Practice Guides

JAPAN M&A

Third edition

Contributing editor
Tatsuya Morita

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1

Introduction

Tatsuya Morita[1]

This is the 2023 edition of the *Practice Guide – Japan M&A* published by Lexology Getting the Deal Through. It provides an up-to-date analysis of the legal framework, opportunities, challenges and risks that arise in connection with M&A transactions in Japan. Each chapter deals with matters of particular relevance to M&A transactions in Japan, a jurisdiction that often follows global trends but has specific laws, regulations, business practices and culture. In continuation of previous Lexology Getting the Deal Through publications, the *Practice Guide – Japan M&A* aims to serve as an introductory yet comprehensive manual for industry practitioners dealing with M&A transactions in Japan and with Japanese entities.

As a longstanding member of the legal department of Sojitz Corporation, I have sought to draw from my experience and familiarity with M&A transactions in Japan and abroad to select the chapters for the *Practice Guide – Japan M&A*. I am also very pleased to have assembled a high-calibre group of authors

1 Tatsuya Morita is chief operating officer in the legal department and chief compliance officer at Sojitz Corporation. The statistics in this chapter were last updated in March 2022.

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known for their expertise and vast experience in M&A and related fields of law. I have been fortunate to work with many of the authors and their respective law firms, and can pleasantly reflect on a track record of numerous successful collaborations.

Trading firms (*sogo shosha*) such as Sojitz Corporation enjoy a unique history and position in the Japanese business environment. Having commenced primarily as import-export-orientated businesses sourcing primary products for an island nation with a scarcity of natural resources, trading firms have expanded over time to encompass a diverse set of business ventures and services. Colloquially, they are sometimes referred to as 'companies that deal with any product, from cup noodles to missiles'. The continued maturation of the Japanese and global business market has seen many of the major trading firms increasingly focus on their investment businesses and the aggressive pursuit of M&A opportunities in Japan and abroad. As the trading firms have expanded their business models, so too have we – in-house counsel of trading firms – expanded the breadth of our legal practice and expertise.

This evolution is something that I have witnessed during my own career. In 1990, I started as in-house counsel with Nissho Iwai Corporation, an entity that later merged with Nichimen Corporation to form Sojitz Corporation in 2004. The 1990s were a volatile decade and saw the Japanese booming bubble economy burst, resulting in a period of sustained economic recession. The differing economic conditions during this time provided me with exposure to, and the opportunity to advise on, a broad spectrum of legal issues: from typical bubble-era activities such as investment into, and the development of, amusement parks, hotels and resort projects to later divestment and restructuring projects. From 2001 to 2004, I relocated to Jakarta and Singapore to assist Nissho Iwai with the restructuring of its then considerable financial exposure in South East Asia. These diverse experiences shaped the early stages of my career and helped me to develop the skillset that is now fundamental to my ongoing in-house legal practice.

Having weathered the aforementioned recession and subsequent economic downturns, such as the collapse of Lehman Brothers and the associated global financial crisis, Sojitz Corporation, like other Japanese companies, has continued to pursue M&A activities in all regions of the world. While each transaction and indeed jurisdiction presents its own unique characteristics, I

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am sometimes amazed to see the recurrence of common issues and themes from deal to deal. Across a range of industry sectors and jurisdictions, we often see a similar process play out time and again – from the initial signing of a confidentiality agreement, development of an early-stage memorandum of understanding, due diligence, negotiation and agreement of definitive transaction documents, followed by post-merger integration. With input from experts, some of these processes and the outputs therefrom have become commoditised, supported by vast data-driven infrastructure. We now regularly see a number of publications from law firms and other entities analysing M&A market trends with a degree of specificity on particular legal issues in differing jurisdictions. Such data and analysis are increasingly employed in the negotiation of deals in the field, perhaps shifting us toward the adoption of template deal contracts. On the other hand, when we dig deeper, we see an increasingly complex set of legal issues and legal practice. For example, in response to regulatory and legislative developments globally, the scope of required legal due diligence is rapidly expanding, prompting organisations to adapt and become ever more sophisticated to avoid overlooking critical risk issues and ensure all necessary steps are taken toward successful deal completion. I explore this in more detail in the first chapter, 'Challenges for In-house Counsel to Manage M&A'.

We cannot deny that such complexity and expansion is partly attributable to regulatory and legislative change in each relevant jurisdiction. Japan is no exception in this regard. Prompted by the persistence of low national economic growth and peculiar issues like Japan's aging society and declining population, the Japanese government, in conjunction with academics and business leaders, continue to assess Japan's legal framework, including corporate laws, with a view to stimulating economic activity and fostering sustained economic growth. At the same time, legislation and regulations in Japan continue to be affected by complex global issues and trends, such as the US–China trade conflict and development of privacy protection laws. In this publication, we explore how those influences affect the environment surrounding M&A activity and practices in Japan.

A total of 4,280 M&A deals were completed by Japanese companies in the period between January and December 2021. This represents an increase of 550 deals (or 14.7 per cent) from the 3,730 deals completed in 2020 (when deal

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volumes were down during the early stages of the covid-19 pandemic). It also exceeded the previously recorded maximum of 4,088 M&A deals completed in 2019. Notably, the level of M&A activity in the period between January–December 2021 appears to demonstrate a return to the apparent year-on-year increase in M&A activity experienced for the eight consecutive calendar years between 2012 and 2019.

For the January–December 2021 period, the breakdown of 4,280 cases by market was IN-IN 3,337 cases, IN-OUT 625 cases, and OUT-IN 318 cases, which increased in all markets. Of these, IN-IN and OUT-IN recorded record highs. The total deal value of M&A activity during this period was ¥16.4844 trillion, an increase of 11.7 per cent from ¥14.7567 trillion the previous year. The breakdown by market was ¥3.087 trillion for IN-IN, ¥7.0737 trillion for IN-OUT, and ¥6.3237 trillion for OUT-IN. Cross-border (IN-OUT, OUT-IN) cases accounted for more than 8 per cent of the total.

Of the 4,280 transactions mentioned, 1,693 involved venture capital related transactions, up 27 per cent from 1,333 in the previous year. The breakdown of 1,693 cases by market was IN-IN 1,304 cases, IN-OUT 255 cases, and OUT-IN 134 cases, and 1,438 cases and 84.9 per cent were invested in domestic ventures (IN-IN, OUT-IN totals). The total deal value of M&A activity of those 1,438 cases involving domestic ventures was ¥916.2 billion, expanding 2.6 times from ¥351 billion in the previous year.

Assessing the 4,280 M&A transactions seen during the January–December 2021 period by industry, we began to see increase deal volumes in manufacturing, finance, and non-manufacturing industries (after declines in all industries in the previous year). On the other hand, it appears that commerce (wholesale/retail, restaurant, etc) is still on a downward trend. Non-manufacturing accounted for 60.7 per cent of sellers, up 2.4 percentage points from 58.3 per cent a year earlier.[2]

I should like to extend a sincere thank you to all the contributing authors and the global counsel team of Sojitz Corporation for their review and thoughtful comments on this introduction and the first chapter. Special thanks go

2 Source: MARR Online Data.

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to Montgomery Neate, senior counsel in the legal department of Sojitz Corporation.

