Minority Investments in Japanese Publicly-Traded Companies

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Acquisitions of minority equity stakes in Japanese publicly-traded companies are attracting greater interest from investors, whether as passive investments, strategic acquisitions, or as first-step purchases towards a future business combination. This heightened interest in Japanese publicly-traded equities is likely being driven by a number of factors, including (i) the recent decline in value of Japanese equities following the rapid rise in the value of the Nikkei 225 index since the introduction of "Abenomics," (ii) statements by the Bank of Japan's Governor Haruhiko Kuroda that monetary easing in Japan may even accelerate, (iii) the return to profitability of many Japanese companies, especially companies that export products from Japan, and (iv) the depreciation in the value of the Japanese Yen against most major currencies (which is beneficial for investors who convert foreign currency into Japanese Yen to fund their equity investment).

In structuring and negotiating the terms of a minority investment in a Japan-domiciled company that has shares publicly trading on a stock exchange in Japan (a "Public Company"), investors must unravel a number of issues that may not emerge in a typical change of control buyout transaction. Such issues may depend upon the long-term investment strategy of the investor, the size of the proposed investment as a percentage of the Public Company's outstanding float, the regulatory regimes applicable to the Public Company,

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and the amount of control that the investor seeks over the Public Company.

This article outlines the main methods of acquiring a minority interest, then proceeds to highlight some of the issues that investors may wish to consider in connection with planning a minority investment in a Public Company, and concludes with some thoughts from the perspective of a Public Company directors facing the prospect of a minority investment.

Methods to Acquire a Minority Interest

Typically, an acquisition of a minority interest in a Public Company can take one of two forms: (i) the investor may purchase the Public Company's shares in the open market, or (ii) the investor may acquire the Public Company's shares in an off-market private transaction directly from a large shareholder or the target company.

The following are some of the benefits and trade-offs when acquiring a minority interest in a Public Company through open market purchases and off-market private transactions:

Open Market Purchases. Acquiring shares of a Public Company over the applicable stock exchange is particularly advantageous in light of this method's implementation ease and execution speed. Open market purchases normally can be arranged and completed within a few days, and most likely even shorter if the investor already has a relationship with a domestic stock broker and there is sufficient liquidity in the Public Company's shares. The foregoing can be significant advantages if the minority investor does not expect the Public Company to welcome the investor's share accumulation. On the other hand, there are significant disadvantages to open market purchases, including the lack in certainty of the purchase price (as the price will depend on prevailing market conditions), the inability to rapidly accumulate a sizeable block if there isn't sufficient trading liquidity in the securities of the Public Company and the risk that the intentions of the minority shareholder will become publicly known (which could cause a spike in the Public Company's share trading price). Although an investor is required to make a publicly available filing if it acquires more than 5% of the outstanding shares of a Public Company (as more fully discussed below), open market purchases are frequently advantageous for minority investors who seek to stealthily acquire a meaningful foothold before publicly announcing a larger share acquisition.

Off-market Purchases. An investor also can purchase shares of a Public Company outside the stock market by either acquiring a block of shares from an existing shareholder or subscribing for new shares directly from the Public Company. There are various considerations as to whether a block trade or a share subscription is the best approach, such as:

- Acquiring a block of shares from an existing shareholder normally can be completed more quickly and with fewer regulatory hurdles in comparison to a share subscription, and can be a transaction form more conducive to supporting an investor's request for representations and warranties and indemnification from the selling shareholder (assuming the selling shareholder is not a purely financial investor). However, a block trade is not a panacea as it is premised on the existence of a single shareholder owning a sufficient number of shares in the Public Company (which may not be the case) and the Public Company will receive none of the proceeds from the investor's share purchase (which could be viewed as an unattractive direction of funds from the investor's point of view if the Public Company has financial issues).

- Because a new share allotment requires the approval of a Public Company's board of directors, acquiring shares directly from an issuer can occur only on a consensual basis (regardless of the number of shares to be allotted). A hostile investor will be left at the altar if it seeks to subscribe for shares directly from the issuer. A large new share allotment can be more cumbersome to implement in comparison to a block trade if the Public Company will allot 25% or more of its outstanding voting shares in a single transaction or series of related transactions to the same

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investor (or group of related investors) or the Public Company's controlling shareholder will change as a result of the proposed share allotment, because under such circumstances the Public Company must obtain either (i) an opinion from a person independent from the Public Company's management confirming the necessity and reasonableness of the proposed share allotment, or (ii) the vote of a majority of the Public Company's shareholders approving the proposed share allotment. On the other hand, while a new share allotment may take longer to complete than a block trade, it can offer a number of benefits to an investor, including providing the investor with due diligence access and the ability to negotiate ongoing board nomination and information access rights.

