PRACTICE GUIDES

Japan M&A

Contributing Editor
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LEXOLOGY
Getting The Deal Through

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Practice Guide

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Labour and Employment Issues in M&A in Japan

Akira Nagasaki[1]

Overview

For M&A transactions in Japan, typical key issues for employment and labour are:

- which employees are transferred;
- whether the buyer needs to keep the same terms and conditions for the transferred employees; and
- post-merger integration.

We shall additionally touch on issues typically observed in HR due diligence for M&A transactions in Japan.

Key statutes

Japan is a civil-law jurisdiction similar to continental European countries like Germany and France, and the law is based on statutes. The primary statutes applicable for employment and labour issues are the Labour Standards Act (LSA),[2] the Labour Contracts Act (LCA)[3] and the Labour Union Act (LUA).[4] The Companies Act[5] is the general statute that provides the rules for corporate governance, including various M&A transactions; however, the Companies Act provides almost no rules for employment and labour issues related to M&A. Additionally, a specific statute for employment and labour issues exists for a company split, as described later in this chapter.

1 Akira Nagasaki is a partner with City-Yuwa Partners.
2 Act No. 49 of 7 April 1947.
3 Act No. 128 of 5 December 2007.
4 Act No. 174 of 1 June 1949.
5 Act No. 86 of 26 July 2005.

Types of transactions – basic principle

The basic principle of the assumption of employment contracts in an M&A under Japanese law is that if the M&A transaction involves a 'comprehensive assignment' of the seller's rights and obligations to the buyer, employment contracts will be automatically transferred as-is as part of the transaction. The comprehensive assignment concept is similar to the common law concept of transfer by operation of law.

Share deal

In a share deal (typically the simple sale and purchase of shares[6]), legally the entity will remain unchanged with no transfer of employment contracts. Thus, typically, there will be no issues related to the transfer of employees and their employment contracts, except for certain benefits that require the company and employee being hired belonging to a particular corporate group, such as health insurance and pension plans. We explain this issue in the relevant section.

Asset deal (business transfer)

Under Japanese law, an asset deal is understood as an M&A transaction where an entire operating business unit, including its related contracts (which includes employment contracts) as well as its associated assets (eg, movables and immovables), are transferred from one legal entity to another. An asset deal is not a comprehensive assignment under Japanese law but a collection of individual assignments of related contracts and assets. Thus, to have the seller's employees transferred, the buyer needs to obtain consent from each and every employee involved.

Merger

A merger under Japanese law is a transaction where two or more companies legally fuse together to form one company. A merger is done by either two or more companies dissolving to create one new company (consolidation-type merger) or one company surviving and the other companies being dissolved and absorbed by the surviving company (absorption-type merger). All employment contracts will be assigned to the new company or the surviving company as-is, and there is no need to obtain individual consent from the employees.

Company split (demerger)

A company split (demerger) is the legal opposite of a merger. It involves splitting a company into two or more companies (incorporation-type company split) or transferring a business unit to another (absorption-type company split). The company split was introduced in 2001 to add a new M&A transaction with the effect of 'comprehensive assumption'. In a sense, a company split is a type of asset deal with a comprehensive assumption of the seller's rights and obligation by the new company or the absorbing company.

6 Other types of share deals are stock swaps and stock transfers, which are used to create holding companies. As the legal effects on employment contracts are the same as with a simple share sale and purchase, we shall not go into further detail on these categories.

Summary of types of M&A transactions

Transaction	Type	Individual consent from employees	Employee involvement (legal)
Share deal	Non-transfer	Not required	None
Asset deal	Individual transfer	Required	Yes, by way of requiring consent
Merger	Comprehensive transfer	Not required	None
Corporate split	Comprehensive transfer	Not required	Yes – notification and objection

Procedures for transfer

Overview

There is no obligation to consult employees in any of the M&A transactions outlined above, except for a company split. Unlike in some European jurisdictions, a Japanese company does not have a labour council or a similar body, and labour is not structurally represented in its management. Below, we explain the procedures for each type of transaction, focusing on the employment and labour aspects.

