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Structuring an Acquisition in Japan

1. Process for Acquisition

The length of the process for acquiring a business can vary, depending on a number of factors, including the size and type of assets being acquired or sold, the type of target company (whether public or private), the level of due diligence required and the length of time needed to obtain required regulatory approvals.

An auction will normally be structured as a two-phase process. In phase one, the seller will usually require the potential buyers to submit a non-binding indication of interest, which typically will address, among other things, the indicative offer price, proposed deal structure, possible conditions that the buyer may seek and necessary regulatory approvals. In phase two, a few selected buyers will be given access to the data room for due diligence and will be required to submit their final bid, together with a mark-up of the draft transaction agreement circulated by the seller. After final bids are submitted, the seller will seek to negotiate and finalise the transaction agreement quickly so that the signing can occur as soon as practically possible. After the signing, the parties will seek any applicable regulatory approvals or clearances for the transaction, such as antitrust clearance and any required prior notification under the Foreign Exchange and Foreign Trade Act (FEFTA).

The FEFTA provides some restrictions on foreign investment in certain restricted businesses. A foreign investor is required to file prior notification with the Minister of Finance and the competent minister for the business and wait a specified period (which is in general 30 days and in many cases shortened to two weeks but may be extended up to five months in a rare case) if: i) the foreign investor intends to acquire shares of a private company (except an acquisition of shares of a private company from another foreign investor, unless the acquisition may have potential risk of harming national security) or more than 10%[1] of the shares of a listed company; and ii) the target company engages in certain restricted businesses identified in the FEFTA, including business regarding national security, public order or public security. After the review, the ministers may order the foreign investor to change or discontinue the plan of investment. Although the scope of businesses identified as a restricted business was expanded under the 2019 amendment to the FEFTA, orders to change or discontinue an investment have rarely been made.

In an acquisition involving a tender offer, the tender offer period must be set between 20 to 60 business days. If the acquisition is effected through a two-step process where the tender offer is followed by a second-step squeeze-out of the remaining minority shareholders who did not participate in the tender offer, the process of the second step will depend on the level of shareholding that the acquirer owns after the first-step tender offer. If an acquirer owns 90% of the voting rights of a target company, the acquirer can

[1] Reportedly, the Japanese government is considering an amendment to lower this threshold to 1%.

complete the second step rather quickly (typically around one month) by exercising the squeeze-out right. In cases where the acquirer is unable to achieve the 90% threshold in the first-step tender offer, the second step will usually take a few months, because in those cases the second step will require the target company to convene a shareholders' meeting and to complete the court permission procedures.

2. Mandatory Offer Threshold

With respect to a listed company (and some other types of companies), the Financial Instruments and Exchange Act (FIEA) provides specific requirements for a mandatory tender offer. Overall, the primary threshold for a mandatory tender offer is one third of the voting rights of a target company (One-Third Rule). Therefore, subject to certain limited exceptions, an acquirer must conduct a tender offer if the "total shareholding ratio" (*kabukentou shoyu wariai*) of the acquirer exceeds one third after the purchase and the purchase is made in off-market trading or off-floor trading (ie trade-sale-type market trading). This means that an acquirer cannot obtain, for instance, a 40% stake of voting shares from the principal shareholder of a listed company through a private buy/sell transaction. The "total shareholding ratio" is defined in detail in the FIEA and the calculation generally includes the aggregate voting rights of the target company held by the acquirer and certain special affiliated parties (*tokubetsu kankeisha*) of the acquirer (on an as exercised and as converted to common stock basis).

The one-third threshold for this purpose derives in part from the requirement under the Companies Act for a special resolution of the shareholders for certain important actions (ie merger, amendment to the articles, dissolution), which requires approval by two thirds of the voting rights present at the relevant shareholders meeting. Therefore, ownership exceeding one third of the voting rights will effectively grant a shareholder a veto right over any special resolution of the shareholders at a shareholders' meeting.

In addition to the One-Third Rule above, a few other situations where a mandatory tender offer is required are generally summarised as follows:

5% Rule - if the total shareholding ratio of an acquirer exceeds 5% as a result of an off-market purchase. An exception applies to the 5% Rule if the acquirer has not purchased shares in off-market trading from more than ten sellers in aggregate during the 60 days before the day of the purchase on which the threshold is crossed (ie during a 61-day period including the date of the threshold-crossing purchase).

Rapid Buy-Up Rule - if the total shareholding ratio of the acquirer exceeds one third as a result of the acquisition of shares within a three-month period, whereby: a) the acquirer accumulates more than a 10% shareholding through on-market trading, off-market trading and subscription of newly issued shares from the company; and b) that accumulation includes an accumulation of more than 5% through off-market and off-floor trading (ie trade-sale-type market trading). The Rapid Buy-Up Rule was introduced in 2006 with the primary aim of capturing a combination of on-market and off-market trading or a combination of off-market trading and new share issuances,

which in each case would result in an acquirer holding more than a one-third total shareholding ratio. This effectively means that, for example, if an acquirer obtains 30% of the voting shares through off-market trading, it cannot then purchase additional shares during the next three-month period at market, off-market (including a tender offer) or otherwise that would result in its shareholding ratio exceeding one third.

