Cashing-out fast

Asa Shinkawa, Hiroko Shibata and James Emerson of Nishimura & Asahi look at Japan's streamlined minority shareholder cash-out procedures and protections

On August 1 2012, the Japanese Ministry of Justice's Legislative Council Subcommittee on the Companies Act published its final draft of a proposal to amend the Companies Act. If the Japanese government approves a bill based on the proposal, this would constitute the first amendment to the Act in nearly a decade.

The proposal covers two important subject matters: corporate governance and regulations relating to parent-subsidiary relationships. The latter includes the introduction of a new cash-out method for the removal of minority shareholders, which provides shareholders controlling more than 90% of the voting rights of a given company with a statutory call option over the remaining shares in such company (the New Cash-out Method).

The push for the reforms related to the New Cash-out Method have come primarily from concerns about protections for minority shareholders in the process of creating 100% parent-subsidiary relationships. As discussed in more detail below, the most common method used to squeeze out minority shareholders involves a series of somewhat bizarre steps using classified shares and requiring approval from the target company's super-majority shareholders. While there have also been demands from Japanese and overseas investors for a more straightforward cash-out method, and the recent proposal is designed in part to address such needs, the discussion at the Subcommittee regarding the proposal has centred on enhancing protections for minority shareholders (who do not necessarily enjoy fully adequate protections under the current dominant cash-out method).

> **"The proposal devises a new minority-protection method in lieu of a shareholders' meeting"**

Since comprehensive amendments to the Companies Act were enacted in 2005, most minority shareholder cash-out transactions, especially MBOs, have been achieved using so-called shares of a class subject to call in their entirety (*zembu shutoku joko tsuki shurui kabushiki*). This is a class of shares specified in the Companies Act that a given company can redeem, not in part but only as a whole, with the approval of the company's shareholders (Cash-out by Wholly Redeemable Class of Shares). Assuming a given company has only common shares, a Cash-out by Wholly Redeemable Class of Shares has typically taken place in the following manner:

First, a single shareholder (or multiple shareholders acting in tandem – the major shareholders) will acquire at least two-thirds of the total voting rights in a given company. To do so, a tender offer will often be conducted.

Next, a shareholders' meeting is convened to approve the following actions: (i) amending the company's Articles of Incorporation to re-characterise the common shares as a new class of shares that can be called/redeemed by the target company, and introduce another new class of

shares that are to be provided in exchange for the shares of the class subject to call in their entirety upon their redemption (Class A shares); and (ii) the actual redemption of all shares subject to call in their entirety in exchange for Class A shares. The redemption of all shares subject to call in their entirety is structured so that minority shareholders receive less than one Class A share each.

Since each of these actions requires the affirmative votes of only two-thirds of those shareholders present at the special shareholders' meeting, the major shareholders are able to satisfy this requirement. Also, in this case, companies will be released from their obligations to file securities reports under the Japanese Financial Instruments and Exchange Act because all of the company's common shares (which would have triggered such a reporting requirement) are redeemed and cancelled.

Finally, once the redemption occurs, the major shareholder(s) will become the sole shareholders of the company, because all former minority shareholders, who as the result of the redemption come to hold only fractional interests in Class A shares, are required to sell such fractional interests in return for cash. The price for such fractional shares needs to be determined with a Japanese court's permission, but minority shareholders are not given an option to remain shareholders of the company. When a tender offer takes place in the first step of the above process for a Cash-out by Wholly Redeemable Class of Shares, the price for the fractional shares will in practice be determined so that the minority shareholders can receive at least substantially the same consideration as the tender offer price, in order to reduce the risk of the process being deemed by a Japanese court to be unlawfully coercive for minority shareholders.

> **"Cash-consideration short-form mergers are rarely undertaken due to their adverse tax implications"**

The process for removing minority shareholders who own interests in subsidiaries has typically involved a short-form merger and a short-form share-for-share exchange (*kabushiki-kokan*), authorised by the Companies Act, which allows parent companies owning more than 90% of the total voting rights in their subsidiaries to remove minority shareholders, resulting in full ownership by the parent of its subsidiaries. Such a share-for-share exchange is a company-to-company transaction in which a given parent company (Company A) acquires all of the shares of its subsidiary (Company B) by requiring the minority shareholders in Company B to exchange their Company B shares for Company A shares, and this exchange can be implemented without the need for approval from Company B's shareholders.