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2

Challenges for In-house Counsel to Manage M&A

Tatsuya Morita[1]

The pursuit of growth through M&A deals poses significant challenges for Japanese companies. In this chapter, I will share my observations on the challenges facing in-house legal counsel advising on M&A transactions in Japanese companies and practical measures used to overcome those challenges.

General perspective on M&A market-driven change

As the M&A market has matured in recent years, there has been significant change among the key market participants. Engagement with a range of M&A consultants and advisers across multiple disciplines has become the norm. The participation of private funds has also played a key role, as sellers, partners and indeed competitors. In response to this dynamic situation, Japanese

1 Tatsuya Morita is chief operating officer in the legal department and Chief Compliance Officer at Sojitz Corporation. The information in this chapter was last accurate as at March 2022.

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companies have adapted and varied elements of their internal operations. This can be seen, for example, through measures intended to accelerate the speed of decision-making and responsiveness of Japanese companies in an M&A context. Although such measures have allowed Japanese companies to remain competitive in the global M&A market, they are often associated with increased development and transaction costs. This can, in turn, require companies to demonstrate a higher return on investment in order to justify the relevant deal.

Traditionally, Japanese companies have enjoyed a favourable reputation of producing high-quality products with low-cost operations. This outcome was first enabled by Japan's abundant and efficient labour force, underpinned by the traditional Japanese mindset of enduring hard work and strong loyalty to one's company. While Japan's reputation as a producer of high-quality products remains today, in the time after the bubble-era economy of the 1990s other aspects of that situation were eroded. Contributing factors include the impact of globalisation on Japan's economy, Japan's aging population and greater diversity in the mindset of younger Japanese people. To overcome the associated periods of low productivity and stagnant economic growth, Japanese companies increasingly turned their attention to M&A opportunities. Simultaneously, the global M&A market grew rapidly, encouraging participation from many different players including new M&A market entrants, some adopting approaches that challenged the traditional Japanese way of doing business and prompted Japanese companies to reflect on and change their approach to business operation and investment.

An example of such change can be seen with modifications to the process for decision-making in Japanese companies, the *ringi* process, which is notoriously time-consuming and lacking in transparency. Generally speaking, the *ringi* is a bottom-up process characterised by review of proposed investments by each relevant administrative department, the provision of each department's respective opinion on differing aspects of the proposed investment, and the subsequent review and consideration of those opinions and the investment's merits by the company's senior management. The final *ringi* decision is typically made following extensive consultation with each relevant department and robust discussion among the company's senior management. In many instances, the *ringi* decision can be difficult to predict, even after all stages of the very formal process have been undertaken. While the *ringi* process is

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fundamental to most Japanese companies and their investment decisions, it is not always understood by M&A participants from countries other than Japan. This can add a layer of complexity to the M&A process for Japanese companies.

With the aim of improving their responsiveness during the M&A transaction process, Japanese companies have adopted various approaches. For example, some have opted for a more top-down decision-making process for M&A deals. In such instances, the decision to proceed with an M&A deal sits with the company's very top management (perhaps supported by an internal M&A specialist team, as discussed below, and outside experts), bypassing the *ringi* process. To support the shift to a more top-down decision-making process, some Japanese companies have established specialist in-house deal teams comprising M&A specialists who work within or alongside the company's existing legal department. While this may sound simple enough, securing and retaining suitably qualified experts has required companies to modify their traditional approach to recruitment. For historically hierarchical organisations with long-established views on career development and progression, this can present challenges. I am also aware of certain companies carving out the M&A function from their traditional legal department and instead allocating responsibility for such matters to the specialist M&A deal teams. More drastic measures have included some Japanese companies shifting their M&A operations to overseas offices or establishing new overseas entities to conduct M&A activity under the general supervision of the company's Japan headquarters.

Challenges for Japanese companies and in-house counsel

M&A deals are typically defined by several distinct stages. There follows an outline of the challenges facing Japanese companies and in-house counsel stage by stage.

Preliminary stage

The first stage of an M&A deal often involves execution of preliminary agreements, such as a non-disclosure agreement, memorandum of understanding, letter of intent and other forms of non-binding documents. These documents are commonly prepared and negotiated by suitably qualified in-house legal

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counsel. Even though aspects of the commercial discussion may remain unsettled at this initial stage, the aforementioned preliminary documents can influence the direction of the deal and tone of future negotiations. With this in mind, it is important that in-house counsel take a forward-looking approach to the transaction from the outset, including an assessment of the potential role for external advisers to assist the company to successfully navigate the later stages of the deal (discussed in more detail below).

Due diligence stage

The next stage is typically the undertaking of due diligence. In the past decade or so, there has been a significant expansion in the scope and complexity of matters assessed during the due diligence phase of M&A transactions. This can be contrasted with the more simplistic approach to legal due diligence that we may have seen in the past, which typically involved in-house counsel engaging a single law firm to conduct legal due diligence of the target entities, with a focus on issues such as the relevant capital structure, material contracts, labour issues, any disputes and intellectual property (and perhaps a role for a second local firm on cross-border deals). In addition to this traditional scope of legal due diligence, the modern regulatory and risk environment necessitates consideration of a continually expanding set of other due diligence items, such as anti-corruption and anti-bribery risks, export control matters (including technology transfer), environmental risk and liability, sustainability (including supply chain), among others. The list of issues to be considered may also be expanded as result of jurisdiction-specific laws and requirements. Japan is no exception in this regard, as can be seen with regulatory requirements issues such as employment law, constraints on inbound investment and the absence of a national court database.

In order to ensure such areas of potential risk and liability are properly assessed during this stage of the M&A process, in-house counsel need to be cognisant of the potential risks, understand the nature of issues to be considered during the due diligence, and work closely with suitably qualified external counsel. Failure to do so, or do so effectively, can slow transaction progress and/or allow critical issues and risks to be overlooked to the detriment of the company.

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Agreement stage

The third stage is to prepare and negotiate the relevant definitive agreements. The approach that each party takes during the negotiation phase of the M&A, and the role of in-house counsel in that process, may be influenced by a variety of factors. For cross-border and complex M&A transactions, this stage of the process can become less burdensome for the in-house counsel if an appropriate team of appropriate external advisers has been engaged in support. That said, each deal is unique and in-house counsel's ongoing attention and input remains critically important. An additional point peculiar to M&A deals and their analysis: more and more we see publication of jurisdiction- and region-specific deal studies and analysis conducted by different institutions and law firms globally. The information contained in these studies can be very useful for in-house counsel to understand developments and trends in the M&A market (and inform aspects of the negotiation). Unfortunately, such studies and analysis are not yet common in Japan, partly due to the absence of disclosure and filing requirements from the Tokyo Stock Exchange.

