Practice Guides

# JAPAN M&A

**Second Edition**

Contributing Editor
Tatsuya Morita

LEXOLOGY
Getting the Deal Through

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## Practice Guide

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Tatsuya Morita is chief operating officer in the legal department at Sojitz Corporation. He has worked as in-house counsel for Sojitz Corporation, which is one of Japan's major trading firms. He has broad experience in domestic and overseas M&A transactions in various industrial sectors, such as chemical, mineral, energy, machinery and others. Mr Morita also has expertise in corporate reorganisations and restructurings, as well as corporate law and general contractual matters, and in addition has overseas experience in the United States, Indonesia and Singapore.

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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), which provides regulations for the protection of employees, such as minimum working hours,[2] the Labour Contracts Act (LCA),[3] which provides rules for entering into and terminating employment contracts, and the Labour Union Act (LUA), which provides rules for union affairs.[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.

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1 Akira Nagasaki is a partner at 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] the entity will remain legally unchanged, meaning there is no need to transfer employment contracts to another entity. Thus, no issues will arise in a share deal concerning the transfer of employees and their employment contracts. However, if the employees participated in health insurance and pension plans requiring the company to belong to a particular corporate group, the share deal results in the company leaving from such group. 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 (including employment contracts) and its associated assets (eg, movables and immovables), are transferred from one legal entity to another. Under Japanese law, an asset deal is not a comprehensive assignment but a collection of individual assignments of related contracts and assets. Thus, to have the seller's employees transferred, the buyer must obtain consent from every employee involved.

### Merger

A merger under Japanese law is a transaction where two or more companies legally fuse 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 company (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 obligations 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 further detail 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, 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 the company split. Unlike 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 it will be status quo for employees. However, suppose a company becomes a subsidiary of a different company or a member of a different group of companies. In that case, the new management may wish to adjust the terms and conditions of employment to align with those of the new parent company or the new company group. We explain this issue in another section.

*Asset deal*

As noted, individual consent from the employees being transferred to the buyer company is needed in an asset deal. Legally, the employment contract with the seller company will be terminated, and a new agreement will be entered into with the seller company. In effect, the buyer company will negotiate the terms and conditions of the new employment contract to align them with its existing employees. However, the employees may refuse the transfer because individual consent is required. As a result, it will be challenging for the seller company to downgrade the terms and conditions of employment while upgrading them will be relatively easy. There is no requirement to hold bargaining sessions with the employees unless a union exists. However, it is still common to announce the transaction to the affected employees and have a Q&A session to achieve a smooth transfer of employees.

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

*Merger*

Unlike a share deal, the merging companies are structurally changed. For example, suppose two companies are merging. In that case, both companies are dissolved to form a new company (incorporation-type merger), or one company is dissolved and is absorbed into the other company (absorption-type merger). Employment contracts are assumed as-is by the new company or the absorbing company. Suppose 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. In that case, it needs to be achieved through a post-merger integration (PMI) process.

In addition to the individual employment contracts, the buyer will need to determine what to do with the 'work rules' of the company being merged/absorbed. In Japan, a workplace with 10 or more employees needs to have in place 'work rules' (also translated as the 'rules of employment'). Work rules are similar to employee handbooks found in many international companies and provide the basic terms and conditions of employment uniformly applicable to the employees, such as standard work hours, holidays, rules for leave, company discipline, termination, etc. In a merger, the new company or the absorbing company will also assume the company's work rules it merges or absorbs. This will result in the company having two or more work rules, meaning different rules will apply to employees depending on which company they belonged to before the merger. This is usually not a preferred outcome of a merger, and post-merger integration needs to be implemented to unify the work rules.

*Company split*

General process

A company split is unique among M&A transactions in Japan in that the law requires involvement by the employees. This employee-involvement process is provided explicitly in the Act on the Succession to Labour Contracts upon Company Split[7] (often referred to as the Workers Assumption Act).

The general flow of the legal 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).
2 The subject employees have the right to object if they believe they were misclassified (ie, not belonging to the division that was split or belonging to the division that was split).
3 If the company does not challenge the objection, the employee will either stay with the former company or be transferred due to the split.
4 If the company challenges the objection, the matter needs to be resolved through a dispute resolution process (typically in court and mediation).
5 The Workers Assumption Act also requires the company to discuss the transfer details with the employees before the notification. Also, it requires the company to use its efforts to achieve 'understanding and cooperation' (ie, consent). The notice to the employees needs to be made on the earlier of: (1) the date the prior disclosure items regarding the company split are disclosed (in accordance with the Companies Act) or (2) 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 made in the post-merger integration process.