Although in theory cash could be used as consideration for a merger or a share-for-share exchange (instead of shares in Company A), in that instance, Japanese tax regulations would not only subject such minority shareholders to capital gains tax, the regulations would also require

About the author

Asa Shinkawa has been a partner in the M&A/Corporate Group at Nishimura & Asahi since 2000. She focuses on M&A, tender offers, cross-border and domestic acquisitions and divestitures and going private transactions, restructurings and spin-offs, joint ventures and numerous other kinds of M&A and commercial arrangements across various industries.

She has also advised extensively on the application of antitrust/competition law in relation to M&A transactions, joint ventures, cooperative arrangements between competitors, sole-distributorship arrangements, distribution agreements, dealer agreements and other types of commercial arrangements.

She is a graduate of The University of Tokyo (LL.B., 1989) and Harvard Law School (LL.M., 1997) and is admitted to practice law in Japan (1991) and New York (1998). Shinkawa is a frequent contributor to both Japanese and English language publications, and speaks Japanese and English.

Contact information

Asa Shinkawa
Nishimura & Asahi

Ark Mori Building
(Main Reception: 28th Floor)
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029

T: +81 3 5562 8500
F: +81 3 5561 9711/12/13/14
W: www.jurists.co.jp

certain assets of Company B to be re-valued on a then-current market value basis, which would give rise to corporate tax at the subsidiary level. In contrast, the Japanese tax implications for a Cash-out by Wholly Redeemable Class of Shares are limited to the capital gains taxes experienced by shareholders. Consequently, cash mergers and stock-for-stock exchanges are not generally used for squeezing out minority shareholders in Company B.

Considering that major shareholders enjoy at least a two-thirds majority of the total voting rights in a given company, complaints have been made that the requirement of a shareholders' meeting, for the approval of a Cash-out by Wholly Redeemable Class of Shares, does not afford adequate protections to minority shareholders. Instead, the convocation of a shareholders' meeting merely unnecessarily delays the consummation of the cash-out, leaving minority shareholders in an unstable position, which increases the coerciveness of the first step of the cash-out process (the tender offer). The proposal therefore devises a new minority-protection method in lieu of a shareholders' meeting, while providing a more straightforward approach to achieve the cash-out of minority shareholders.

The new cash-out method

In response to calls for reforms, the Subcommittee in its proposal has outlined a new cash-out method as follows:

Requirements for controlling shareholders

A shareholder that controls more than 90% (or a higher-than-90% threshold if such a threshold is specified in a company's articles of incorporation/organisational documents) of the total voting rights in a given company, either by itself or together with its wholly-owned subsidiaries, is defined in the proposal as the controlling shareholder. The controlling shareholder can be a natural person or an entity such as a partnership or a corporation.

In contrast to other countries such as the United Kingdom, France and Germany, a tender offer is not the only means of obtaining a controlling share in a company in Japan. A controlling shareholder may, therefore, obtain

About the author

Hiroko Shibata joined Nishimura & Asahi in 2001 and is an associate in the M&A/Corporate group. Her practice focuses on domestic and cross-border acquisitions, leveraged buyouts and corporate preparedness and takeover defensive measures.

In 2008, she worked at the Ministry of Foreign Affairs of Japan to help negotiate free trade agreements and investment agreements, where she strengthened her expertise in regulations, especially restrictions on foreign investments imposed on cross-border transactions. Since returning to Nishimura & Asahi in 2009, she has been deeply involved in advising clients on cross-border acquisitions and other strategic corporate transactions.

Ms. Shibata is a graduate of The University of Tokyo (LL.B., 1998) and University of California, Berkeley (LL.M., 2007) and is admitted to practice law in Japan in 2001 and New York in 2008.

Contact information

Hiroko Shibata
Nishimura & Asahi

Ark Mori Building
(Main Reception: 28th Floor)
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029

T: +81 3 5562 8500
F: +81 3 5561 9711/12/13/14
W: www.jurists.co.jp

About the author

James Emerson is a senior foreign attorney and member of the cross-border transactions group at Nishimura & Asahi. His practice focuses on international M&A, complex commercial real estate, project finance and capital markets transactions.