PMI stage

Finally, the post-merger integration (PMI) stage remains a significant challenge for Japanese companies and their in-house counsel. When it comes to PMI, Japanese companies have a tendency to put their emphasis on governance and control rather than synergy and growth. In the context of implementing governance and control measures during the PMI phase, we see the recurrence of two major issues:

- it appears that Japanese companies continue to struggle to provide the global infrastructure to implement the requisite governance and control measures, especially in the field of human resources and information technology; and
- the language barrier is a major issue for Japanese companies and successful PMI. I hope that the rising younger generation, who have experienced living overseas, and technological progress, such as AI interpretation and translation tools, will ease the impact of this issue. As it stands, the language barrier faced by Japanese companies casts a shadow over, and hinders the progress of, PMI.

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With respect to the pursuit of synergy growth, my view is that for Japanese companies as well as their in-house counsel there remains scope for greater consideration of issues from the initial stage of the deal by looking forward to the PMI stage.

Latest changes and current topics of Japanese laws and regulations

While the other chapters of this publication address Japanese law issues that directly affect M&A deals in Japan, it is helpful to mention recent changes to laws, regulations and other published guidelines, which reveal certain trends indirectly related to M&A, especially in terms of the management of corporations in Japan.

Reform of Labour Law to promote new work style

In the series of revisions and reform of the Labour Law, the Japanese government seeks to implement change to the traditional Japanese work style (characterised by a lack of flexibility and the 'workaholic' approach of continued long working hours). The new laws limit the maximum number of hours an individual may work and introduce certain mandatory paid leave and flexible working arrangements, with the aim of facilitating improved work–life balance and productivity.

Corporate laws and corporate governance code

Japanese corporate laws have been revised to introduce a more transparent disclosure and corporate governance system, such as the requirement to appoint an outside director, increased disclosure of directors' remuneration and other measures. Similarly, the Japanese government publishes the Corporate Governance Code. Although a guideline only, listed companies in Japan generally follow the Corporate Governance Code and adopt the measures stipulated therein.

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Revised Privacy and Personal Information Protection Act

The Personal Information Protection Act has been revised to strengthen the protection of privacy and personal information, which follows the global trend.

Enactment of Harassment Act and revised Whistle-blower Law

A new law, the Harassment Act, was introduced to protect employees from power-abusive harassment (pawahara, meaning power harassment). Revision of the Whistle-blower Law was made in order to protect the anonymity of a person who makes a report, and to encourage people to report on relevant inappropriate and/or unlawful conduct of a company.

As can be seen from the reform of existing laws and the introduction of new laws and regulations, generally speaking, the Japanese government is trying to follow global trends and introduce global standards to the operation of Japanese companies. This is undertaken to improve the productivity of Japanese companies and invite more capital investment from overseas entities. In my opinion, while there may be some backlash in certain areas, such as limiting foreign investment in areas of specific national security interest, this direction will continue in the longer term. Following these movements and endeavouring to stay ahead of the issues they present will be an ongoing challenge for Japanese companies as well as their in-house counsel.

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3

Recent Trends and Changes in M&A in Japan

Takashi Toichi, Masanori Bito and Masato Tanaka[1]

Overview of recent trends and changes

General

According to RECOF Data Corporation (Recof), in 2022, mergers and acquisitions involving Japanese companies numbered 4,304 transactions (a 0.6 per cent increase from the previous year).[2] However, in 2022, the number of outbound deals did not increase from the previous year, and the number of large-scale deals decreased, resulting in a significant decrease in the

1 Takashi Toichi, Masanori Bito and Masato Tanaka are partners at TMI Associates.

2 RECOF Data Corporation, Review of M&A in 2022 (M&A Trend of Japanese Companies from January to December 2022), MARR Online No. 340 (4 January 2023), www.marr.jp/menu/ma_statistics/ma_markettrend/entry/41398 (last visited 19 February 2023).

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aggregate value of the transactions, amounting to US$87.9 billion (a 31.6 per cent decrease from the previous year).[3]

Outbound transactions

Outbound transactions in 2022 numbered 625 (the same number as the previous year), amounting to US$26.7 billion (a 51.7 per cent decrease from the previous year). Outbound transactions stagnated in 2022 due to increased uncertainty in the global economy and business environment such as the global recession, high inflation, depreciation of the yen and the situation in Ukraine. Notable outbound transactions include the following:

- in December 2022, Takeda Pharmaceutical Company Limited announced the acquisition of all shares of Nimbus Lakshmi, Inc with a deal value of US$4.20 billion.
- in July 2022, Sony Interactive Entertainment LLC, a US subsidiary of Sony Group Corporation, completed acquiring all shares of Bungie, Inc with a deal value of US$3.95 billion; and
- in March 2022, The Yokohama Rubber Co Ltd announced the acquisition of all shares of Trelleborg Wheel Systems Holding AB with a deal value of US$2.05 billion.

Domestic transactions

Domestic transactions in 2022 numbered 3,345 (a 0.2 per cent increase from the previous year), amounting to US$30.8 billion (a 25.7 per cent increase from the previous year). Among others, the following trends for recent domestic transactions are noteworthy.

In 2022, there were 59 tender offer transactions (a 16.9 per cent decrease from the previous year), which amounted to US$12.7 billion (a 25.7 per cent decrease from the previous year). In this context, going-private transactions remained robust, structured as cash tender offers followed by squeeze-out procedures

3 In this article the assumed exchange rate is US$1 = ¥130. Deal values have been mainly provided by Recof.

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involving listed subsidiaries, including acquisitions of listed subsidiaries by their parent companies, management buyouts of public companies, and sales of shares of listed subsidiaries to third parties.

The notable takeovers of listed subsidiaries or affiliates by their parent companies in 2022 include the following:

- Kintetsu Group Holdings Co Ltd launched a cash tender offer for all shares in its equity-method affiliate, Kintetsu World Express Inc, in May 2022, and completed the acquisition through a subsequent exercise of a statutory call option in August 2022, with a deal value of US$1.29 billion; and
- in December 2022, Nippon Steel Corporation announced its plan to launch a cash tender offer for all shares in its equity-method affiliate, Nippon Steel Trading Corporation, with a deal value of US$1.05 billion (ongoing).

In 2022, the number of going-private management buyouts (including inbound transactions) was 12 (versus 19 in the previous year). One notable transaction that took place in December 2022 was Integral Corporation completing its acquisition of Shinoken Group Co Ltd as a management buyout through a cash tender offer and a subsequent share consolidation with a deal value of US$411 million.

Sales of shares of listed subsidiaries or affiliates by parent companies to third parties remain robust. One recent noteworthy transaction was Hitachi Ltd selling shares in its equity-method affiliate, Hitachi Transport System Ltd, to Kohlberg Kravis Roberts & Co (KKR) through a cash tender offer launched by KKR in October 2022, and a subsequent share consolidation in February 2023 with a deal value of US$5.16 billion.