Share deal

A share deal will be executed between companies without any labour consultation. As noted, the company itself will not change, and for employees it will be status quo. However, if a company becomes a subsidiary of another company or a member of another group of companies, the management may wish to adjust the terms and conditions of employment to align with those of the parent company or the company group. We explain this issue in another section.

Asset deal

As noted, individual consent from the employees being transferred to another company is needed in an asset deal. Legally, the employment contract with the seller will be terminated, and a new contract will be entered into with the seller. In effect, the seller will negotiate the terms and conditions of the new employment contract to align them with its existing employees. However, because individual consent is required, the employees have the freedom to refuse the transfer and, as a matter of practice, it will be challenging to downgrade the terms and conditions of employment, while upgrading the terms and conditions will be relatively easy. Also, to obtain consent, it is typical to announce the transaction to all employees affected and hold a Q&A session, even if consultation with labour is not a statutory requirement.

In an asset deal involving numerous employees, conducting individual negotiations for obtaining consent may be impractical. Instead, consent is typically obtained by requesting the employees to sign a uniform consent form.

Merger

Unlike a share deal, the merging companies are structurally changed. For example, if two companies are merging, both companies are dissolved to form a new company (incorporation-type merger), or a company is dissolved and is absorbed into another company (absorption-type merger). Employment contracts are assumed as-is by the new company or the absorbing company. If the new company or the absorbing company wishes to amend the terms and

conditions of employment of the acquired employees to align with those of its existing employees, it needs to be achieved through a post-merger integration.

In Japan, a workplace with 10 or more employees needs to have in place work rules or rules of employment. Work rules may be a unique aspect of Japanese employment law. Work rules are similar to an employee handbook found in many companies worldwide and provide the basic terms and conditions of employment uniformly applicable to employees, such as work hours, holidays, leave, company discipline, etc. In a merger, the new company or the absorbing company will also assume the work rules, as they are considered to form part of the employment contract. The immediate result of the merger is having two or more sets of work rules in a single company. This may result in employees working under different hours and entitled to different holidays and other benefits depending on the company the employees came from. This is usually not a preferred outcome of a merger, and post-merger integration is a necessary process.

Company split

General process

A company split is unique among M&A transactions in Japan in that the law requires involvement by labour. This process is mainly covered by a particular statute that governs the procedure for the succession of the employees (Act on the Succession to Labour Contracts upon Company Split[7] (the Workers Assumption Act).

The general flow of the process is as follows:

1 The company will notify the employees to be transferred to the new company (in an incorporation-type split) or the absorbing company (in an absorption-type split) under the company split.
2 The subject employees have the right to object if they believe they were misclassified (ie, belonged to a division in the former company that was not subject to the company split).
3 If the company challenges the objection, the matter will be resolved through a dispute resolution process (typically, in court, but also mediation).
4 The Workers Assumption Act also requires the company to discuss the details of the transfer with the employees before the notification. Also, it requires the company to use its efforts to achieve 'understanding and cooperation' (ie, consent). The notification to the employees needs to be made on the earlier of the date the prior disclosure items regarding the company split are disclosed according to the Companies Act or the date the convocation notice of the general shareholders' meeting for approving the company split is sent. These dates are when the company split procedure is officially initiated.

Likewise, as with a merger, the terms and conditions of employment will be assumed by the seller as-is, and changing these needs to be done in a post-merger integration.

Trade union

If a trade union exists, notification also needs to be made to the trade union. If a collective bargaining agreement exists between the company and the trade union, this will be assumed by the new company or the absorbing company. In essence, the union at the company being split

7 Act No. 103 of 31 May 2000.

will also be split and assumed by the new company or the absorbing company. However, for any terms of the collective bargaining agreement that do not relate to the terms and conditions of employment (eg, union shop agreements and benefits offered to trade unions such as free use of company facilities), the splitting company and the trade union may determine, through a mutual agreement, the terms that will be assumed by the new company or the absorbing company.

