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Lessons Learned from Recent Japanese M&A Contract Interpretation Cases

October 10, 2013

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Discussion Points

- **Emancipation of Japanese M&A Contract Drafting**
- **Buyer's Knowledge**
- **Liquidated Damages**
- **Entire Agreement Clause**
- **Indemnification Claims**
- **Closing Remarks**

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Emancipation of Japanese M&A Contract Drafting



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Movement Toward Changes

- *Historically*, Japanese M&A contracts were short-form (material terms and conditions left open for future negotiations)
- *Gradually*, Japanese M&A contracts have become more “complex” and common law concepts have been introduced (e.g., indemnification)
- As a civil law county, how can common law contractual provisions appear in Japanese M&A contracts when such concepts do not appear in Japan’s Civil Code?

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Rational Behind Changes

- Japan's legal system is a hybrid of legal influences – a conventional civil law legal system with case law that interprets legislation and develops new laws where legislation is silent
- Increase in foreign direct investment in the late 1990's provided foundation for non-Japanese legal principles to be incorporated into Japanese contracts (overseas buyers had significant bargaining power)
- Delaware legal concepts more widely referenced due to increase in disputes over Japanese corporate acquisitions

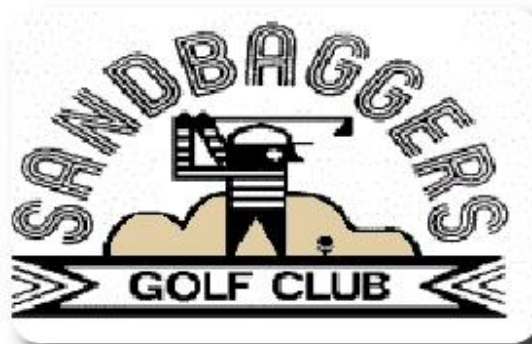
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Rational Behind Changes (*continued*)

- Japanese commercial and regulatory law particularly influenced by common law concepts and overseas regulatory regimes:
 - (a) Japanese attorneys and judges may incorporate concepts learned from overseas studies (US drafting techniques placed in the spotlight and given greater acceptance)
 - (b) academic writing often shapes thinking of judges and lawyers
- Increase in the number of litigated disputes in Japan

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Buyer's Knowledge



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Frequently Impacts

- Indemnification claims (*own knowledge*)
- Closing over breaches (*knowledge subsequently gained from Seller*)
- Information disclosed during due diligence process (*knowledge disclosed to advisors*)

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Case -- Indemnification

*Shinki KK v. Youko KK and others, Tokyo District Court,
January 17, 2006*

- Parties entered into a stock purchase agreement for the sale of a consumer finance company. Sellers made representations and warranties concerning the target consumer finance company's financial condition in a stock purchase agreement, and provided indemnification for losses arising from any breaches
- Due to a deterioration in its financial condition, target consumer finance company (i) treated debtor settlement payments as payments for interest (and not as payments to cancel/forgive loans), and (ii) didn't increase its bad-debt reserves. Foregoing treatment not in accordance with J-GAAP. Buyer claimed the Sellers breached their representation that the target consumer finance company's financial statements were accurate and complete, and prepared in accordance with J-GAAP

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Case (*continued*)

- Sellers argued that they didn't breach the representation and warranty covering the target company's financial statements and, even if they did, Sellers shouldn't be liable because either the Buyer had knowledge of the breach before closing or would have been grossly negligent not to know of the breach

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Court Decision

- Tokyo District Court held if the Buyer was able to find and gain knowledge that the Sellers were in breach of the matters that they represented and warranted or the Buyer was grossly negligent for not having knowledge of Sellers' breach, then *there is room to interpret* that the Sellers will be exempt from their liabilities under the representations and warranties in the acquisition agreement in light of the viewpoint of fairness
- Tokyo District Court did not expressly state the reason for holding that Buyer's "knowledge" could exempt the Sellers from liability (only "there is room to interpret") and did not explain the nuance of a grossly negligence standard