Counter Tender Offer Rule - if, during the period in which there is an ongoing tender offer by a third party, an acquirer with an existing shareholding ratio of more than one third purchases more than a 5% additional shareholding. The Counter Tender Offer Rule effectively captures on-market trading, because off-market trading resulting in a total shareholding ratio exceeding one third will be subject to the One-Third Rule in any event.

3. Consideration

While cash is more commonly used as consideration in acquisitions, the type of consideration varies depending on the nature and structure of the acquisition.

In a share purchase or business transfer, the consideration has been predominantly cash-only. However, an exchange offer through which the acquirer offers its own securities as consideration in a tender offer is legally permitted and there is special legislation specifically relaxing the rules related to such exchange offers under certain circumstances where the transaction is pre-approved by the relevant government ministries. The special legislation was amended in 2018, for example, to expand the scope of such pre-approved transactions from tender offers only to a "transfer" in general, which would include a sale of privately held shares. The amendment also resolved a taxation issue of the selling shareholders and now allows deferral of taxation on capital gain if the acquirer obtained the approval of a "special business combination plan" from the relevant governmental ministries. There is a caveat, however, that such special business combination plan which allows the deferral of taxation for the selling shareholders can be obtained only where a corporation (*kabushiki kaisha*) incorporated under the laws of Japan offers its own shares as the consideration of the transaction (i.e., such deferral of taxation is not available where the consideration offered is shares of a Japanese or foreign parent company).

In a statutory business combination, such as a merger, share exchange (*kabushiki koukan*) or company split (*kaisha bunkatsu*), stock is more commonly used as consideration, although cash or another consideration is legally permitted and it is often seen in the case of a company split.

A mix of cash and stock is not common in Japan. The aforesaid amendment to the special legislation allows a mix of cash and stock, although the special business combination plan which allows the deferral of taxation for the selling shareholders is available only where the full consideration is stock of the acquirer.

However, a cash tender offer followed by a second-step stock-for-stock merger or share exchange is often seen and this structure effectively provides the shareholders with the choice of cash or stock.

4. Common Conditions for a Takeover Offer

The FIEA strictly regulates tender offer conditions and permits the withdrawal of a tender offer only upon the occurrence of certain narrowly defined events. Those withdrawal events must also be specifically provided in the tender offer registration statement. The withdrawal events include:

- a decision by a target company to make a material change, such as a merger, reduction of capital stock split and issuance of new shares;
- the occurrence of a material event with respect to the target company, such as damage due to a natural disaster;
- the failure to obtain regulatory approvals; and
- the occurrence of a material event with respect to an acquirer, such as dissolution and bankruptcy.

A financing condition is not permitted and an acquirer must prepare, as part of the tender offer registration statement, a document evidencing pre-arranged financing on a firmly committed basis. If the pre-arranged financing is subject to conditions, the substance of these conditions is generally required to be described in the statement.

In a statutory business combination, there are no specific limitations on conditions. However, in practice, the conditions in a business combination among listed companies are typically quite limited, such as necessary shareholder approval and regulatory approvals and clearances. A financing condition is not commonly used in a business combination because stock is more commonly used as the consideration for a business combination.

5. Irrevocable Commitments

If there is a principal shareholder of a target company, it is relatively common for an acquirer to obtain an irrevocable commitment from the principal shareholder to tender its shares in the target company in the contemplated tender offer. The commitment will be made in a written agreement (*oubo keiyaku*) which is negotiated prior to the announcement of the transaction by the parties. Where such a commitment exists, material terms of the commitment are disclosed in the tender offer registration statement.

The commitment may be negotiated to include a certain level of representations and warranties by the principal shareholder in relation to the business of the target company. It is also possible for the parties to negotiate a clause where the principal shareholder

will be required to revoke its tender upon the occurrence of certain events (ie material breach of representations and warranties by the principal shareholder or failure of the target company's board to recommend the contemplated transaction to the shareholders). However, by a combination of this clause and the minimum acceptance condition (that would not be satisfied but for the tender by the principal shareholder), the acquirer could essentially withdraw the tender offer in circumstances that would not constitute permissible withdrawal events under the FIEA. The regulator (FSA) has interpreted this type of clause as being subject to strict tender offer withdrawal restrictions under the FIEA (as explained above). For example, the agreement by a principal shareholder to revoke its tender on the failure of obtaining financing by a bidder would not be permitted because this falls outside the scope of the statutorily defined withdrawal events under the FIEA.

Whether this type of commitment agreement includes a clause that would permit the principal shareholder to refuse to tender in the event that a competing bid is made by a third party at an offer price higher than the tender offer price varies, depending on the type of principal shareholder (eg a founder, senior management, a private company, a listed company) and other factors. This is a matter of negotiation and may be incorporated in the commitment, particularly if the deal did not involve an auction process and the principal shareholder is interested only in the financial aspects of the transaction.

6. Minimum Acceptance Conditions

A minimum acceptance condition is permitted for a tender offer. Where a minimum acceptance condition is specified in the tender offer registration statement, an acquirer will not purchase any shares if the number of shares tendered is lower than that specified minimum number. If a minimum acceptance condition is set at the commencement of the tender offer, that minimum threshold may not be increased by the acquirer, but the acquirer may decrease or remove the condition.