Prior to joining Nishimura & Asahi in 2009, Emerson was an associate at Skadden Arps Slate Meagher & Flom in New York and at Morrison & Foerster in Tokyo.

Emerson graduated, Phi Beta Kappa and summa cum laude, from the University of Southern California in 1996. He also earned a master's degree from Cambridge University in 1997 and his JD degree from Harvard Law School in 2003. Emerson is admitted to the United States Court of Appeals for the Third Circuit and is admitted to practice law in New York.

He is a native English speaker and is proficient in Japanese.

Contact information

James Emerson
Nishimura & Asahi

Ark Mori Building
(Main Reception: 28th Floor)
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029

T: +81 3 5562 8500
F: +81 3 5561 9711/12/13/14
W: www.jurists.co.jp

the requisite shareholding percentage through transactions such as an acquisition of newly-issued or previously-issued stock from the target company or through share repurchases by the target company.

> "Traditional views on directors' duty of loyalty may shift where a transfer of value between shareholders is inevitable"

Exercise of statutory call option

If the Subcommittee's proposal becomes law, the controlling shareholder will be granted by statute a conditional call option over all of the outstanding shares and warrants other than those owned by the issuing company itself and the controlling shareholder (in other words, over the minority shares: which are such shares and warrants that are held by the minority shareholders). In order to exercise the call option, the controlling shareholder must notify the issuer's board of the proposed call option exercise price and the effective date for the acquisition by the controlling shareholder of the minority shares (the closing date) and make a request (the request) for approval from the issuer's board.

These procedures are noteworthy insofar as the parties privy to the sale and purchase of the minority shares pursuant to the call option are the controlling shareholder and the minority shareholders, and yet the controlling shareholder is required to declare its exercise of the call option to the board of the issuer, and no direct communication between the controlling shareholder and the minority shareholders is required or even anticipated. Instead, the board of directors of the issuer will be responsible for informing the minority shareholders of the proposed price and the closing date.

Under the New Cash-out Method, consideration for the minority shares must be cash. Furthermore, the controlling shareholder cannot cherry-pick the shares or warrants to be purchased. Instead, all of the minority shares will be subject to any exercise of the call option.

Board approval

The issuer's board must act on behalf of the minority shareholders and protect their interests when determining whether or not to approve the request. As discussed below, in Japan it has traditionally been generally construed that under most circumstances directors do not directly owe a duty of loyalty to any segment of a company's shareholders. The introduction of such duties, even in this limited squeeze-out context, therefore represents a significant departure from well-established norms.

If the board of directors elects to approve the request from the controlling shareholder, it must notify the minority shareholders of its decision at least 20 days before the closing date. This requirement has the effect of setting a deadline for approving or rejecting the request. In many cases, however, a tender offer will likely precede the request so that a 90%+ shareholding in the company can be obtained. Thus, in reality, the board of directors and the controlling shareholder will probably have substantive discussions and may even reach a tentative agreement on the price and closing Date before any actual tender offer launch.

Minority protections

The Subcommittee's proposal provides three legal defensive measures for use by minority shareholders: an injunction, a petition to the court to determine a fair price, and an action seeking the invalidation of the transfer of the minority shares.

In most cash-out transactions, the consideration for the applicable shares is the primary concern for minority shareholders. An injunction (or preliminary injunction) may be difficult to obtain in a timely fashion. As such, a petition to the court to determine a fair price will likely be the priority for minority shareholders that object to being cashed-out. In fact, a similar petition is already available for shareholders who dissent from a Cash-out by Wholly Redeemable Class of Shares. Upon the filing of a fair-price-determination petition in the case of the New Cash-out Method, the price applicable to the minority shares of the petitioning minority shareholders will be re-determined by a Japanese court if the court deems the original price to be "grossly improper in light of the financial status" of the issuer.

It should be noted that the court's approaches to determining fair value have been criticised, and some practitioners believe that a Japanese court ought to respect the consideration levels approved by the board of an issuer and refrain from inserting its own opinion (especially when such consideration was set as a result of fair negotiations between independent members of the issuer's

board and the controlling shareholder). Naturally, the tendency of Japanese courts to intercede from time to time in fair price determinations is likely to be a concern in connection with the New Cash-out Method.

