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NEW WAY TO SQUEEZE OUT MINORITY SHAREHOLDERS IN JAPAN – A STEP FORWARD BUT A GENERATION BEHIND

A recent amendment to Japanese corporate law has been heralded as a major advancement to Japanese M&A practice by providing a new scheme to squeeze out minority shareholders on an expedited basis; however, there are certain inherent problems with this new scheme that could discourage its widespread use in Japan. On June 20, 2014, the National Diet of Japan adopted long-awaited amendments to Japanese corporate law to facilitate the cashing out of minority shareholders (the "Squeeze Out Amendments"). Once effective, the Squeeze Out Amendments are expected to make two-step acquisitions of Japanese publicly traded companies (*i.e.*, a tender offer followed by a squeeze out transaction to acquire the remaining shares held by the target company's minority shareholders) more equitable for all constituents by allowing the majority shareholder to acquire full control of the target company quicker and with less expense (in comparison to current squeeze out methods), while at the same time fostering the rights of minority shareholders. However, in light of the new gate-keeper role that a target company's directors are expected to play towards the minority shareholders, the Squeeze Out Amendments may not be a panacea for acquirors and could even embolden minority shareholders to challenge acquisitions.

This edition of the *Corporate Counselor* briefly discusses the current approach commonly used by acquirors to squeeze out minority shareholders in Japan, then explains the new way to cash out minority shareholders under the Squeeze Out Amendments, and then provides an analysis of the potential benefits and detriments of conducting a squeeze of minority shareholders under the Squeeze Out Amendments. This Newsletter also examines how inherent limitations in the Squeeze Out Amendments could discourage its widespread use by acquirors, and then concludes with a discussion of how the legislation may not address perceived shortcomings in the Japanese M&A process or bridge the gap with other notable take-private legislation.

Current Approach to Squeezing Out Minority Shareholders

The June 2010 edition of the *Corporate Counselor* discusses the various ways an acquiror can squeeze out minority shareholders in Japan (available here), which methods are still available today. Of the ways to squeeze out minority shareholders in Japan, the "shares subject to call" squeeze out method (*zenbu shutoku jōkōtsuki syurui kabushiki*) offers a number of tax advantages and completion assurances over other methods to take a company completely private; however, there are fundamental problems with the "shares subject to call" method. In particular, the "shares subject to call" method requires (i) a somewhat bizarre re-characterization of the target company's shares so they can be redeemed by the target company, which re-characterization requires the approval of at least two-thirds of the target company's shareholders duly present at a shareholders' meeting, and (ii) a Japanese court to approve the amount of cash consideration to be paid to the target company's minority shareholders for the fractional shares they hold arising from the capital restructuring. As a result, time and money could be lost as the target company holds its special shareholders' meeting to effect the squeeze out, and there is no assurance that a particular judge would not adopt a radical view towards the cashing out of the target company's fractional shares held by the minority shareholders.

Calls for legislative reform date back to early 2011 to provide a method that more efficiently and equitably squeezes out minority shareholders in Japan. These calls finally have been answered in the form of the Squeeze Out Amendments.

The Squeeze Out Amendments

The Squeeze Out Amendments are expected to become effective by no later than December 26, 2015 (with pundits predicting an April 1, 2015 effective date). Prior to their effective date, Japan's Ministry of Justice is required to promulgate regulations to elaborate certain provisions of the legislation. The following discussion of the Squeeze Out Amendments and the remedies available to minority shareholders, therefore, is tentative and subject to the forthcoming Ministry of Justice regulations (though these regulations are not expected to change material elements of the Squeeze Out Amendments).

New Approach under the Squeeze Out Amendments. The Squeeze Out Amendments do not replace or invalidate the "shares subject to call" squeeze out method. Instead, the Squeeze Out Amendments provide an additional method to gain complete control over a Japanese target company. Under the Squeeze Out Amendments, a cash squeeze out of the minority shareholders can be effected according to the following scheme:

- A "Special Controlling Shareholder" (as defined below) is granted by operation of law with a conditional call option over all of the outstanding shares and derivative equity securities (*e.g.*, stock options and warrants) of the target company not owned by the Special Controlling Shareholder, other than any treasury shares held by the target company. The basic features of the conditional call option include: (i) it is created immediately upon an acquiror's qualifying as a Special Controlling Shareholder, and no documentation must be prepared to issue the conditional call option to the Special Controlling Shareholder (since the conditional call option is created automatically by operation of law), (ii) it covers all of the

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outstanding shares and derivative equity securities of the target company (and is not with respect to only a portion or a class of securities, and it must be exercised in full), and (iii) there is no expiration date for the exercise of the conditional call option by the Special Controlling Shareholder.