In a 100% acquisition deal, the minimum acceptance condition is typically set such that the voting rights held by an acquirer after the tender offer will reach two thirds of a target company's voting rights on a fully diluted basis. The ownership of two thirds of the voting rights of the target company will ensure that the acquirer will be able to pass a special resolution of the shareholders at a shareholders' meeting (eg merger, amendment to the articles, dissolution). The acquirer will then proceed to the second step of the acquisition to squeeze out any remaining shareholders who did not tender their shares in the tender offer.

If an acquirer does not seek 100% ownership of a target company, the minimum acceptance condition is typically set such that the voting rights held by the acquirer after the tender offer will be a majority of the voting rights of the target company on a fully diluted basis. The majority ownership will allow the acquirer to pass an ordinary resolution of the shareholders at a shareholders' meeting (ie election of directors,

dividend). The primary purpose of a deal of this type is typically to allow the shares of the target company to continue to be listed on a stock exchange.

In addition, the acquirer may also set a maximum number of shares to be purchased by the acquirer, provided that the total shareholding ratio of the acquirer after the tender offer will remain less than two thirds (which means that the acquirer cannot set that maximum at a level of two thirds or higher). If the number of shares tendered exceeds that maximum number, the acquirer must purchase the tendered shares on a pro rata basis. If, for instance, a bidder sets both a minimum and maximum at the level of a simple majority, a majority acquisition can be achieved without purchasing all shares tendered.

7. Squeeze-out Mechanisms

In a tender offer for 100% of a listed company, the remaining shareholders who did not tender their shares in a successful tender offer will generally be squeezed out through a second-step squeeze-out mechanism.

In practice, if an acquirer owns 90% of the voting rights of a target company after the first-step tender offer (thereby becoming a special controlling shareholder), the acquirer will usually complete the second step by exercising a statutory right to force the other shareholders to sell their shares to the special controlling shareholder (the Squeeze-out Right), a mechanism recently introduced under the 2015 amendment to the Companies Act. To exercise the Squeeze-out Right, a special controlling shareholder must first notify the board of a target company of certain particulars regarding the squeeze-out, including the amount of consideration, and obtain the target company's approval to proceed. When the board approves the squeeze-out, the target company must then notify its shareholders of the particulars of the squeeze-out or make a public notice on or before the 20th day prior to the acquisition date. Upon exercising the Squeeze-out Right, dissenting shareholders will have the right to exercise appraisal rights. In addition, if the exercise of that right would violate law or the company's articles of incorporation or the consideration is grossly improper, the dissenting shareholders will have a right to seek an injunction.

In cases where the acquirer is unable to achieve the 90% threshold in the first-step tender offer, it may still implement the second-step squeeze-out through other means, such as the so-called "stock consolidation (*kabushiki heigou*) scheme" or the previously often used "wholly callable share (*zenbu shutoku joukou tsuki shurui kabushiki*) scheme", in each case to the extent that the acquirer holds two thirds of the voting rights of the target company (ie the threshold to pass a special resolution at the target company's shareholders meeting). Each of these alternative schemes normally takes a few months, as the process requires the target company to convene a shareholders' meeting and to complete certain court permission procedures (as described below).

A straightforward cash-out merger or statutory share exchange is legally permitted under the Companies Act, but traditionally not used because it was traditionally not

treated as "tax qualified," meaning that the target company would be required to revalue its assets at the then-current market value basis and recognise taxable gains from the transaction. However, under the 2017 tax reforms effective as of 1 October 2017, "tax qualified" treatment has become available in case of a merger or share exchange where a surviving or parent corporation has at least two thirds of the total outstanding shares of a disappearing or subsidiary corporation, and we may find an increase in the number of such cash-out mergers or share exchanges going forward.

In the share stock consolidation scheme, a target company will implement a stock consolidation in which the ratio of stock consolidation is set so that the shares held by each minority shareholder will become less than one full share of the target company. As the 2015 amendment to the Companies Act introduced certain protection mechanisms for minority shareholders, such as the appraisal right and the right to seek injunction under certain circumstances, the stock consolidation scheme has become a primary option to implement the second-step squeeze-out. In the wholly callable share scheme, the target company technically re-characterises its common stock as a type of redeemable share (so-called "shares wholly subject to call" (*zenbushutoku joukou tsuki shurui kabushiki*) that can be called/redeemed by the target company in exchange for a new class of shares. Similar to the stock consolidation scheme, the exchange ratio under the wholly callable share scheme is set so that each minority shareholder receives less than one full share of this new class of shares. The wholly callable share scheme used to be a primary option for the second-step squeeze-out, but is much less used after the 2015 amendment to the Companies Act.

In completing the stock consolidation scheme or the wholly callable share scheme, there is a procedure under Japanese law whereby the fractional interests that would be allocated to the minority shareholders will instead be sold by the target with court permission, with the minority shareholders receiving cash, usually in an amount substantially equivalent to the offer price used in the first-step tender offer.

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