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The Corporate Counselor

- Insights into Japanese Corporate Law -

September 2013/No.14

LETTERS OF INTENT IN JAPANESE M&A TRANSACTIONS

Inbound Japanese M&A may have found an unexpected lifeline! With the introduction of *Abenomics* and support from the Bank of Japan, from fourth quarter of 2012 through September 24, 2013, the Japanese Yen has depreciated approximately 27% against the U.S. Dollar and approximately 35% against the Euro. While the Nikkei has catapulted in value during this same time period, thereby increasing the trading prices of many publicly traded companies (which softens the greater purchasing power that overseas acquirors could have enjoyed through foreign exchange gains), not all of the quality publicly traded companies have seen their trading prices commensurately increase and the value of privately held Japanese companies does not always correlate to gains in stock exchange indices.

With the value of target Japanese companies potentially lower when expressed in foreign currency terms and Prime Minister Abe's statement on June 19, 2013 that he is resolved to use all of his political power to double foreign direct investment into Japan to JPY35 trillion by 2020, M&A professionals could soon face a boom in inbound Japanese M&A and commercial transactions not seen for decades. Should the ice thaw on inbound Japan transactions, then practitioners may need to sharpen their pencils and wipe the dust off their precedents in response to increased deal flow. This edition of the Corporate Counselor, therefore, provides an information booster shot on issues and drafting tips to consider when preparing a letter of intent for an inbound Japanese M&A transaction.

Why Have a Letter of Intent?

In Japanese M&A transactions, a letter of intent, memorandum of understanding, and term sheet essentially cover the same ground and follow the same practices, though the format and style of each document differs. For purposes of this newsletter, we collectively refer to each as a "letter of intent."

The letter of intent is often one of the first transaction documents that deal parties consider when undertaking an M&A transaction, and frequently sets the tone for the rest of the transaction in terms of negotiating style and establishment of trust. The significance of this document can be heightened in the cross-border context. While negotiating and documenting a corporate transaction is often a complicated and time consuming process in itself, a cross-border transaction adds further layers of challenge. Additional hurdles in a cross-border transaction include differences in culture, deal structuring techniques, due diligence styles, and documentation standards. Thus, a letter of intent is especially helpful in a cross-border transaction as this document memorializes the basic terms of a proposed deal, thereby providing the parties with basic assurances that they have reached a common understanding of the transaction before undertaking costly and time consuming due diligence and deal document preparation. Of course, if the execution of a comprehensive letter of intent could require a party to publicly disclose the transaction or could expose a party to damages if it fails to execute a definitive agreement (as discussed below), then memorializing specific deal terms in a letter of intent could be counter-productive for a transaction party.

Typical Provisions in a Letter of Intent

There is no one-size-fits-all letter of intent for an inbound Japanese M&A transaction. The following items could be considered baseline information to include in a letter of intent used in a non-auction context for an acquisition that is not a merger of equals:

- a description of the structure of the transaction and a valuation of the target, including the purchase price or a purchase price range, and the material assumptions underlying the formulation of the purchase price (e.g., all outstanding stock options being cancelled, all target debt being paid off or assumed at closing, etc.);
- the expected timetable for due diligence, signing of the definitive agreement and the closing;
- the key conditions to signing (e.g., completion of due diligence, receipt of board approval, etc.);
- a mutual confidentiality covenant concerning deal publicity; and
- binding deal protection devices, such as a covenant by the seller not to engage in discussions with other parties pending the execution of the acquisition agreement, a conduct of business in the normal course covenant, walk-away fee, and other restrictive covenants.

When determining the use and scope of a letter of intent, practitioners also should consider whether the dynamics of the deal and time/expense concerns warrant the parties to (i) verbally agree on the major structuring points for the transaction (as opposed to preparing a written agreement), and thereafter (ii) promptly proceed to the operative agreement preparation stage.

Binding versus Non-Binding Letters of Intent

The default rule under Japanese law is that a letter of intent is a binding agreement, unless the letter of intent expressly states that all or a portion of its terms are non-binding. While there

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are a number of ways to distinguish the binding from the non-binding provisions of a letter of intent (such as placing all of the binding provisions in one section of the letter of intent and the non-binding sections in another section), the practice in Japan is to include an express statement that the letter of intent is not intended to be a binding arrangement, except for specified provisions.