A "Special Controlling Shareholder" is defined as a person or entity that gains control of 90% or more (or a higher ownership threshold if stipulated in the target company's articles of incorporation) of the total voting rights in the target company, either alone or together with its wholly-owned subsidiary. Target company shares owned by a less than wholly-owned subsidiary of the acquiror do not count towards the ownership threshold, and it is conceivable that a Special Controlling Shareholder could subsequently lose its status if derivative equity securities are subsequently exercised by minority shareholders (though the issuance of a top-up option to the acquiror should provide the acquiror with an equity cushion to thwart to some degree dilution in its ownership position in the target company, and a top-up option also could help the acquiror reach the 90% ownership threshold if its ownership percentage in the target company falls short after the first-step transaction). If a top-up option will be granted by the target company to the acquiror in connection with the acquisition, then legal counsel should be retained in advance as there are various potential issues associated with its establishment and payment provisions that are beyond the scope of this Newsletter.

- To exercise the conditional call option, the Special Controlling Shareholder must (i) notify the target company's board of directors in writing of its intention to exercise the conditional call option and provide the relevant details concerning the conditional call option exercise (in particular, the proposed closing date for the share purchase and the purchase price for the shares and derivative equity securities held by the minority shareholders -- which consideration must be in the form of cash), and (ii) request that the board of directors of the target company accept the exercise of the call option by the Special Controlling Shareholder pursuant to such terms (which is why the call option is considered "conditional"). No direct communications between the Special Controlling Shareholder and the minority shareholders are required for the Special Controlling Shareholder to exercise its conditional call option, and the Special Controlling Shareholder cannot assign to a subsidiary (wholly-owned or otherwise) its rights under the conditional call option.

- The target company's board of directors is required to act on behalf of the minority shareholders to protect their interests and to inform them about the details of the conditional call option exercise by the Special Controlling Shareholder. If the target company's board of directors approves the call option exercise by the Special Controlling Shareholder, then the board must notify the minority shareholders in writing at least 20 calendar days prior to the proposed closing date for the share purchase.

The Squeeze Out Amendments also amend Japanese corporate law to provide shareholders with appraisal rights when a target company effects a reverse stock split that results in the cashing out of minority shareholders' shares. Appraisal rights previously were not available to shareholders cashed out as a result of a reverse stock split, which reduced the appeal of this squeeze out technique to acquirors due to the belief that a Japanese court would invalidate a reverse stock split squeeze out given the harsh treatment to the minority shareholders under this scenario (*i.e.*, being forced to exit at a price that could not be contested through an appraisal proceeding). While providing shareholders with appraisal rights in the reverse stock split context would technically provide an additional method to permissibly squeeze out minority shareholders, there are *de minimis* procedural distinctions under Japanese corporate law between effecting a squeeze out through a "shares subject to call" and a reverse stock split.

Remedies Available to Minority Shareholders Who Object to the Squeeze Out. Minority shareholders who object to a decision by the target company's board of directors to accept the terms proposed by the Special Controlling Shareholder for the exercise of the call option can (i) exercise their appraisal rights and seek a court's determination of the fair market value of their shares, (ii) seek an injunction to prevent the closing of the call option exercise, or (iii) file a lawsuit alleging a breach of fiduciary duties by the target company's board of directors arising from its improper approval of the exercise of the call option. The latter claim will be easier for the minority shareholders to successfully allege in the squeeze out context, which could severely dampen the utility and use of the Squeeze Out Amendments (as discussed below).

Pros and Cons of the Squeeze Out Amendments

While the Squeeze Out Amendments offer various benefits to an acquiror when effecting a minority shareholder squeeze out, its potential detriments could discourage widespread use by acquirors.

Benefits of the Squeeze Out Amendments. The Squeeze Out Amendments offer two immediate benefits to an acquiror in comparison to the "shares subject to call" squeeze out method and a reverse stock split: (i) there is no longer a need for the acquiror to convene a shareholders' meeting to approve amendments to the target company's articles of incorporation (to re-characterize the target company's shares for use in the redemption of the minority shareholders' interest or to effect the reverse stock split), which should save the acquiror time and expense, and (ii) derivative equity securities (*e.g.*, stock options and warrants) of the target company are subject to the conditional call option, so a Special Controlling Shareholder can be assured of complete ownership over the target company, which is especially helpful if the target company has outstanding employee stock options that cannot be readily cancelled.

Similar to the Japanese tax treatment under the "shares subject to call" squeeze out method, a cash out utilizing the Squeeze Out Amendments will not result in the target company realizing a capital gains tax on its assets and goodwill as of the date of

the squeeze out. While this tax treatment is not unique, the continuation of this tax treatment to a cash out utilizing the Squeeze Out Amendments is an important feature. A capital gains tax at the level of the target company's shareholders remains in squeeze out transactions utilizing a "shares subject to call," a reverse stock split, and the Squeeze Out Amendments.

Detriments of the Squeeze Out Amendments. The Squeeze Out Amendments do not take into account the frequent Japanese practice in friendly transactions for an acquiror to enter into a take-private acquisition agreement with the target company prior to launching the first-step tender offer, which agreement typically stipulates the proposed consideration to be offered to the minority shareholders in the second-step squeeze out transaction. By agreeing upfront the consideration to be offered in the second-step squeeze out transaction, it is not clear (i) whether the consideration to be offered to the minority shareholders could ever be fixed at an amount not equal to the first-step tender offer price (as the material details of the take-private acquisition agreement must be publicly disclosed and it would be an improper tender offer tactic to disclose that the minority shareholders will be squeezed out for a purchase price lower than the first-step tender offer price), and (ii) how vigorously the board of directors of the target company could negotiate on behalf of the minority shareholders once the target company's board receives the conditional call option exercise notice from the Special Controlling Shareholder, as the target company would have already agreed to the squeeze out price pursuant to an executed agreement.