In light of the consensual nature of the transaction, the expected duration of the investment relationship and the potential for board nomination and information access rights, the new share allotment method is ordinarily the preferred approach when a strategic investor desires to make a minority investment in a Public Company.

Japanese Legal Considerations

An investor may wish to consider the following Japanese legal issues when making a minority investment in a Public Company, regardless of the acquisition method:

Tender Offer Rules. An investor should be extremely careful to structure the timing, manner and number of shares that it acquires in a Public Company in order to avoid triggering the application of Japanese tender offer rules to its contemplated purchase. Very generally speaking, under Japanese tender offer rules an investor is required to launch a mandatory general offer open to all shareholders of a Public Company if the investor's ownership interest in the outstanding voting shares and certain derivative securities (as defined under Japanese securities laws) of a Public Company will exceed one-third as a result of its acquisition of such company's shares in an off-market transaction. For example, an investor already owning 13.3% of the outstanding voting shares of a Public Company would not be able to subsequently acquire more than an additional 20% of the outstanding voting shares of such company directly from shareholders in an off-market transaction (*e.g.*, by entering into a stock purchase agreement with a major shareholder) without launching a tender offer open to all shareholders of the Public Company. In addition, Japanese tender offer rules apply if an investor acquires more than 5% of the outstanding voting shares of a Public Company through transactions conducted "outside the market" with more than 10 persons during a rolling 60-day period.

The purpose of requiring the mandatory application of Japanese tender offer rules in certain circumstances is that if an investor (i) obtains substantial control over a Public Company, which equates under Japanese securities laws to owning one-third or more of the outstanding voting shares in a Public Company (since this threshold would allow the investor to veto material matters, such as the approval of a merger involving the Public Company), or (ii) accumulates shares of a Public Company through transactions negotiated directly with a seller that do not clear through the applicable stock exchange (*i.e.*, shares acquired "outside the market"), then not only the major shareholder that sells the shares to the investor but the Public Company's minority shareholders also should have the opportunity to participate in the sale.

Complying with Japanese tender offer rules will increase the time it will take to complete an investment (since a Japanese tender offer must remain open to all of the Public Company's shareholders for at least 20 business days), and add to the investor's overall transaction costs and completion risks. As a result, it is difficult to imagine a scenario where devising an acquisition structure that requires compliance with Japanese tender offer rules would promote the interests of an investor that seeks to acquire only a minority interest in a Public Company.

Antitrust. Even when a minority interest is acquired, compliance with Japanese antitrust laws and regulations is not automatically obviated. If an investor will acquire more than 20% of the outstanding voting shares in a Japanese company (ei-

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ther a publicly or privately-held company), then a notification 30 days prior to the target acquisition date will need to be filed by the investor with the Japan Fair Trade Commission if during the most recently completed fiscal year revenues from sales made in Japan by the (i) investor and its "corporate group" (as defined under Japanese antitrust laws) exceeded 20 billion Japanese Yen and (ii) target company and its subsidiaries exceeded five billion Japanese Yen. The 30-day standstill period can be shortened at the discretion of the Japan Fair Trade Commission. Failure to comply with the notification requirements under Japanese antitrust laws can lead to a monetary penalty payable by the investor of up to two million Japanese Yen and the imposition of criminal sanctions on members of the investor's management team.

Foreign Ownership Restrictions. Pursuant to Japan's Foreign Exchange and Foreign Trade Act, if a foreign investor acquires (either directly or along with its affiliates) 10% or more of the outstanding shares of a Japanese company (either a publicly or privately-held company), then the investor must file a notification with Japan's Ministry of Finance and the Japanese economic ministry overseeing the industry in which the target company operates by the 15th day of the month *after* the month in which the acquisition closes. The notification is a short-form document and typically takes only a few days to prepare, and is not publicly available. A filing *before* an acquisition followed by a 30-day waiting period is required pursuant to Japan's Foreign Exchange and Foreign Trade Act depending on the country of origin of the investor or if the target company or any of its subsidiaries engage in a business that is either deemed to be critical to Japan's national security (*e.g.*, weapons, aircraft, and nuclear power) or engage in certain protected industries (*e.g.*, agriculture, petroleum, and leather). In the pre-acquisition filing context, the filing should be made no later than six months and no sooner than 30 days before the anticipated share acquisition date. The investor can proceed with the acquisition if it is not notified by the applicable Japanese ministry within a 30-day waiting period that its investment is blocked or subject to further review. The foregoing 30-day waiting period can be shortened depending on certain facts associated with the proposed investment (often down to 14 days). Failure to comply with the notification requirements under Japan's Foreign Exchange and Foreign Trade Act can lead to members of the investor's management team being subject to imprisonment for up to three years and/or the investor being required to pay a monetary penalty of up to one million Japanese Yen (however, if the amount of the investment for the violative transaction exceeds one million Japanese Yen, then the monetary fine can be increased to up to three times the amount of the investment).