Inbound transactions

Inbound transactions in 2022 numbered 334 (a 5.0 per cent increase from the previous year), reaching a record high, and amounting to US$30.4 billion (a 37.5 per cent decrease from the previous year). More than half of these inbound transactions in 2022 were transactions involving global private equity sponsors. The number of M&A transactions by private equity sponsors targeting Japanese companies in 2022 was 1,071, the highest ever (of which 81.6 per cent are inbound transactions), and amounting to US$29.5 billion (of

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which 78.5 per cent are inbound transactions). The presence of foreign private equity sponsors is increasing. The background to this is that low interest rates have reduced funding costs for funds, and the weaker yen has increased the sense of bargaining for Japanese companies. Notable transactions include the following:

- in November 2022, Bain Capital Private Equity, LP (Bain Capital) announced the acquisition of a majority of shares of MASH Holdings Co Ltd, with a deal value of US$1.53 billion; and
- the Carlyle Group launched a cash tender offer for shares in Uzabase, Inc in October 2022, and completed the acquisition through a subsequent exercise of a statutory call option in February 2023, with a deal value of US$473 million.

Many Japanese listed companies are actively divesting their non-core businesses especially to non-Japanese companies in order to focus on their core businesses using a strategy of selection and concentration. In 2022, these carve-out transactions numbered 333 (an 18.6 per cent decrease from the previous year), amounting to US$26.6 billion (a 34.8 per cent decrease from the previous year). Notable carve-out transactions (excluding sales of shares of listed subsidiaries or affiliates to third parties through tender offers as mentioned above) include the following:

- in August 2022, Olympus Corporation announced the sale of all shares in Evident Corporation, which operates business relating to the development, manufacture, sale and provision of solutions for biological microscopes, industrial microscopes, industrial endoscopes, non-destructive inspection equipment and X-ray analysers, to Bain Capital, with a deal value of US$3.28 billion;
- in August 2022, Toshiba Corporation completed the sale of 55 per cent shares of Toshiba Carrier Corporation, Carrier Corporation, with a deal value of US$923 million; and
- in August 2022, HIS Co Ltd announced the sale of all shares held in Huis Ten Bosch to PAG, with a deal value of US$512 million.

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Industries

Increase in the number of sellers in non-manufacturing industry

In 2022, the number of transactions by sellers in non-manufacturing industries constituted 61.2 per cent (versus 60.7 per cent in 2021) of those in all industries, and, among others, investments in software and IT have been robust. Notable transactions include the acquisition of Bungie by Sony already described.

Transactions relating to decarbonised society

To reduce greenhouse gases and carbon emissions that cause global warming and achieve sustainable growth and supply of renewable energy, transactions relating to a 'decarbonised society' have been regarded as important in terms of Environmental, Social and Governance (ESG) investments. In this context, mergers and acquisitions relating to the electricity and gas industries have increased, and many large Japanese companies have started to utilise mergers and acquisitions as a tool to change their business portfolios in a short period of time to grapple with this trend. A notable transaction relating to decarbonised society goals took place in October 2022: Tokyo Gas announced the sale by Tokyo Gas Australia Pty Ltd of its Australian subsidiaries that hold interests in Australian LNG projects, to MidOcean Energy Holdings Pty Ltd, a subsidiary of EIG Global Energy Partners LLC, with a deal value of US$2.39 billion.

Background and analysis of recent trends and changes

Corporate governance reforms

Background

Traditionally, many listed shares were cross-held by their business partners (mainly by other listed companies) who acted as loyal and management-friendly shareholders. For instance, in 2018, 372 subsidiaries (owned by both listed parent companies and non-listed parent companies) were listed on the Tokyo Stock Exchange (TSE), constituting 10.4 per cent of the total number of listed companies on the TSE that year. Also, domestic institutional investors (particularly banks, pension funds, insurance companies and other financial

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institutions) were historically passive with their votes in Japanese listed companies, rarely voting against the company's proposals. Cross-shareholdings and loyal shareholders, coupled with a lack of qualified outside directors in the listed companies, result in less stock market discipline and ineffective dialogue with minority shareholders, and cross-shareholdings were criticised as having lower capital efficiency. Also, listed subsidiaries were criticised as prioritising the interests of their parent companies or group companies over the interests of their minority shareholders. Recent corporate governance reforms, set out below, were taken to address these criticisms and improve the creditworthiness of the Japanese stock market.

Japan's Stewardship Code

Japan's Stewardship Code (issued in 2014, amended in 2017 and 2020) is a voluntary code of conduct for institutional investors to enhance medium- to long-term investment returns for their clients and beneficiaries by promoting sustainable growth of companies through constructive dialogue. As many as 322 institutional investors had signed up as of 31 December 2022.[4]

Japan's Stewardship Code requests institutional investors to disclose clear policies on voting[5] and voting records for each investee company on an individual agenda item basis as well as the reasons why they voted for or against an agenda item.[6] In particular, asset managers, who owe accountability to asset owners below, are requested to regularly disclose self-evaluations regarding the status of their implementation of the Code together with the results of their stewardship activities including dialogues with investee companies.[7] Asset owners (eg, corporate pensions and employee pension funds) are requested to

4 Financial Services Agency, the list of institutional investors who have accepted to 'Principles for Responsible Institutional Investors' Japan's Stewardship Code – To promote sustainable growth of companies through investment and dialogue (as of 31 January 2023), www.fsa.go.jp/en/refer/councils/stewardship/20160315.html; (last visited 19 February 2023).

5 Guidance 5-2 of Japan's Stewardship Code.

6 Guidance 5-3 of Japan's Stewardship Code.

7 Guidance 7-4 of Japan's Stewardship Code.

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provide their asset managers with clear policies regarding stewardship activities, including voting,[8] and to monitor whether their asset managers conduct stewardship activities in line with these policies.[9]

The function of institutional investors as defined in Japan's Stewardship Code and that of directors as defined in Japan's Corporate Governance Code (including the Guidelines for Investor and Company Engagement (issued in 2018, amended in 2021)) are complementary and both form essential elements of high-quality corporate governance to ensure the sustainable growth of the company and the medium- to long-term investment returns for the clients and beneficiaries.

Japan's Corporate Governance Code

As a component of broader corporate governance reform, Japan's Corporate Governance Code was issued in 2015 (amended in 2018 and 2021) as a soft law, adopting a comply and explain approach instead of a legally binding, mandatory regime. Japan's Corporate Governance Code requests that directors secure the appropriate cooperation of stakeholders and act in the 'common interests of its shareholders', as well as the interests of the company, with due attention to their 'fiduciary responsibilities to shareholders'.[10] Also, Japan's Corporate Governance Code requests that listed companies (if listed on markets other than the Prime Market) appoint two or more independent outside directors and, if such listed companies believe they need to appoint at least one-third of its directors as independent outside directors, they should appoint a sufficient number of independent outside directors.[11] In 2022, 99.2 per cent of the Prime Market listed companies of the TSE have appointed two or more independent outside directors and 92.1 per cent have at least one-third of their directors being independent outside directors.[12] Also, under the Companies Act, listed

8 Guidance 1-4 of Japan's Stewardship Code.

9 Guidance 1-5 of Japan's Stewardship Code.

10 Principle 4.5 of Japan's Corporate Governance Code.

11 Principle 4.8 of Japan's Corporate Governance Code.

12 TSE, Appointment of Independent Directors / Establishment of Nomination and Remuneration Committees by TSE-Listed Companies (3 August 2022), www.jpx.co.jp/

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companies must appoint outside director(s).[13] This development may pave the way for effective engagement with shareholders.