The following language could be used to indicate that an entire letter of intent is non-binding (with the understanding that the parties would need to carve out from this statement any provisions that they intend to be binding, such as confidentiality obligations and any walk-away fee payments):

> *This letter of intent is for discussion purposes only and does not create or constitute a legally binding obligation between the parties or any of their affiliates. Unless a definitive [acquisition agreement] is executed by the parties with respect to the matters contemplated by this letter of intent and all subsequently determined matters, none of the parties or any of their affiliates shall be entitled to any damages or other form of relief whatsoever based upon or arising from this letter of intent, the discussions related thereto, or the failure to enter into an [acquisition agreement].*

Notwithstanding the inclusion of a provision stipulating that all or a portion of a letter of intent is non-binding, a party that seeks to break off discussions will need to consider whether such withdrawal can lead to liability.

Consequences of Breaking Off Discussions – Breach of Trust

Clearly, where a letter of intent states that it is a binding arrangement, a party withdrawing from discussions could face a breach of contract claim. The situation is somewhat more complex with a non-binding letter of intent.

On one hand, under Japanese law a party can normally freely break off discussions after the entry into a non-binding letter of intent and refuse to execute a definitive agreement. On the other hand, such party could be exposed to damages under Japanese law if it has led the other party to reasonably believe that a definitive agreement between the parties would be subsequently executed. Such false signaling by the withdrawing party would constitute a "breach of trust" under Japanese law. Unlike other jurisdictions, Japanese law does not specifically focus the foregoing analysis on the existence of any express or implied covenant for a contracting party to negotiate in good faith. Given the elements typically required to support a breach of trust claim, however, the distinction in this context between breaching a covenant to negotiate in good faith versus committing actions that cause a breach of trust to occur is most likely inconsequential.

There is no Japanese statute or other fixed criteria that Japanese courts use to evaluate whether a breach of trust occurred. The existence of a breach of trust is highly fact specific and possibly influenced by the result that a particular judge considers as fair. However, the existence of all or most of the following factors immediately before a party unilaterally withdraws from negotiations may likely lead a Japanese court to find the occurrence of a breach of trust:

- the letter of intent is very detailed, providing an outline of essentially all of the principal terms of the proposed transaction;
- the withdrawing party did not seriously intend to enter into a definitive agreement and used the letter of intent negotiations for ulterior motives;
- the withdrawing party delays informing the counter-party of the existence of an event that requires it to withdraw from discussions or does not clearly indicate the non-fulfillment of a condition to proceed to documentation (e.g., the withdrawing party knows that it cannot obtain a third party consent to move forward with the proposed transaction, but it fails to promptly notify the other party of this impossibility or uses unequivocal language about its ability to satisfy such condition);
- the withdrawing party knew that the counter-party expected that a definitive agreement would be executed; and
- the non-withdrawing party did not breach any obligations owed to the withdrawing party.

In *Advantage Partners KK, et al. v. Minowa Koa KK* (2005), the Tokyo District Court provided helpful guidance on the scope and application of the breach of trust doctrine in the M&A context.

In the *Advantage Partners* case, Minowa Koa and Advantage Partners and other sellers (collectively referred to for ease of reference as "Advantage Partners") entered into the equivalent of a letter of intent pursuant to which Advantage Partners agreed to sell to Minowa Koa shares that Advantage Partners held in Fuji Kikou Denshi KK. The recitals in the letter of intent stipulated that the parties had essentially agreed to the Fuji Kikou Denshi share sale, but the share sale was subject to Minowa Koa being able to refinance a specified Fuji Kikou Denshi bank loan. Shortly before the targeted execution date for a definitive share purchase agreement for the Fuji Kikou Denshi shares, Minowa Koa notified Advantage Partners that it would need to withdraw from the transaction because it could not obtain the requisite bank's consent to refinance its loan to Fuji Kikou Denshi. Advantage Partners sued Minowa Koa for damages.

The Tokyo District Court held that even though the letter of intent was a non-binding arrangement and any purchase of the Fuji Kikou Denshi shares by Minowa Koa was subject to the refinancing of a bank loan to Fuji Kikou Denshi, Minowa Koa breached its trust relationship with Advantage Partners by not disclosing for approximately one month that it was encountering difficulties obtaining the requisite bank's consent to refinance its loan to Fuji Kikou Denshi (and, to the contrary,

during this one-month period gave Advantage Partners the impression that obtaining such bank's consent was a foregone conclusion). The Tokyo District Court awarded Advantage Partners approximately JPY50,000,000 in damages.