If the acquiror and the target company do not agree upfront the consideration to be offered to the minority shareholders in the second-step squeeze out transaction (or the take-private acquisition agreement stipulates that the squeeze out consideration is just an indicative price subject to further discussions), the target company's directors may not be ideal gate-keepers to ensure price fairness to the minority shareholders in light of their expected continuation with the target company post-transaction. The target company's incumbent directors often remain with the target company post-transaction since directors of Japanese companies typically hold key senior management positions as well, so they may be inclined to have the minority shareholders cashed-out at the lowest price possible.

The target company's incumbent directors themselves also may prefer that the acquiror not effect a squeeze out utilizing the Squeeze Out Amendments because they could be caught in a whipsaw arising from their mandated role to protect the economic interests of the minority shareholders because:

- if the target company's incumbent directors do not vigorously negotiate on behalf of the minority shareholders and simply follow the directions of the Special Controlling Shareholder due to their symbiotic relationship, then the minority shareholders would have an incentive to initiate a lawsuit against the incumbent directors alleging an improper conflict of interest and a breach of the fiduciary duties owed to them under the Squeeze Out Amendments (which, if successful, could expose these directors to personal liability that cannot be indemnified by the target company); and

- if the target company's incumbent directors vigorously negotiate on behalf of the minority shareholders with the Special Controlling Shareholder, then (i) the incumbent directors would be left in an awkward position of having to negotiate against the *de facto* owner of the target company, and (ii) more shareholders could be inclined to hold out from the first-step tender offer since they may believe that there might be a reasonably good chance of receiving at least the tender offer price in the second-step squeeze out transaction (which could further exacerbate the friction arising from the incumbent directors' responsibility to champion the economic interests of the minority shareholders).

As a definitive analysis concerning the benefits and detriments of the Squeeze Out Amendments to a transaction cannot be provided in a vacuum given the heavy reliance on the particular facts of the matter, legal counsel should be consulted at the initial stage of a contemplated acquisition to assist in the delicate evaluation of the best approach to gain complete control over a target company. Ultimately, practices used in Japanese management buyout transactions may be transplanted to effect a squeeze out utilizing the Squeeze Out Amendments.

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Though it remains to be seen whether many acquirors will utilize the Squeeze Out Amendments due to its perceived inherent limitations, the legislation already appears to be a generation behind in light of (i) its late-stage application of measures to curb misconduct by controlling shareholders, and (ii) its high share accumulation requirements.

The investor community may not fully appreciate the Squeeze Out Amendments because it remains unclear why the prevention of misconduct by a controlling shareholder in the take-private context is not invoked earlier in the acquisition trail. Under Japanese corporate law prior to the adoption of the Squeeze Out Amendments, directors owed fiduciary duties to the company as a whole (and not to a specific segment of the shareholder base or a particular constituent). However, under the Squeeze Out Amendments, the target company's directors will owe fiduciary duties to the minority shareholders. If minority shareholders in a cash squeeze out transaction are now entitled by Japanese law to certain protections, shouldn't the full shareholder base in a first-step cash tender offer be entitled to basic statutory protections against misconduct by a controlling shareholder as well, such as by requiring (i) the board to engage in a competitive bidding process and make available due diligence materials to potential third-party bidders, (ii) the board to deliver fair disclosure to the minority shareholders concerning the valuation of the offer, (iii) the formation of an "independent" special committee to oversee the going-private process and provide a recommendation as to whether the minority shareholders should tender their shares in the offer, and (iv) the controlling shareholder not to undertake or threaten coercive tactics if the minority shareholders do not tender their shares in the offer?

Also, it could be considered excessive to require a majority shareholder to own at least 90% of the total voting rights in the target company in order to benefit from modern squeeze out legislation. Legal commentators note that recent Japanese corporate law reforms have been influenced by Delaware corporate law and legal precedents. At the time when reforms to the minority squeeze out process were initially raised in Japan, Delaware corporate law permitted a shareholder owning 90% of the outstanding shares of a target company to effect a cash squeeze out merger without going through a shareholder vote. On June 30, 2013, the Delaware state legislature adopted an amendment to Delaware corporate law to permit a shareholder owning as little as a majority of the issued and outstanding shares to effect a cash squeeze out merger without holding a shareholders' meeting, subject to the satisfaction of certain requirements, as the Delaware legislation is tied to the minimum percentage ownership that would be necessary to adopt a merger agreement. It is possible that similar calls for reform will be raised in Japan that an acquiror should need to own only the number of shares necessary to approve a merger agreement (which is two-thirds of the outstanding voting rights in the target company pursuant to Japanese corporate law) in order to benefit from minority shareholder squeeze out legislation. Perhaps the writing is on the wall with respect to how Japanese minority shareholder squeeze out legislation will be amended in the future?

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