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Sample Provision -- Buyer

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Reason for the Provision

- Buyer should not be penalized from undertaking an extensive (and possibly costly) due diligence review if the knowledge gained will be used to its detriment
- Sellers should not be able to disclose harmful information between signing and closing to modify bargained for representations and warranties
- Indemnification section often contains a cap and time limitation for claims to accommodate contract breaches
- Seller will have an incentive to claim that Buyer had knowledge of the breach in order to avoid an indemnification claim

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What to Consider if an Anti-Sandbagging Clause Must be Included

- Limit the scope of knowledge to a fixed, small group of individuals
- Limit the standard of proof to “actual” knowledge and not constructive, implied or imputed knowledge
- Limited to the actual knowledge of the subject persons as of the date of the agreement (in order to avoid a subsequent data dump by the Seller shortly before the closing)
- Avoid imputation of knowledge gained by accountants and attorneys in the due diligence process that was not specifically communicated to the persons of the Buyer defined to have knowledge

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Case – Closing Over Breaches

*Taiyo Kikai Ltd. v. Yamaichi Electric Co., Ltd., Tokyo
District Court, April 19, 2011*

- Parties entered into a stock purchase agreement for the sale of Advancel (a wholly-owned subsidiary of Yamaichi)
- Representations and warranties included that Advancel has not received any notices of default in relation to agreements executed with third parties that may have a material adverse effect on Advancel's business, operations, assets, obligations or prospects
- Advancel had entered into an agreement with AU Optronics for four machines uses to make mobile phones. Approximately **one week before closing**, Seller sent an email to Buyer indicating that (i) it was highly likely that AU would cancel the purchase of one machine due to product defects, and (ii) AU would seek a purchase price reduction for the other three machines

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Case (*continued*)

- Closing of the sale and purchase was conditioned on the following:
 - (a) no changes in Advancel's business, assets, financial condition and operating results that have a material adverse effect;
 - (b) no breaches of the agreement that have a material adverse effect; and
 - (c) Seller's representations and warranties being true and correct on all "Material Points" (defined to mean a breach of which will cause a material adverse effect on Advancel's business, operations, assets, obligations, or prospects)

- A few months after the closing, AU cancelled the purchase of all four machines. Buyer claimed damages in an amount equal to the purchase price of the four machines

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Court Decision

- Tokyo District Court held that prior to the closing the Buyer knew or should have known that the value of Advancel could be impacted due to the following:
 - (a) Buyer received information that all of the machines did not meet their performance specifications;
 - (b) Buyer was informed that it was highly likely that the purchase of one machine would be cancelled (and other cancellations likely); and
 - (c) Buyer could have postponed the closing and conducted further due diligence

- Buyer cannot collect damages because a breach by Seller should be determined whether objective and accurate information regarding the AU Optronics agreement was disclosed. Since Buyer was provided with sufficient information to decide whether to proceed with the Closing, Seller did not breach obligations under the acquisition agreement

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Implications of Court Decision

- Does Buyer or Seller assume the risk of loss for events occurring between signing and closing?
 - How will Japanese courts treat representations and warranties that are not “dated?”
 - When can disclosure schedules be updated?
 - Can a MAE clause be triggered in Japan?
- ⇒ **Default rule is unclear, so clear contract drafting could persuade the court**

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Sample Provision -- Seller

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Sample Provision -- Buyer

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Case – Information Disclosed During Due Diligence

UCC Holdings Co., Ltd. v. [undisclosed individuals], Osaka District Court, July 25, 2011