Post-merger integration

The following are typical post-merger integration issues in Japanese M&As. For the purpose of this section, all integration made after an M&A transaction, regardless of the type of the transaction, shall be referred to as post-merger integration (ie, shall apply to all types of M&A, not only a merger).

Aligning the terms and condition of employment

As noted, the acquirer may wish to align the terms and conditions of employment of the assumed employees. This will be an issue mainly for a transaction where the terms and conditions of employment are assumed as-is, namely, a merger and a company split.

Under Japanese employment law, the employer may not unilaterally change the terms and conditions of employment as it sees fit. Instead, the employer needs to obtain individual consent from the employees. However, the court has allowed an exception to this, which was later codified into a statute (article 10 of the LCA). Article 10 of the LCA provides that if the work rules are to be changed to the detriment of the employees, then it needs to be 'reasonable in light of the extent of the disadvantage to be incurred by the worker, the need for changing the working conditions, the appropriateness of the contents of the changed rules of employment, the status of negotiations with a labour union or the like, or any other circumstances pertaining to the change to the work rules'. In essence, a post-merger integration where the terms and conditions of the work rules applying to the assumed employees are aligned with those of the new or absorbing company's work rules would generally be considered 'reasonable' under article 10 of the LCA. However, if it involves a drastic change to the employee's detriment, then its enforceability will be suspect. Therefore, it is advisable to introduce mitigation measures, such as a transition period and mixing with changes that are to the benefit of the affected employees, instead of being all negative.

Pension or retirement allowance

Many Japanese companies offer pensions or retirement allowance to their employees. These will also be assumed in a merger and company split, and the buyer should review whether the company or the division being assumed has enough reserves to fund the assumed pensions and retirement allowances. If a pension of retirement allowance scheme is tied to the assumed employees being employed by a company that is a member of a particular group of companies and the M&A results in the company leaving the group, the buyer may need to make special arrangements to maintain the former benefits as much as possible.

Can employees be dismissed?

The conclusion is that M&A cannot by itself be a justified reason for redundancy. Under Japanese law, employers must have cause to terminate employment contracts. The cause for termination is strictly scrutinised in a Japanese court and will generally require the termination to have been an unavoidable consequence of the employee's actions or the company's status. If not, the court

will determine the termination to have been abusive and will deny its enforceability. With respect to dismissal of employees concurrent with M&A (ie, redundancy), courts in Japan require that termination of the contract meets the four criteria for redundancy:

- necessity (ie, the employer needed to decrease the number of personnel);
- effort to avoid dismissal (ie, the employer made efforts to avoid dismissal, meaning alternatives to dismissal such as cutting costs other than human resources);
- reasonable selection (ie, the employer was fair in its process of selecting employees to be dismissed); and
- due process (ie, the employer followed the due process for termination of employment).

Generally, an M&A should improve the economic situation of a company, and termination due to redundancy may not be a possible option as the reason for termination will diminish. If the buyer wishes to streamline its acquired workforce, then it may need to achieve this by seeking mutual separation instead of termination.

The buyer may also wish to select only employees it sees as competent. However, dismissing employees for incompetence is not an easy task in Japan owing to the courts' strict scrutiny and is generally not suitable for managing collectively.

HR due diligence

The following legal issues are common in M&A transactions in Japan and are commonly reviewed in legal HR due diligence.

Unpaid salary

Unpaid salary typically occurs by way of unpaid overtime. According to the LSA, an employer may not cause its employees to work more than 40 hours a week and eight hours a day (statutory work hours). In addition, an employer must establish one rest day per week (typically a Sunday) (statutory rest day).

The LSA further provides that an employer must pay overtime premiums for any hours of work that exceed statutory work hours (overtime work), that are done between 10pm and 5am (late night work) and that are performed on statutory rest days (rest day work).