Further, Japan's Corporate Governance Code requests listed companies to disclose their policies for the reduction of cross-shareholdings and annual assessments regarding whether to continue holding each individual cross-shareholding, as well as to establish and disclose specific standards with respect to the voting rights of their cross-shareholdings.[14] The Code also aims to prevent listed companies from hindering the sale of cross-held shares[15] and from engaging in transactions with cross-shareholders that may harm the interests of the companies or the common interest of their shareholders.[16]

In June 2021, Japan's Corporate Governance Code was amended. This amendment, among others, aims to set higher corporate governance standards for companies listed in the Prime Market as follows:

- Appointment of at least one-third of independent outside directors (the majority if necessary).[17] In particular, subsidiaries listed in the Prime Market should appoint the majority of directors as independent outside directors or establish a special committee composed of independent persons including independent outside director(s) to deliberate and review material transactions or actions that conflict with the interests of the controlling shareholder and minority shareholders.[18]
- Appointment of the majority of members of nomination committee and compensation committee as independent outside directors.[19]

english/equities/listing/ind-executive/b5b4pj000004ehtg-att/b5b4pj0000051v4z.pdf; (last visited 17 February 2022).

13 Article 327-2 of the amended Companies Act.

14 Principle 1.4 of Japan's Corporate Governance Code.

15 Supplementary Principle 1.4.1 of Japan's Corporate Governance Code.

16 Supplementary Principle 1.4.2 of Japan's Corporate Governance Code.

17 Principle 4.8 of Japan's Corporate Governance Code.

18 Supplementary Principle 4.8.3. of Japan's Corporate Governance Code.

19 Supplementary Principle 4.10.1 of Japan's Corporate Governance Code.

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- Enhancement of the quality and quantity of disclosure based on the Financial Stability Board (FSB)'s Task Force on Climate-related Financial Disclosure (TCFD) recommendations or an equivalent framework.[20]
- To make the electronic voting platform available, at least to institutional investors.[21]
- Disclosure of necessary information in English.[22]

Practical Guidelines for Group Governance Systems

To address structural conflicts of interest between listed companies (as controlling shareholders) and general shareholders in their listed subsidiaries, in 2019, the Ministry of Economy, Trade and Industry (METI) issued the Practical Guidelines for Group Governance Systems. The Practical Guidelines for Group Governance Systems request listed companies to periodically review whether it is an optimal strategy in their group business portfolios to maintain their listed subsidiaries. Also, the Practical Guidelines for Group Governance Systems request listed companies to disclose reasonable justifications and effective governance systems (including the appointment of qualified independent outside directors) if they maintain their listed subsidiaries.

Rules for interested party transactions

Background

Management buyouts have become more active since the mid-2000s. Early cases often posed problems in terms of minority shareholder protection, which can be mostly attributed to the insufficiency of then-existing judgments on conflicts of interest and a lack of practical experience. For instance, minority shareholders in certain cases argued the squeeze-out price was too low and, in others, directors were actually sued by shareholders. Because of information asymmetry between directors and minority shareholders, as well as a lack of minority shareholder protection in the case of management buyouts,

20 Supplementary Principle 3.1.3 of Japan's Corporate Governance Code.
21 Supplementary Principle 1.2.4 of Japan's Corporate Governance Code.
22 Supplementary Principle 3.1.2 of Japan's Corporate Governance Code.

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in September 2007, METI published the MBO Guidelines to address these issues as well as others typically found in management buyouts. Although the MBO Guidelines were highly respected in practice and certain court cases, the MBO Guidelines became outdated after Japanese companies became more experienced and certain changes relevant to listed companies occurred (including the progress of corporate governance reform). Also, it was said that certain guidance was needed to handle issues regarding conflicts of interest in non-management buyout M&A transactions, such as acquisitions of controlled companies by controlling shareholders in light of the increasing number of such transactions.

The Fair M&A Guidelines

In June 2019, METI published the Fair M&A Guidelines, which govern the acquisition of controlled companies by controlling shareholders as well as management buyouts. The Fair M&A Guidelines set forth approaches to fair M&A for the Japanese business community, mainly in terms of procedures to enhance global trust in Japanese capital markets and to promote the types of M&A that contribute to the enhancement of corporate value. The Fair M&A Guidelines have inherited and reorganised many of the basic ideas and practical responses presented in the MBO Guidelines, presenting more substantial practical innovations in detailed and concrete terms.

In particular, the Fair M&A Guidelines emphasise the role of independent special committees in order to ensure fair procedures in interested party transactions. At the time of the publication of the Fair M&A Guidelines, the establishment of an independent special committee was already common practice in tender offers involving management buyouts and acquisitions of controlled companies by controlling shareholders, but the Fair M&A Guidelines facilitated this trend.

Also, among other things, since we have seen non-directors becoming members of the special committee, the Fair M&A Guidelines provide that independent outside directors are most suitable as members of a special committee and, accordingly, they are substantially being included when special committees are formed. In fact, we have seen an increasing number of independent outside directors becoming members of a special committee since

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the Fair M&A Guidelines were published. The Fair M&A Guidelines further provide that it is advisable to ensure that the special committee is substantially involved in the negotiation process with respect to the transaction terms with the tender offerors and provides two types of roles of the special committee: the recommendation type and the direct negotiation type.

In addition, the Fair M&A Guidelines emphasise that it is useful to obtain fairness opinions to address issues with respect to structural conflicts of interest and information asymmetries when formulating transaction terms and to ensure accountability to general shareholders, including international investors. The Fair M&A Guidelines further emphasise the function of active market checks, including 'go-shops', in which prospective acquiring parties are investigated and evaluated in the market, to ensure opportunities for competing proposals by other prospective acquiring parties. Although fairness opinions still remain uncommon in Japan as methods to ensure fair transaction terms, they may increase in the future, considering the growing trend of shareholder activism and increase in unsolicited transactions, described below.

Growing trend in shareholder activism and increase in unsolicited transactions

Background

As a result of the decrease in cross-shareholdings and lower loyal shareholder ratios, activist shareholders may stand a better chance in succeeding in public campaigns to obtain affirmative votes from other shareholders. With the above-mentioned corporate governance reforms as a background, Japanese listed companies are asked to manage their businesses paying close attention to the company's capital costs by setting targets on profitability and capital efficiency while also paying due attention to their 'fiduciary responsibilities to shareholders'. This may also facilitate activist investors to effectively submit shareholder's proposals through constructive engagement with investee companies. On the other hand, many institutional investors are requested to fulfil their accountability obligations to asset owners and carefully consider individual agenda items at shareholders' meetings in terms of whether they are consistent with their investment management policies.