- Background tax controversy:
 - Twin Tree KK owned all of the shares of Shaddy Co., Ltd. Potential tax claim against Twin Tree arose in connection with Twin Tree's purchase of Shaddy Co. shares
 - In January 2000, in connection with a prior consultation, the Japan National Tax Agency suggested to sellers of Shaddy Co. that the agency was considering a tax on the manner in which the Shaddy Co. shares were transferred to Twin Tree
- In 2005, UCC began its due diligence over its acquisition of Twin Tree and retained Mori Hamada & Matsumoto as legal counsel

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Case (*continued*)

- On September 25, 2005, parties entered into a stock purchase agreement for the sale of the Twin Tree shares, which provided:
 - (a) There are no disputes or discrepancies in view between Twin Tree and any tax authorities, and, to the best knowledge of the Sellers, there are no threatened disputes
 - (b) The Sellers shall not be liable to the Buyer if they have sold the Shares to the Buyer after expressly disclosing the facts that constitute the breach of the Sellers' representations and warranties prior to the Closing Date

- On April 18, 2007 (post-closing), Twin Tree (now a subsidiary of UCC) was investigated by local tax authorities and assessed a corporate income tax in connection with its acquisition of Shaddy Co.

- On September 6, 2007, UCC agreed with the tax authorities to file an amended tax return and paid JPY232,591,550 as additional corporate income tax and tax advisory fees in the amount of JPY2,347,221

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Case (*continued*)

- UCC sought indemnification from the Sellers of Twin Tree for the additional corporate income tax and tax accountant advisory fees
- Court found for the defendants/Sellers of Twin Tree
- Court held that even though defendants breached a R&W, since the defendants directly explained to Mori Hamada & Matsumoto (UCC's legal counsel) the details of the subject tax controversy and delivered to the law firm documents that contained the National Tax Agency's reservation of rights to challenge the share purchase transaction, then such disclosure placed UCC on notice about the possibility of Twin Tree having to amend its tax return (and may need to pay additional corporate income taxes)

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Sample Provision

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Liquidated Damages



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Case

*Sumitomo Trust Bank v. UFJ Bank, Tokyo District Court,
February 13, 2006*

- On May 21, 2004 Sumitomo Trust Bank and UFJ Bank entered into a letter of intent for a business alliance
- The letter of intent contained a clause that the respective parties shall not, whether directly or indirectly, provide information to or consult with third parties in relation to transactions that may conflict with the purposes of the letter of intent
- On July 13, 2004, UFJ verbally notified Sumitomo Trust Bank that it is withdrawing from the negotiations in order to integrate with the Mitsubishi-Tokyo Financial Group (*written notice delivered shortly thereafter*)

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Court Decision

- Tokyo District Court found that UFJ breached its exclusive negotiation obligation under the letter of intent
- Tokyo District Court dismissed Sumitomo Trust Bank's claim for lost profits by reasoning that such damages do not fall under damages that have adequate causation relationship with UFJ's breach of an exclusive negotiation covenant
- Subsequent litigation appealed to the Tokyo High Court and the parties ultimately settled for a JPY2.5 billion payment from UFJ to Sumitomo Trust Bank

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Penalty vs. Liquidated Damage Payments

- Under Japanese law, a plaintiff is required to prove the amount of damages suffered, absent any provisions to the contrary in an agreement
- Under Article 420(3) of Japan's Civil Code, a liquidated damages clause can be helpful because it establishes a fixed amount of damages without the requirement to demonstrate that damages were suffered (let alone the amount of damages incurred); however, damages will be fixed at such amount
- Characterizing a payment as a “penalty” can be helpful because it enables a party to establish a threshold for damages that must be paid, and the plaintiff can collect further damages if such additional amount can be proved (so not limited to a liquidated damage amount)
- To qualify for “penalty” characterization, should specifically state in the agreement that the aggrieved party shall be entitled to “X” plus additional damages that are proven
- A liquidated damage and a penalty amount will be considered null and void if the amount is set so high that it contravenes Japanese “public policy” (*undefined*)

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Common Contract Usage

- Letter of Intent
- Confidentiality agreement
- Business acquisition agreement (special indemnity section)