Overtime premiums for each type of overtime

Type	Rate of premium (compared with normal hourly wage)[8]
Overtime work (60 hours/month or less)	25 per cent or more
Overtime work (more than 60 hours/month)	50 per cent or more
Late night work	25 per cent or more
Rest day work	35 per cent or more
Overtime work and late light work	50 per cent or more
Rest day work and late night work	60 per cent or more

8 It is rare for a company to offer more than the legal minimum for overtime premiums.

An employer needs to enter into a labour–management agreement with a trade union organised by a majority of the employees at the workplace or, if no such trade union exists, with a person representing the majority of the employees to make its overtime work or rest day work. This agreement is called a '36 Agreement' because it is based on article 36 of the LSA, and it is essential to check whether this agreement is in place to confirm whether the seller is complying with overtime regulations.

A common issue with overtime is illegal overtime, which is overtime lacking any 36 Agreements and also misclassification of employees. Both typically result in unpaid overtime, and the latter (ie, misclassification) occurs because, under the LSA, managerial employees are exempt from work hour regulations, including payment of overtime premiums. In other words, a company is not required to pay for overtime work and rest day work for managerial employees (it should be noted that this exemption does not apply to late night work). Courts and regulatory authorities adopt a restrictive definition of managerial employee and, according to the definition, a managerial employee is basically limited to employees who are very close to management (management here means the directors and officers of a company). Managers of entire departments and factory chiefs would fall under this definition, but having several subordinates does not automatically make one a managerial employee. In a famous case where a hamburger store manager sued a hamburger franchise company for unpaid overtime, the court determined that store managers were non-managerial because of their lack of discretion in the manner of work and company management.[9] In general, if a company classifies a substantial proportion of its employees as managerial (such as 20 to 25 per cent), then the classification is suspect, and this percentage is an important subject of HR due diligence.

If the seller classifies too many employees as managerial, it may result in considerable contingent liability. If the court finds the non-payment was made in bad faith, then it could order double pay, which is essentially a type of punitive damages.

Fraudulent company split

In a company split, the remaining company may have insufficient funds to pay for unpaid salary to its employees if the bulk of assets was assumed by the new company or the absorbing company. Under the Workers Assumption Act, an employee is entitled to seek payment that is proportionate to the value of assets assumed by the new company or the absorbing company, if the splitting company was aware that it would have insufficient funds to pay unpaid salary after the company split.

Overtime as a health issue

Excess overtime is also a health issue for employees and is one factor government authorities will look into when determining eligibility for worker's compensation insurance payment. The government (the Ministry of Health, Labour, and Welfare) has two sets of worker's compensation insurance guidelines for illness related to overwork: one for cardiovascular diseases and another for mental health issues. According to the guidelines for cardiovascular disease, if an employee was working overtime hours in excess of 100 hours per month during the one month before the onset of the disease or in excess of 80 hours per month during the period of six to

9 *Japan McDonalds Case*, Tokyo District Court Judgement dated 28 January 2008.

12 months before the onset of the disease, a strong correlation can be made with the disease and overtime work. The guideline for mental health provides that correlation will be determined together with other events that may adversely affect mental health (ie, stress) for work in excess of 100 hours per month for a two-month period of 120 hours per months for a one-month period immediately before the onset of the illness, but if the employee was doing overtime for 160 hours a month or 120 hours every three weeks immediately before the onset of the illness, then overtime itself will be seen as a strong cause for the mental illness.

In HR due diligence, the buyer should look out for these numbers, and it is a common question for due diligence sessions.

Disputes

Common disputes are unpaid wages (typically unpaid overtime), wrongful termination, harassment claims, and work-related injury or death claims. The first has been discussed and contingent liability will be an issue.

Wrongful termination may become a material issue for an M&A if the buyer had recently gone through redundancy and is challenged by the former employees (applicable to share deals, mergers and company splits). It is therefore essential to check that the seller has taken appropriate steps to mitigate the risks of being challenged, such as entering into mutual termination agreements that include a waiver and release clause or have taken the steps required by law (ie, whether the four criteria for redundancy have been met).