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Shareholder proposals

Shareholder proposals has been robust (96 listed companies from July 2021 to June 2022).[23] These shareholder proposals typically include not only dividend declarations and acquisitions of treasury shares, but also, taking into account corporate governance reforms, the appointment or dismissal of directors and changes to articles of incorporation relating to the sale of cross-shareholdings, disclosure of capital costs. Recently we also have seen several shareholder proposals for changes to articles of incorporation relating to ESG in power companies, general trading companies and financial institutions, including disclosure of risk concerning climate change based on the TCFD.

We have seen several shareholder proposals for the appointment or removal of directors and statutory auditors of listed companies, reduction of stated capital and distribution of surplus being approved in 2022. In several listed companies, large shareholders (holding at least 3 per cent of the total voting rights) not only make proposals in an annual shareholders' meeting, but also exercise their right to request the convocation of an extraordinary shareholders' meeting. For example, in February 2023, at Fujitec Co Ltd, listed on the Prime Market, in connection with the appointment of the former president, (who was from the founding family), as chairman without being reappointed as a director at a shareholders' meeting, Oasis Management Company Ltd (Oasis) pursued the supervisory responsibility of the outside directors who endorsed this, and submitted shareholder proposals, which were partially passed, resulting in removal of three outside directors and appointment of four new outside directors. This example may show that the effectiveness of the role of outside directors to supervise management from an independent standpoint is being called into question.

These successful cases of shareholder activism show that shareholders' direct monitoring may work effectively, and their bargaining power may have been enhanced in dialogue with target companies.

23 Tatsuya Makino, Case Analysis on Shareholder's Proposal Right No. 1 – Shareholders' meetings from July 2021 to June 2022, Shiryoban Shojihomu No. 461, at 45 (2022).

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Unsolicited transactions by activist shareholders

In the past, there were many cases where a target company announced a significant increase in dividend distribution and/or acquisition of its treasury shares from activist shareholders to respond to requests made by activist shareholders. These tactics imposed a large financial burden on the target companies and were not always beneficial to the remaining shareholders.

Although significantly increasing dividend distributions and acquiring treasury shares from activist shareholders continue to be approaches considered by many listed companies against its activist shareholders, in some cases we have seen some listed companies engage 'white knights' to sell themselves to a third party or partner with third parties to conduct management buyouts. Although these transactions may be beneficial for the remaining shareholders, activist shareholders may receive more benefit from them, since these transactions usually involve a good premium over the market price, even after the increase of the stock price due to the activist shareholders. Further, activist shareholders are not only prepared to conduct public campaigns, but are also showing an increased willingness to launch unsolicited takeover bids by themselves. Given the decrease in cross-shareholdings and the number of management-friendly shareholders in listed companies, a management buyout is unlikely to be successful if its amount is lower than a competing bid. Notable 2022 deals include the following:

- in 2022, Infroneer Holdings Inc launched a tender offer for shares of its equity-method affiliate, Toyo Construction Co Ltd (Toyo Construction). However, Yamauchi-No.10 Family Office (YFO), the founding family of Nintendo, bought up the shares, and the tender offer ended in failure. After that, YFO made an unsolicited tender offer proposal to Toyo Construction; and
- in 2022, Oasis launched a tender offer for shares of Raysum Co Ltd, which was successfully completed and its voting right ratio increased to 64 per cent.

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Unsolicited transactions by strategic investors

We have not seen many unsolicited takeovers targeting Japanese listed companies over the past 10 years, mainly owing to low success rates and reputational risks. Even following the 2008 financial crisis, the number of unsolicited takeovers targeting Japanese companies did not increase, and the number remained only two or fewer each year. However, since 2019, we have started to see several unsolicited deals, initiated not only by hedge funds and other financial investors, but also by strategic investors, including well-known Japanese corporations listed in the TSE. These movements were partially caused by the above-mentioned corporate governance reforms and changes in the investment environment (such as the decrease in cross-shareholdings, a decrease in the number of management-friendly shareholders of listed companies and a focus on capital efficiency). Since we have seen more investors engaging in commercially reasonable investment activities, it is possible that these successful unsolicited takeovers will lower the bar for strategic investors to initiate unsolicited takeovers as realistic investment activities. Among others, the following unsolicited tender offer by a strategic investor was successfully completed in 2022: in 2022, Oisix ra daichi Inc launched an unsolicited tender offer for shares in Shidax Corporation with consent of its founding family. Shidax's board of directors initially expressed an opposing opinion, but then took a neutral stance and the tender offer was successfully completed. As a result, Oisix acquired 28.47 per cent of shares in Shidax.

Takeover defence

The number of listed companies (particularly those with large market capitalisations) that are discontinuing existing takeover defence measures is increasing given recent corporate governance reforms.

During the 10-year period prior to 2020, we did not see emergency takeover defence measures being introduced in situations where a Japanese company encountered an unsolicited takeover. However, since 2020 (the *Toshiba Machine Co Ltd*, now known as *Shibaura Machine Co Ltd*, case), we have started to see emergency takeover defence measures being implemented (ie, by way of free allotment of share acquisition rights with discriminatory exercise conditions and acquisition provisions between the acquirer and other shareholders), and

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the unsolicited acquirers filed actions for preliminary injunctions against the takeover defence measures, resulting in several judicial decisions. A fund, along with its affiliates, acquired shares of Mitsuboshi Co Ltd, a listed company on the Standard Market of TSE. In 2022, the board of directors of Mitsuboshi resolved to introduce and activate a takeover defence measure, later approved at its shareholders' meeting. The fund filed an action for a preliminary injunction against the takeover defence measure. The lower courts granted the preliminary injunction, which decision was upheld by the Supreme Court on 28 July 2022 (Shiryoban Shojihomu No. 461, at 143 (2022)). The appropriateness of takeover defence measures was not recognised by the courts because the requirements for discontinuing the takeover defence measure were not clearly defined before the litigation, and they were too extensive.

There are neither definite precedents nor concrete views on this matter yet, and it is on a case-by-case basis whether institutional investors approve emergency takeover defence measures. On 18 November 2022, METI set up a study group on fair takeovers, aiming to formulate guidelines for principles related to takeovers in general, board actions in response to takeover proposals, further transparency regarding takeovers, prevention of acts that distort shareholder decision-making, and takeover defence measures, by around spring 2023. Since this study group may further develop the currently growing discussion on the legal reform of the tender offer system and the formation of related soft laws, it is necessary to pay attention to its future developments.

Leveraged buyout

In the past few years, the balance of LBO finance has grown significantly due to the growing need for funds accompanying M&A transactions by private equity sponsors and business restructuring of large companies. The balance of LBO loans of major banks in Japan exceeded US$30 billion as of 2021. In this way, major banks have been proactively providing LBO loans.

However, from 2022 onwards, the domestic and overseas market environment deteriorated. In addition, the management crisis of Marelli Holdings Co Ltd (Marelli) became apparent, and in August 2022, banks had to waive large-scale claims against Marelli as part of the business rehabilitation proceedings.