To date, only one proposed foreign investment has been blocked pursuant to the rubric of Japan's Foreign Exchange and Foreign Trade Act—the proposed acquisition in 2008 by the Children's Investment Fund (a British hedge fund) to increase its holdings in J-Power, a Japanese electric wholesale company, from 9.9% to more than 20%. Japan's Ministry of Economy, Trade and Industry objected to the ownership increase based on the argument that the purpose of the Children's Investment Fund was to maximize profits, which was incompatible with J-Power's function as an energy provider to Japan.

In addition to restrictions under Japan's Foreign Exchange and Foreign Trade Act, a foreign investor also should bear in mind whether there are any industry-specific regulations that could impact its ability to acquire an ownership interest in a target Japanese company. For example, there are specific regulations restricting foreign ownership in Japanese companies engaged in broadcasting, air transportation, and telecommunications.

Share Ownership Reporting Requirements. Under Japan's Financial Instruments and Exchange Act, if an investor (domestic or foreign), together with its affiliates (which is defined by statute to include other persons with whom the investor has formed a group), acquires more than 5% of the outstanding shares of a Public Company, then the investor must file with the Local Finance Bureau a "Large Shareholding Report" within five business days from the date on which it acquired its 5% interest. The Large Shareholding Report requires the investor to disclose various kinds of information about itself and the

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share purchase, most importantly (i) the percentage of the outstanding shares of the Public Company beneficially owned by the investor, (ii) the purchase price for the shares acquired by the investor and the source of funds used to finance the acquisition(s), (iii) the purpose of the investment, and (iv) a summary of any agreements relating to the share acquisition (including, any put option, call option, or right of first refusal). In addition to an initial filing, an investor is required to file an amendment to its Large Shareholding Report within five business days upon a decrease or increase in its ownership by more than 1% of the outstanding shares of the Public Company or upon any other material change in the contents of its Large Shareholding Report. Certain financial institutional investors that do not intend to control the Public Company are eligible to report initial acquisitions and subsequent changes on a relatively more delayed basis.

In light of the disclosure obligations necessitated by the requirement to file a Large Shareholding Report, a minority investor would not be able to clandestinely acquire a large block of a Public Company's shares unless it rapidly accumulates shares prior to the filing date of its Large Shareholding Report (which, depending on the Public Company's historical trading volume, may not be a cost-effective option as sudden large purchases could cause the trading price of the Public Company's shares to spike and rumors to circulate). Failing to timely file a Large Shareholding Report or including a material misstatement (or an omission) exposes a first-time delinquent investor to a monetary penalty equal to 0.001% of the total market value of the Public Company as of the date when the Large Shareholding Report should have been filed (in a failure-to-file case), or the filing date of the defective Large Shareholding Report (in a material misstatement/omission case). This formula applies regardless of the number or percentage of shares held by the delinquent investor, and the penalty amount increases by 150% if the investor was subject within the past five years to a monetary penalty arising from a violation of Japanese securities laws.

Poison Pills. Many Japanese blue chip companies have adopted so-called "poison pills" in an effort to foil a hostile takeover. There is no one-size-fits-all "poison pill" in Japan; however, a popular variant is the "advance warning" pill. In this defense, generally speaking the subject company discloses in advance the type of information that it seeks from any would-be acquiror of a large block of the company's shares. The subject company also typically sets a waiting period, such as 60 days, that it seeks an acquiror to observe before purchasing the subject company's shares. If the acquiror does not follow these rules, or if the target company's board (or a special committee) concludes that the offer is likely to damage shareholder value, then the board may thwart the acquiror's share purchase plan by issuing warrants exercisable by all other company shareholders.

Whether a Public Company has adopted a "poison pill" and the details of the plan are both matters of public record. Accordingly, before acquiring a large amount of a Public Company's shares in the open market, it is imperative for an investor to research whether the Public Company has adopted a "poison pill" and, if so, to understand the contours of the plan. As "poison pills" adopted by Japanese companies typically permit its board of directors to waive the application of the "poison pill," the potential negative economic consequences to an investor associated with the triggering of a "poison pill" should not exist if the investor acquires shares directly from the Public Company. However, the initial waiver of the application of a "poison pill" ordinarily is not an evergreen pass for future share acquisitions, so an investor owning shares in a company with a "poison pill" should balance the likelihood of the investor seeking to acquire additional shares in the Public Company against the likelihood of the Public Company triggering its "poison pill" against subsequent share accumulations by the investor.