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Entire Agreement Clause



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Case

Sharp corporation v. Hann Star Display, Tokyo District Court, December 25, 2006

- Sharp entered into a license agreement to grant a certain patent license to Hann Star Display Corporation (Taiwan)
- Hann Star Display argued that Sharp agreed to provide it with a “most favored nations” status with respect to pricing, even though the license agreement was silent on this point
- License agreement contained the following clauses:

“This agreement constitutes the entire understanding and agreement of the parties with respect to the subject matter hereof, and supersedes all prior agreements, express or implied, and oral and written.”

“No modification or amendment hereof shall be valid or binding upon the Parties, unless made in writing and duly executed on behalf of the Parties by their respective duly authorized officers.”

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Court Decision

- Since the license agreement contains an entire agreement clause, even if the parties agreed to a most favored clause prior to the execution of the license agreement, it is difficult to find that the parties intended to comply with any most favored rights since such provisions are absent from the final agreement
- Amendment modification clause in license agreement thwarts claims by Hann Star Display that a subsequent mail contained a binding “most favored nations” agreement because such mail communication could not be considered executed by a “duly authorized officer” of Sharp

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Parol Evidence Rule

- *Rule:* Parol evidence rule in common law countries provides that where the parties to a contract embody their agreement in writing and intend the writing to be the final expression of their agreement, then the terms of the writing may not be contradicted by evidence of any prior written or verbal agreement
- There is no parole evidence rule in Japan – judges may freely determine the evidence presented and make their own findings

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Effect of “Entire Agreement” Clause under
Japanese Law

- Since no parole evidence rule in Japan, parties to a dispute governed by Japanese law can introduce agreements made outside the contract (*unless the contract speaks for itself on its face*)
- **Should include an “entire agreement” clause to reduce the ability of a claiming party to introduce non-contractual agreements**

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**Effect of “Entire Agreement” Clause under
Japanese Law (*continued*)**

- *Compare with Walt Disney Japan KK v Planet Hollywood Japan KK, Tokyo District Court, April 7, 2009*
 - “It is doubtful whether at the time the Agreement was executed, Defendant had any expectation of what is called ‘Disney Branding’ when operating the restaurant; therefor we cannot accept Defendant’s assertion that there was an agreement between Plaintiff and Defendant that Plaintiff shall have a Branding Obligation.”
- Goal is to prevent a claim being considered by a judge (time, expense issue and settlement posture)

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Reasons for this Provision

- Reduces the risk that the express provisions of an otherwise unambiguous contract will later be supplemented, or even altered, through *external communications (subject to certain exceptions, as explained in the following slides)*
- Gives the parties greater certainty that the terms set forth in the executed agreement are the terms that will govern the parties' relationship

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Exception #1—Fraudulent Inducement

- Japanese law does not prevent a party from introducing evidence to show that he/she was fraudulently induced to enter into the agreement by false representations made during the contract negotiation process
- FIX: *“In entering into this Agreement, neither party has relied upon any statement, representation, warranty, or agreement of the other party except for those expressly contained in this Agreement.”*

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Exception #2—Course of Dealings/Usage of Trade

- Japanese law does not preclude a party from attempting to explain, supplement or even qualify the express terms of a written contract through a prior course of dealings or usage in the trade
- FIX: *“The provisions of this Agreement may not be explained, supplemented or qualified through evidence of trade usage or a prior course of dealings.”*

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Omit an Entire Agreement Provisions?

- Parties have entered into a side-deal reflected in a written agreement that vary the terms of the main agreement (often to avoid disclosing the terms of the side deal to a third party)
 - EXAMPLE: side-letter from buyer to selling detailing the calculation of EBITDA or an earn-out provision
 - FIX: (1) include entire agreement provision in main agreement and indicate in side-letter that it intentionally supplements the main agreement and/or (2) have side-letter dated later than main agreement
- Concern that an entire agreement provision will cause another unrelated agreement among the parties to be considered superseded (e.g., sequential purchase orders)
 - FIX: question of fact regarding the parties' intent (so no easy fix), but ambiguity reduced if contract expressly confirms the continuing force and effect of other agreement.