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For this reason, the fact that major banks are aggressively taking risks in relation to large-scale M&A transactions through LBO loans has come to be recognised as a risk factor in maintaining the soundness of the financial system. In fact, after the Marelli crisis became apparent, banks appear to have shifted to a more cautious approach to loan screening. The change in banks' attitude toward LBO loans may affect the success or failure of corporate acquisitions by private equity sponsors. The Financial Services Agency of Japan (JFSA) has pointed out that the portfolio has shown deterioration and tends to be larger loans than in the overseas market (The JFSA Strategic Priorities July 2022–June 2023). Whether the Japanese LBO market will play a role in promoting corporate growth and contributing to the development of the domestic economy in the future depends on the future development of practices related to LBO loans.

Future developments

There remain various uncertainties such as the global recession, high inflation, high raw material prices, supply chain turmoil caused by the situation in Ukraine, and soaring prices of materials and energy. If concerns over the deterioration of the global economy persist, large-scale deals may stagnate.

On the other hand, there is a possibility of recovery in large cross-border deals due to changes in China's zero-corona policy, as well as changes in the Japanese government's policy against the covid-19 pandemic (lowering covid-19 from a high-risk category to an influenza-equivalent category).

It is likely that carve-out transactions will continue to increase. In Japan, interest rates are lower than in other countries, keeping fund procurement costs low, and Japanese companies are becoming more undervalued due to the depreciation of the yen. If this situation continues, M&A deals for Japanese companies by private equity may continue to be active.

On the other hand, JFSA is becoming more cautious about the rapid increase in domestic LBO loan balances of major banks and their credit management systems. There is a possibility that the private equity sponsor's fundraising will be affected. It is becoming more difficult for private equity sponsors to finance larger transactions through LBO loans from financial institutions and we have seen a valuation gap between sellers and private equity sponsors, which could

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potentially decrease the number of larger transactions involving private equity sponsors. Alternatively, we have seen foreign strategic companies from Europe and the United States in particular being more active in the market. However, it may take more time for strategic companies to complete the transactions, not only because they may need to consider FDI regulations or competition laws, but also because they are not familiar with the Japanese market and need to take Japanese culture, etc into consideration when doing transactions in Japan. Therefore, we have started to see transactions taking much longer than parties expect or transactions being suspended even after they have started.

With Japan's amended Corporate Governance Codes as a background, governance discipline especially for companies listed in the Prime Market will be required more than ever, and it is likely that there will be more transactions involving listed subsidiaries or affiliates, including acquisitions of listed subsidiaries or affiliates by their parent companies, management buyouts and sales of shares of listed subsidiaries or affiliates to third parties.

In addition, shareholder activism will continue to be operational and the burgeoning trend in unsolicited deals by strategic investors may continue. Japan's tender offer regulations have not undergone major revisions since 2006. Due to the increase in unsolicited takeovers, competitive takeovers, and the introduction and implementation of takeover defence measures, discussions on reviewing the current tender offer regulations are becoming active in Japan. It is also necessary to pay attention to future revisions to tender offer regulations as well as formulation of guidelines on takeover defence measures by METI.

Conclusion

In summary, large-scale outbound transactions declined in particular in 2022. Although the effect of the global economy is still uncertain, the corporate governance reforms and other recent developments will continue to require greater stock market discipline of listed companies, such as using reasonable efforts to achieve sustainable growth and enhancing capital efficiency in 2023. We anticipate seeing more transactions involving listed subsidiaries or affiliates, a growing trend of shareholder activism and unsolicited transactions entered into not only by financial investors but also by strategic companies.

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It is necessary to pay attention to trends for regulations on LBO finance and revisions to laws and guidelines regarding takeover bids and takeover defence measures.

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4

Regulatory Issues and Hurdles for M&A in Japan

Kosuke Hamaguchi and Ryohei Tanaka[1]

Introduction

When it comes to the regulatory regime in relation to M&A transactions in Japan, there are two major obstacles that foreign investors or acquirers should keep in mind: foreign investment control and merger control. Generally speaking, as the regulatory hurdles for M&A in Japan are not so stringent compared with many other jurisdictions, it would be advisable, in the early stages of the entire process, to meticulously identify the issues, assess their implications and prepare for scrutinised review by the government authority. This chapter discusses the legal framework and recent practical challenges in relation to these two issues.

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Legal framework of foreign investment control in Japan

The Foreign Exchange and Foreign Trade Act (FEFTA) is the primary Japanese legislation that governs foreign investment. Where a foreign investor either acquires shares of a non-listed Japanese company from a seller who is not a foreign investor or acquires a certain number of shares of a listed Japanese company whereby the shareholding ratio or voting ratio of such foreign investor after the share acquisition is at least 1 per cent, this acquisition generally falls under a regulated investment classification referred to as 'inward direct investment, etc' (inward direct investment) under the FEFTA. In addition, an acquisition by a foreign investor of businesses from a Japanese entity through a business transfer, demerger or merger constitutes an inward direct investment. The purchaser who carries out an inward direct investment would generally be required to file either a prior notice or an ex post facto report, subject to certain exemptions. In the case of an acquisition by a foreign investor of shares of a non-listed Japanese company where the seller is another foreign investor, such acquisition falls under another regulated investment classification referred to as a 'specified acquisition' and the purchaser would generally be required to file a prior notice if such non-listed company engages in certain categories of businesses.

In general, the Japanese government has been relatively lenient in terms of foreign investment control and has very rarely blocked transactions under the FEFTA. However, this trend is changing in response to the global trend toward tightening foreign investment control. We have seen a number of cases where the Japanese government has scrutinised an inward direct investment and imposed certain restrictions on a foreign investor under the current regime.

Inward direct investment

Prior notice requirement

If either (or both) of the following conditions are met, a foreign investor must file a prior notice before completion of an inward direct investment unless certain exemptions (as explained below) apply:

- the target company or any of its affiliates conducts or is going to conduct any of the businesses designated by the Japanese government as requiring

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the filing of a prior notice (the Specified Businesses, a list of which is set forth below); or

- the 'foreign investor' is from a country or region that is not included in the list of approved countries and regions set forth in the FEFTA (ie, Iraq, North Korea, Somalia and Yemen) (please note that an inward direct investment in certain nuclear businesses from an Iranian entity is also subject to a prior notice although Iran is included in the list).

The Specified Businesses include:

- businesses related to national security (eg, manufacturing activities or software development related to weapons, aircraft, satellites or rockets, or nuclear energy);
- businesses related to public infrastructure (eg, production and/or supply of electricity or gas, heat supply, telecommunications, broadcasting, water-related services and railways and passenger transport);
- business related to dataprocessing (eg, manufacturing activities with respect to data-processing-related equipment and parts, and development of data-processing-related software);
- businesses related to medical care (eg, manufacturing activities related to certain medical drugs for infectious diseases or specially controlled medical devices)
- certain businesses related to metallic mineral; and
- certain other regulated businesses (eg, businesses related to agriculture, forestry and fishing, petroleum, leather and leather goods manufacturing, air and marine transport, and security services).