Public Disclosure Requirements. The Public Company and the investor ordinarily desire to keep a contemplated minority investment confidential until the transaction is completed. From the viewpoint of the Public Company, confidentiality is important because a minority investment that will be accomplished through a new share issuance could have a negative impact on the trad-

ing price of the company's shares in light of the dilutive nature of the new share issuance and the potential "shorting" activities that arbitrageurs may undertake (and a lower trading price for the Public Company's shares could allow the minority investor to demand a lower purchase price). Similarly, an investor would want to keep confidential a proposed subscription for newly-issued shares if there is a reasonable likelihood that the trading price of the Public Company's shares could increase in light of the stature of the investor or the proposed strategic relationship that would be forged between the Public Company and the investor. A sudden spike in the trading price of the Public Company would be problematic not only to the investor given the potentially higher acquisition price for its minority investment, but to the directors of the Public Company because they could be held personally liable if the Public Company's board approves a stock issuance at a "substantially favorable" price without shareholder approval (as more fully discussed at the end of this article).

The rules and regulations of the Tokyo Stock Exchange (and not Japanese corporate or securities laws) govern the disclosure obligations of a Public Company.

Insider Trading Concerns. An investor owning a block of shares in a Public Company will need to consider whether Japan's insider trading rules will impact the investor's ability to management its investment. An investor with information access rights, board appointment rights, or who has entered into a strategic alliance with the Public Company is particularly susceptible to receiving insider information. Should an investor be subject to Japan's insider trading rules, then its investment in the Public Company could be frozen at suboptimal times (with potentially lucrative opportunities lost).

Article 166 of Japan's Financial Instruments and Exchange Law provides that "insiders" (which term includes directors, officers, employees, agents, and shareholders owning more than 3% of a Public Company and its parent company and subsidiaries) who receive "material information" are prohibited from trading or otherwise transferring securities of the Public Company until the "material information" has been made public. Japanese securities laws do not rely solely on a catch-all description to define "material information," such as any information that a reasonable investor would consider important when making an investment decision. Rather, Japanese securities laws also provide specific examples of events that are automatically considered "material information," such as the issuance or repurchase of shares, cancellation of a business collaboration, suspension of business, and material changes in published financial forecasts. Insiders (and as a result of recent amendments, tippers as well) who violate the insider trading prohibition are subject to imprisonment for up to five years and/or a maximum fine of five million Japanese Yen, plus a hefty administrative fine. If an officer of a corporation violates the insider trading prohibition for the benefit of his employer, then the employer-corporation also can be subject to a maximum fine of five hundred million Japanese Yen.

As the use of "Big Boy" letters is not an effective shield in Japan, counsel should be consulted at the outset of a block investment to devise methods to help cleanse an investor from possessing "material information."

Conclusion

As owning an interest in Public Companies becomes more attractive to investors, the directors of Public Companies may actively seek minority investors for potentially very different business reasons—placing a large block of shares with a "friendly" stable investor could be a useful defensive measure to help insulate the company from a hostile acquiror. At the same time, placing newly issued shares with a desirable minority investor will require the directors of a Public Company to consider a host of business and legal issues. The methodology used to determine the share allotment price is typically the board's most critical legal decision.

Under Japan's Companies Act, the board of directors may not authorize the issuance of shares at a "substantially favorable" price without obtaining the approval of a supermajority of the company's shareholders. A subscription price is

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not considered to be "substantially favorable" if the price is "fair." As a matter of black-letter Japanese corporate law, the question of what constitutes a "fair" or a "substantially favorable" price is open-ended. The answer depends on all of the facts and circumstances of the particular share issuance, as determined by the court. However, a well-established principle is that if the price for the new shares is based on the trading price for the shares as of the date the board makes its decision to issue the shares in the allotment, then the purchase price ordinarily will not be considered "favorable" if the subscription takes place within a reasonably short period after the board's approval for such share allotment to the investor. Japanese courts also have generally considered a discount of 10% from the market price as not constituting an issuance at a "substantially favorable" price.

An investor should be sensitive to the legal issues faced by the directors of a Public Company when structuring its investment proposal. If the board does not support the investor's acquisition proposal, then the investor most likely will face an uphill battle. Of even greater consequence, an investment opportunity could be forever lost or trust irreparably broken if an investor proposes an investment plan that could expose the Public Company's directors to personal liability or could lead the Public Company to excessive scrutiny. Accordingly, careful planning and expert advice is needed to negotiate an investment that is favorable to the investor and at the same time can be embraced by the Public Company.