The following are further points to consider when evaluating potential liability under Japanese law arising from breaking off discussions after the execution of a non-binding letter of intent:

- *Delicate balance of detail*. A heavily negotiated non-binding letter of intent that covers all of the essential terms for a proposed transaction will inherently have a higher probability of exposing a party to damages if it refuses to execute the deal (through a breach of trust argument) in comparison to a simple letter of intent negotiated over a short time period. However, an analysis of potential damage exposure should not be made in isolation when considering the degree of specificity for a letter of intent, since due diligence traditionally commences after the execution of a letter of intent. Thus, a party may strategically decide to execute a very detailed and highly negotiated letter of intent before it undertakes or permits due diligence even if there is a greater possibility for breach of trust damages as such potential damages may pale in comparison to the immediate costs that would be incurred in connection with a full due diligence exercise that screeches to a grinding halt because the parties subsequently learn that the basic parameters of the deal were not mutually understood.

- *Available damages*. In the *Advantage Partners* case, despite demonstrating that a breach of trust occurred, the Tokyo District Court awarded Advantage Partners only reliance damages. Without receiving expectation damages (i.e., diminution in value, coupled with consequential and incidental damages), an aggrieved party may experience only a bittersweet victory. The range of available damages may not only impact the eagerness of an aggrieved party to pursue an action, but may also influence a party's calculation whether to walk away from a transaction as it can estimate its potential monetary exposure.

- *Termination Date*. A party may wish to include in a letter of intent a specific termination date for discussions (e.g., "this letter of intent will terminate on the earliest to occur of December 31, 2013 and a date nominated by buyer if it is not satisfied with the results of its due diligence investigation over the company"). With a built-in termination date, a Japanese court may find that a counter-party could not form a reasonable expectation that a definitive agreement would be executed since a looming termination date always existed. Of course, a termination date would not be an effective shield if a party simply refuses to negotiate or offers false pretenses in order for the termination date to lapse.

Public Disclosure and Antitrust Filings

A requirement to publicly disclose a transaction as a result of signing a letter of intent could increase interloper risk. Accordingly, deal publicity is a sensitive issue to transaction parties. The rules and regulations of the Tokyo Stock Exchange (and not Japanese corporate or securities laws) govern letter of intent disclosure obligations of a public company in Japan (private companies are not subject to mandated disclosure obligations).

Under Tokyo Stock Exchange rules, a listed company should disclose a letter of intent if (i) the proposed transaction is "material," and (ii) a decision has been made by a party to proceed with the proposed transaction. The materiality of a proposed transaction is assessed according to Tokyo Stock Exchange rules, a discussion of which is beyond the scope of this newsletter given their length. As to whether a party has made a decision to proceed with a proposed transaction, factors considered include whether the letter of intent is binding or not, the degree of specificity of the letter of intent, and if the aim of the letter of intent is only to kick-start the due diligence and negotiation process. Whether the letter of intent has been executed or omits a price or merger ratio will not have an outcome determinative impact on a public company's disclosure obligations under Tokyo Stock Exchange rules, so long as the public company's board of directors has reviewed the letter of intent and consented to move forward on the basis of such document.

There is a potential exemption from the requirement to disclose a letter of intent that details a material transaction that a party has decided to pursue. If the public disclosure of the proposed transaction is likely to jeopardize the ability of the parties to consummate the transaction, then there is room to argue under Tokyo Stock Exchange rules that public disclosure of the letter of intent can be waived. However, if news of the transaction has leaked to the public, then legal counsel should be consulted as the Tokyo Stock Exchange may more heavily scrutinize the public disclosure obligations of a listed company under such circumstances (and a "no comment to market rumors" response adopted by a listed company to such leak could be viewed by the Tokyo Stock Exchange as an unacceptable communication).

It is a standard practice in Japan for a local anti-trust filing to be made only after the execution of an acquisition agreement that has been approved at a meeting of the target's board of directors. Unlike other jurisdictions, an antitrust filing cannot be submitted to the Japanese regulator merely upon the execution of a letter of intent, regardless of the binding nature of the letter of intent, the level of detail in the letter of intent, or the antitrust sensitivity of the proposed transaction. The antitrust filing sequence in Japan is primarily due to (i) the requirement under Japanese antitrust laws that a copy of the executed acquisition agreement be furnished to the Japan Fair Trade Commission upon the first antitrust submission to the agency, and (ii) the practice adopted by most boards of directors in Japan that the board must approve the final version (and not a close-to-final version) of a material acquisition agreement. Thus, a buyer eager to initiate a Japanese antitrust review process upon the execution of a letter of intent may face an impregnable wall.

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A letter of intent that is ambiguous or not carefully drafted may impose obligations and liabilities that one or both sides did not anticipate, and even serve as an invitation to litigation. The advice of legal counsel ordinarily should be obtained to determine whether a letter of intent is desirable under the circumstances and, if so, which provisions should be binding and which should be non-binding, and how to effectively shield a party from breach of trust and other claims.

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