Harassment claims (owing to sexual harassment and bullying[10]) typically are non-material issues with respect to an M&A deal (ie, will not become deal-killers) because Japanese courts do not award large amounts of damages. However, if there are numerous claims made against the company, then it does suggest bad overall HR management and will be an issue that needs to be corrected post-merger. Also, if it involves predatory employees, the buyer should be aware of it so that it can deal with them appropriately post-merger.

Work-related injuries and deaths are also subjects of HR due diligence. If numerous incidents are occurring within the company, it suggests bad management. Legally, work-related injuries and deaths are substantially covered by worker's compensation insurance, which is paid by the government, but unlike in other jurisdictions, the employee and his or her heir could seek full compensation in court apart from worker's compensation, and if the court determines that the employee or heir is entitled to more compensation, then the employer will be required to pay the difference.

Retention of key employees

The general rule under Japanese employment law is that the employee is free to leave employment by giving prior notice, which is in contrast to the rights of an employer, which are restricted by law. In addition, the LSA prohibits contractual arrangements that restrict the free movement of employees, such as predetermined compensation (ie, an arrangement that sets a predetermined amount of damages for breach of contract by the employee) and offsetting against advances (ie, an arrangement that offsets an employee's wages against money advanced to the

10 In Japan, a subcategory of workplace bullying, that is, that done by superiors, is typically an issue, and is called 'power harassment'.

employee or a claim for the return of advances as a condition to providing labour). These rules have a historical background in slave labour-like practices in Japan and were introduced after the Second World War when Japan democratised. On the other hand, these rules mean that arrangements such as a retention bonus are illegal and non-enforceable in Japan.

An alternative may be to enter into employment agreements that include a non-compete clause. This does not fully replace a retention bonus scheme but may discourage key employees from joining competitors. Under Japanese law, a non-compete clause is enforceable during the term of employment, as employees have a general duty to devote his or her services to the employer (which also means that employers can do without non-compete clauses during employment, although it is always better to have rules in writing).

For non-compete clauses that have an effect post-employment, however, the situation is not so clear-cut. Based on court precedents (there are no statutes that regulate this issue), the enforceability of post-employment non-compete clauses will be determined based on factors such as:

- whether there was a need for the non-compete clause;
- whether the employee was in a position such that a non-compete clause was necessary;
- whether the duration of non-competition was reasonably limited;
- whether the geographical scope of non-competition was limited;
- whether the scope of job or work covered by the restriction was reasonably limited; and
- whether compensation (ie, consideration) was offered.

In practice, all these factors are rarely met, and generally courts tend to recognise the enforceability of non-compete clauses for management-level or highly professional employees and for a duration of one year or less. Non-compete clauses for ordinary employees and longer non-compete durations are not likely to be enforceable.

Retention of all employees

In a Japanese M&A, the seller sometimes requests the buyer to retain all assumed employees. This could be for a set period, such as three years from the acquisition date. The clause can be mandatory or effort-based. If the former, the clause is legally binding in theory. Nevertheless, if the buyer proceeds to dismiss in violation of the retention clause, it is unlikely that the seller will incur any liability for damages. Hence, the clause is more symbolic than practical. However, in an M & M&A deal, the retention clause can become a highly contested issue in negotiations. To achieve a smooth transfer, the seller often explains to its employees being transferred that there is nothing to worry about because the new company will fully protect their employment.

Appendix 1

About the Authors

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Akira Nagasaki is a partner at City-Yuwa Partners in Tokyo, Japan. His main focus is on international transactions, and he assists overseas clients abroad investing into and expanding their business in Japan and also Japanese clients investing abroad, in Europe, North America and, most recently, South East Asia, especially Vietnam. Akira spend his childhood in the US and maintains close ties there. He also obtained his master's degree (LLM) in the US.

Akira also advises on many labour and employment issues, including labour and employment disputes, employment regulations and M&A issues related to labour and employment.

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