With respect to potential actions seeking ex-post invalidations, one topic that remains open is whether each minority shareholder is still entitled to individually assert an invalidation claim relative to its own transferred minority shares, or whether the new legislation based on the Subcommittee's proposal will preclude individual invalidation claims. During public discussions the Subcommittee debated this point but did not reach any conclusions, thus leaving this matter open for further consideration in the future.

Three key advantages

In comparison to available cash-out methods, the New Cash-out Method is expected to offer at least three primary benefits.

The first is related to tax. As explained above, the main reason why cash-consideration short-form share-for-share exchanges or mergers are rarely undertaken in practice is because of their adverse tax implications. However, for the time being at least, reports are that the New Cash-out Method will be treated as a sale of shares between shareholders from a tax perspective, and therefore only capital gains taxes at the shareholder level will apply. This means the New Cash-out Method will enjoy the same tax treatment afforded to a Cash-out by Wholly Redeemable Class of Shares.

Secondly, shareholders' approval lacks real significance when there is a controlling shareholder. Accordingly, the New Cash-out Method only requires board approval and does away with the needless expenditure of time (and money) associated with the convocation of a shareholders' meeting. For this reason, the amount of time needed to consummate a cash-out of the Minority Shareholders may be reduced.

Finally, warrants can be included under the new method. If a subsidiary has any outstanding warrants, its parent company will be unable to achieve 100%-ownership of the subsidiary, unless those warrants are also cashed out. In the case of a Cash-out by Wholly Redeemable Class of Shares, however, warrants are not redeemable or made available for purchase. In share-for-share exchanges or mergers, parent companies/surviving companies are permitted to replace the warrants for shares in a wholly-owned subsidiary with warrants for shares in such parent company/surviving company. On the other hand, warrantholders cannot be cashed-out if a Japanese joint stock corporation is the parent company/surviving company.

In contrast, in the case of a New Cash-out Method transaction, the controlling shareholder may elect to include warrants. Therefore, even if a subsidiary has outstanding warrants, a parent entity can obtain complete ownership of its subsidiary by means of the New Cash-out Method.

A drastic change to directors' fiduciary duties

Japanese courts have historically held the view that company directors have a duty of care and loyalty to all of a company's shareholders, taken as a whole. In other words, the concept of a duty of loyalty to minority shareholders, specifically, has been broadly rejected. Furthermore, the idea of imposing fiduciary duties on controlling shareholders has never been accepted by Japanese courts. The basic point is that, traditionally, directors have complied with their fiduciary duties by acting in a manner that treats all shareholders equally, without favouring any faction or group.

Because of this legal policy, Japanese directors are unaccustomed to acting as advocates for any subset of company shareholders. Consequently, the Subcommittee indicated that directors should be compelled to comply with a new duty of loyalty to minority shareholders, in particular, at least in the context of a New Cash-out Method transaction, where a transfer of value between shareholders is inevitable.

The impact in practice

The new proposal is intended to provide a direct and more time- and cost-efficient path to achieving a cash-out of minority stakeholders, while also introducing a duty of loyalty for the issuer's directors to minority shareholders as a counterbalance. Whether or not the New Cash-out Method will successfully replace the current Cash-out by Wholly Redeemable Class of Shares, however, may depend on whether or not directors will be required to take any special or additional measures, beyond those taken to ensure independence and fairness in the decision-making process that leads to the approval of any request. One possibility (perhaps a likely one) is that a duty may be imposed on the issuer to notify minority shareholders, not only of the board of directors' decision itself regarding the fairness of the price, but also the reasons behind such decision, as well as a description of whatever measures the board took to protect the minority shareholders' interests under the circumstances. A valuation report prepared by a third party, together with an opinion issued by an external board member (*shagai torishimari yaku*), are examples of measures that the Subcommittee has hinted at as being appropriate.

Presently, in cases involving a Cash-out by Wholly Redeemable Class of Shares that include a tender offer, the issuer's board of directors will typically obtain a third party's valuation report. In addition, a special committee consisting of external board members and/or outside experts will often be organised and the non-binding recommendation of such committee is then be considered by the issuer's board. On the other hand, to date, it has been rare for a board to seek a fairness opinion from a third party regarding the level of consideration for a transfer of shares, or to organise a special committee empowered to negotiate a fair share price. If those additional measures are required in the context of New Cash-out Method transactions, the result may be added concerns and headaches for directors who may then frown upon the new method and be less willing to approve requests.