence of any other event or circumstance that would cause a reasonable purchaser to withdraw its offer), so a purchaser launching a tender offer in Japan is generally required to assume the consequences of unforeseeable events during the tender offer period.
16. According to data published by Thomson Reuters, during the period from January 1, 2005, through December 31, 2010, there were only nine hostile offers in Japan, none of which the hostile offeror succeeded in gaining majority ownership in the voting rights of the target.
17. According to the data provided in the July 2010 issue of *MARR*, 547 Japanese companies have adopted “advance warning” procedures as of May 31, 2010.
18. The *Bull-dog Sauce* case (Steel Partners Japan Strategic Fund (Offshore) LP *v.* *Bull-dog Sauce*, 61 MINSHŪ 2215 (Sup. Ct., August 7, 2007)) is widely known in Japan as the only case where a poison pill, which was adopted by the target after the purchaser had commenced its hostile takeover bid, was intentionally triggered. One may think that, in light of the *Bull-dog Sauce* case, Japanese corporate law allows the target to adopt a poison pill after the emergence of a hostile purchaser. Bull-dog’s pill, however, was far from the typical “poison pill” when compared to those adopted in the United States. Under the Bull-dog pill (which was approved by approximately 83.4% of the outstanding voting rights in Bull-dog), all shareholders (including Steel Partners) would receive three share purchase warrants per share. However, Steel Partners was required to exchange its warrants for cash, while other shareholders were required to exchange their warrants for Bull-dog’s newly-issued shares. As a result, Steel Partners’ share ownership level in Bull-dog reportedly decreased from 10.52% to 2.86%, but it received a cash payment of approximately \$26.1million. In essence, Bull-dog’s exercise of its pill was a partial cash-out of an existing shareholder. For fiscal 2006, Bull-dog reported a net profit of only approximately \$6 million, making the large cash payment to Steel Partners rather remarkable under the circumstances. The *Nihon Keizai Shinbun* newspaper reported on July 3, 2007 that an investment banker referred to the Bull-dog poison pill as the “honey pill.”
19. In the *Nippon Broadcasting* case, the court enjoined the issuance of new share purchase warrants to a friendly third party. See *Livedoor v. Nippon Broadcasting*, 1213 KINYŪ HANREI 2 (Tokyo High Ct., March 23, 2005).
20. See *STF Value Realization Master Fund v. Nireco*, 1186 HANREI TAIMUZU 274 (Tokyo D. Ct.,

- June 1, 2005), and *Yumeshin Holdings v. Japan Engineering Consultants*, 1222 KINYŪ HANREI 4 (Tokyo D. Ct., July 29, 2005).
21. The Japan Federation of Bar Associations has not published a model acquisition agreement and there is no equivalent in Japan of the American Bar Association's "Deal Points Study," so the matters addressed in this section reflect the observations of the authors with respect to small-to-mid cap domestic private M&A transactions.
  22. We note that in the cross-border context, Japanese courts may respect an integration clause if the parties knew or should reasonably have known the significance of the provision. See e.g., *Forest v. Prudential Bache Trade Services, Inc.*, 938 HANREI TAIMUZU 160 (Tokyo D. Ct., Dec. 13, 1995) (although the agreement was governed by Japanese law, the plaintiff was advised by a New York-licensed lawyer and the defendant's general counsel and corporate secretary was a New York-licensed lawyer, and therefore, the parties should have been fully capable of understanding the meaning of the integration clause), and *Sharp Corp. v. Hann Star Display*, 1964 HANREI JIHŌ 106 (Tokyo D. Ct., Dec., 25, 2006) (court referred to the integration clause in a definitive license agreement as a reason to deny the introduction of a most favored nations clause allegedly agreed prior to the execution of the license agreement).
  23. See *Rex Holdings Shareholders Litigation*, 1301 KINYŌ HANREI 28 (Tokyo High Ct., Sep. 12, 2008), and *Sunstar Shareholders Litigation*, 1316 HANREI TAIMUZU 219 (Osaka High Ct., Sep. 1, 2009).
  24. For the third factor, Japanese courts typically consider: (i) whether the reduction of headcount is needed in light of the company's financial performance, (ii) whether the company has made a reasonable good-faith effort to avoid the termination through other ways, such as trying to change the employee's work-position or second the employee to other companies, (iii) whether the selection of the terminated employees was made based on fair and reasonable standards, and (iv) whether the company has undertaken good-faith discussions with the affected employees and labor unions.
  25. When assessing whether a termination meets "socially accepted standards," a Japanese court would consider various factors, including: (i) the significance of the reason for the termination, (ii) the process leading to the termination, (iii) the terminated employee's performance, (iv) the severity of the employee's default, (v) the remorse shown by the terminated employee, (vi) the existence of measures taken by the employer to avoid the termination, and (vii) the lack of alternative measures available to the employer (e.g., easier work or more suitable work for the affected employee).
  26. The Japanese Supreme Court has not provided any specific rule to determine what constitutes a "justifiable and unavoidable reason," but the factors that Japanese lower courts have considered when determining the existence of a "justifiable and unavoidable reason" include the following: (i) the non-terminating party committed a prior breach of the "continuous contract;" (ii) trust between parties has been destroyed; (iii) the non-terminating party faces severe financial difficulties that make it difficult to perform its obligations under the "continuous contract" (i.e., as a result, the terminating party makes an anticipatory repudiation of the "continuous contract"); (iv) a material change in circumstances has occurred; (v) the length, term, and subject matter of the "continuous contract" in question (i.e., whether the goods/services are unique or can be sourced from several other suppliers); (vi) the number of times the "continuous contract" has been renewed and the manner in which the renewals were granted (i.e., renewed automatically or after negotiations); (vii) the reason(s) for terminating the "continuous contract;" (viii) the amount of damages the non-terminating party will suffer due to the termination of the "continuous contract;" (ix) the costs incurred by the non-terminating party in order to continuously fulfill its obligations under the "continuous contract" (e.g., capital expenditures, employees hired, advertising expense, etc); and (x) the amount of prior notice offered before the termination takes effect.
  27. As of July 2007, the United States had 307,006,550 inhabitants (according to the survey of the U.S. Census Bureau) and 1,102,106 lawyers as of December 2008 (based on data published by the American Bar Association and excluding judges and public prosecutors). As of October 1, 2009, Japan had 127,510,000 inhabitants (according to the survey of the Statistics Bureau of Japan's Ministry of Internal Affairs and Communications) and 28,828 lawyers as of April 1, 2010, (based on data published by the Japan Federation of Bar Associations and excluding judges and public prosecutors).