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Indemnification Claims



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Case

*Tokyo Catering Co., Ltd. v. Sorun Corporation, et. Al.,
Tokyo District Court, July 26, 2007*

- Parties entered into a stock purchase agreement for the sale of Kawakami Ltd. (a subsidiary of Sorun), which operated *izakaya* restaurants throughout Japan. The purchase price was JPY5 million
- Sellers represented and warranted to Buyer that *all the information contained in any document or material that was delivered or disclosed to Buyer or its advisors by Sellers or Kawakami are true and correct and do not omit any material information* (the “**Accuracy Representation**”)

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Case (*continued*)

- Buyer discovered post-closing that information:
 - *not disclosed*
 - (a) **Totsuka store's JPY19.5 million early lease termination penalty was not disclosed**
 - (b) Kawakami account receivable in the amount of JPY785,2000 uncollectible due to the debtor's bankruptcy was not disclosed
 - (c) Matsumoto Station Midori Building store deposit reduced by JPY1 million was not disclosed
 - *inaccurate*
 - (a) Kashiwa store deposit was JPY1.4 million, not JPY5 million
- Buyer made an indemnification claim against Sellers due to a breach of the Accuracy Representation

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Court Decision

- Court held that since it is extremely difficult to disclose fully and without any error all the information that is necessary to assess the assets and liabilities of a target company and it is unrealistic to require that all possible items be disclosed and be warranted to be accurate, the Accuracy Representation should be interpreted as a warranty that the disclosed information that would affect the decision whether to acquire the target company or how to decide the amount of consideration does not contain any *material* discrepancy or error
- Court held that only the Totsuka store's JPY19.5 million early lease termination penalty was material (and **not** the other alleged breaches)

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Defining Materiality

- Court imposed its sense of “materiality” into a contract. Parties may wish to avoid such a pro-active approach from the bench
- Defining materiality using subjective terms may not be helpful
- Utilize the indemnity section and create an indemnity basket
- If there are specific concerns, a Buyer should not rely on a “catch-all” representation and warranty from Seller

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Sample Provision

Indemnification

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Sample Provision

Closing Condition

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Case

UCC Holdings Co., Ltd. v. [undisclosed individuals], Osaka District Court, July 25, 2011

- Stock purchase agreement provided that if any losses arise from the Buyer's action without prior consultation with the Sellers, then the Sellers shall not be required to indemnify for such losses
- UCC paid the local tax authority and advisors without contacting the Sellers (*see slide 22*)
- Court held that UCC's damages arose from it acting without prior consultation with the Sellers, so UCC should not be entitled to indemnification for such amounts

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Method of Asserting Third Party Claims

- Procedures to notify claim
- Designate who should be entitled to control the defense
- Exceptions for when a party cannot control the defense (e.g., conflict of interest, claim relates to a criminal proceeding, adverse holding could impact business reputation, third-party is a government authority, etc)
- Written consent to settle third party claim
- Unconditional release with no injunction or criminal liability

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Closing Remarks

- Commercial litigation does exist in Japan
- Court-backed legitimate reasons to request certain contractual language
- Suggested drafting tips do not provide a blanket guarantee:
 - no doctrine of lower court precedent *per se*
 - judges may pursue own sense of fairness
 - career judges + litigation outside major commercial centers subject to further risks
 - no jury system for commercial disputes

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Closing Remarks (*continued*)

- Carefully draft language, as US-style wording may lead to friction under Japanese law / Civil Code system
- Consider arbitration as a dispute resolution mechanism based in a neutral forum (*especially in a cross-border transaction due to enforcement reasons*)

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Thank You !

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