7 Act No. 103 of 31 May 2000.

Trade union

If a trade union exists, the 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 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 conditions of employment

As noted, the acquirer may wish to align the assumed employees' terms and conditions of employment. 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, its enforceability will be suspect. Therefore, it is advisable to introduce mitigation measures, such as a transition period and mixing with changes that benefit the affected employees (such as pay raise), instead of being all negative.

### Pension or retirement allowance

Many Japanese companies offer pensions or retirement allowances 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. Suppose a pension or other 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. In that case, 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. It will generally require the termination to have been an unavoidable consequence of the employee's actions or the company's economic status. If not, the court will determine the termination to have been abusive and reject its enforceability. Concerning 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).

There is an argument whether these four criteria should be treated as valid criteria (meaning all four conditions needs to be met) or merely considerations that the court will look into. Still, in practice, the company should review all four conditions.

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, 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 is 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 |

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.

A common issue with overtime is 'illegal' overtime, typically lacking a 36 Agreement (without the 36 Agreement, the company may not make its employees work overtime) and misclassification of employees. Both commonly 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 (please note that this exemption does not apply to late night work, ie, managerial employees are always compensated for late-night work). Courts and regulatory authorities adopt a restrictive definition of managerial employee. According to the definition, a managerial employee is limited to employees close to management ('management' here means the directors and officers of a company). Managers of entire departments and factory chiefs would count as 'managerial', but having subordinate employees does not automatically make one a managerial employee (ie, team leaders and the like are not managerial employees). In a famous case where a hamburger chain store manager sued the franchise owner for unpaid overtime, the court determined that these store managers were non-managerial because of their lack of discretion in their work and having no say in the company's management.[9] In general, if a company classifies a substantial proportion of its employees as managerial (such as 20 to 25 per cent), then such classification is suspect. The percentage of managerial employees is an important point to check in an HR due diligence.

If the seller classifies too many employees as managerial, it may result in significant contingent liability. If the court finds the non-payment was made in bad faith, 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 salaries to its employees if the new company or the absorbing company assumed the bulk of assets. Under the Workers Assumption Act, an employee is entitled to seek payment proportionate to the

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

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

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 diseases, if an employee was working overtime hours more than 100 hours per month during the one month before the onset of the illness or over 80 hours per month during the period of six to 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 over 100 hours per month for two months or 120 hours per month for one month 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 disease, then overtime itself will be seen as a substantial cause for the mental illness.

In HR due diligence, the buyer should look out for these work hours, which 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 seller had recently gone through redundancy and is subsequently challenged by its 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 concerning an M&A deal (ie, will not become deal-killers) because Japanese courts do not award large amounts of damages for these claims. However, if numerous claims are made against the company, it hints at 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 the incidences to 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 workplace safety management. Legally, work-related injuries and deaths are substantially covered by worker's compensation insurance, but unlike in other jurisdictions, employees could seek total compensation in court apart

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

from worker's compensation, and if the court determines that the coverage provided by worker's compensation insurance was not enough, the employer will be required to pay to cover the shortage.

### 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 termination rights of an employer, which, as noted, 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 employee or a claim for the return of advances as a condition to providing labour). These rules mean that arrangements such as a retention bonus may be illegal and non-enforceable in Japan, depending on how they are structured.

An alternative way of retention 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 critical 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 their services to the employer.

For non-compete clauses that affect post-employment, however, the legal interpretation is not 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. Still, Japanese courts tend to uphold the enforceability of non-compete clauses for management-level or highly professional employees, but only for a period of one year or less. Non-compete clauses for ordinary employees or non-compete periods that extend multiple years 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 and include such a clause in the M&A agreement. 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. If violated, the buyer may need to pay damages; however, it is unlikely that the seller will incur any damage due to the violation. Hence, the clause is more symbolic than truly legally binding. However, in an M&A deal, the retention clause can be highly contested in negotiations because many sellers assure their employees that they will not be adversely affected by the M&A.

# 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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