In principle, if a foreign investor is required to file a prior notice, such investor will not be allowed to complete an inward direct investment until the passage of 30 days from the date the government authority receives the prior notice. However, in practice, such waiting period is typically reduced to two weeks for most filings. In some cases, the relevant authorities may further reduce the waiting period to five business days from the date of receipt of the prior notice. However, if the government authority determines that additional time is necessary to investigate, for instance, whether the investment impairs national security, disturbs the maintenance of public infrastructure or hinders the protection of public safety, or whether the investment has a significant adverse effect on the seamless management of the Japanese economy, it may extend the

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waiting period (often to four and occasionally up to five months), although such extensions are rare. In practice, the government authority implements a stringent review process with regard to investments involving the Core Businesses (as explained below) or those made from certain countries and regions such as China (although China is on the list of approved countries and regions as described above). In the case of such potentially sensitive inward direct investments, it would be advisable to undertake a pre-consultation process with the government authority before filing a prior notice to ensure the timely review by the government authority and gauge the likelihood of obtaining clearance. Once the waiting period has elapsed without objection by the relevant government authority, the foreign investor is allowed to complete the investment.

In the course of the review, the government authority may request a foreign investor or other parties to the investment to provide certain relevant information. In this case, the review process continues until the requested information has been provided and the government authority has assessed the information in order to make its determination. Such information requests can span various topics such as the identity and other basic information of the foreign investor, purposes and key terms of the potential investment, details of the concerned technology and businesses, and the information management system of the foreign investor. In practice, if the review is not expected to be completed until the expiry of the initial waiting period, the foreign investor is often encouraged to withdraw and refile the prior notice so that the government authority does not have to extend the waiting period. In addition, the government authority may request the foreign investor to wait to file the prior notice until the government authority feels comfortable with starting the waiting period. As a result of the review, the government authority may request the foreign investor to abide by certain conditions in order to allow it to proceed with the investment.

Under the FEFTA, a foreign investor who files a prior notice pertaining to an inward direct investment must also file a separate report upon the completion of the investment. Such foreign investor must file such report within 45 days from the date of the completion of the investment.

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Exemptions from prior notice obligation

With respect to inward direct investment by way of share acquisition, a prior notice is not required as long as certain conditions are met. First, in the event that a foreign investor is a foreign financial institution that is regulated or supervised under Japanese laws and regulations or equivalent foreign laws (a Foreign Financial Institution), such foreign investor who intends to acquire shares of a listed company is exempted from filing a prior notice as long as it complies with the following requirements:

- the foreign investor or its affiliates will not become a director or statutory auditor of the target company;
- the foreign investor will not propose an agenda item regarding the transfer or cessation of any of the Specified Businesses; and
- the foreign investor will not have access to any information on non-public technology belonging to the Specified Businesses (collectively, the exemption requirements).

In addition, a foreign investor, whether a Foreign Financial Institution or otherwise, who intends to acquire shares of either a listed company or a non-listed company is entitled to exemption from the prior notice obligation as long as the foreign investor complies with the exemption requirements and the target company is not engaged in the limited categories of the Specified Businesses, including the following (collectively, the Core Businesses):

- businesses related to weapons, aircraft, satellites or rockets, or nuclear energy;
- certain types of cyber security-related services;
- manufacturing activities related to certain medical drugs for infectious diseases or specially controlled medical devices;
- certain types of production and/or supply of electricity or gas;
- certain types of telecommunications services;
- certain types of water-related services;
- businesses related to railways
- businesses related to petroleum; and
- certain businesses related to metallic mineral.

However, even if the target company is engaged in any of the Core Businesses, a prior notice is not required with respect to the acquisition of the shares of a

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listed company whereby the shareholding ratio or voting ratio of such foreign investor after the share acquisition is 1 per cent or more but less than 10 per cent, as long as the foreign investor complies with the exemption requirements and the following additional requirements: the foreign investor, with respect to any of the Core Businesses, will not participate or delegate someone to participate in the target company's board of directors or another important body that has authority to decide on important matters and will not make a written proposal to the target company's board of directors or such other body, or a member thereof, requesting that certain responses or actions be taken before a specified deadline. Such exemption with respect to the Core Businesses is not applicable to the acquisition of shares of a non-listed company. A foreign investor who was sanctioned because of a violation of the FEFTA or is a certain government entity specified under the FEFTA is not allowed to benefit from the exemptions.

Ex post facto report

If a foreign investor makes an inward direct investment that is not subject to a prior notice or is subject to any of the exemptions from the prior notice obligation, such foreign investor will generally be required to file an ex post facto report with the government authority. The filing of an ex post facto report is a relatively simple procedure that only requires the completion and submission of a short-form report within 45 days after the completion of the inward direct investment.

With respect to an acquisition by a foreign investor other than a Foreign Financial Institution of the shares of a listed company to which the exemptions from the prior notice obligation apply, such foreign investor needs to file an ex post facto report in the following circumstances:

- when its shareholding ratio or voting ratio reaches 1 per cent or more for the first time;
- when its shareholding ratio or voting ratio reaches 3 per cent or more for the first time; and
- for every share acquisition whereby the shareholding ratio or voting ratio of such foreign investor after the share acquisition is 10 per cent or more.

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In case of an acquisition by a foreign investor (including Foreign Financial Institutions) of the shares of a listed company in other circumstances, the threshold of an ex post facto report is 10 per cent.

With respect to an acquisition of the shares of a non-listed company that is not engaged in any of the Specified Businesses, a foreign investor is not required to file an ex post facto report if the shareholding ratio or voting ratio of such foreign investor after the share acquisition is less than 10 per cent.

Corrective measures imposed by the Japanese government

If, in the following scenarios, the government authority determines that the inward direct investment is likely to undermine national security, it may order the foreign investor that has conducted the inward direct investment to take corrective measures such as disposing of all or part of the acquired shares:

- the foreign investor conducted the inward direct investment without filing the required prior notice;
- the foreign investor conducted the inward direct investment before the waiting period had elapsed;
- the foreign investor made a false statement in the prior notice; or
- the foreign investor did not comply with, or violated, a government order.

Specified acquisition

As discussed above, a specified acquisition is a transaction whereby a foreign investor acquires a certain number of shares of a non-listed company from another foreign investor. If the target company or any of its affiliates conducts any of the businesses designated as requiring the filing of a prior notice, the foreign investor must file a prior notice before acquiring the subject shares of such target company. The major categories of businesses subject to the prior notice requirement are provided separately from the Specified Businesses although some of them overlap. As is the case with an inward direct investment, a foreign investor may rely on the exemptions from the prior notice obligation in the case where a target company engages in businesses other than the core businesses that comprise of part of the Core Businesses. On the other

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hand, no exemption applies in the case of an acquisition of the shares of a non-listed company that conducts any of such core businesses.

The filing requirements and procedures, as well as the subsequent reporting requirements, are the same as those for an inward direct investment. An ex post facto report is required for a specified acquisition only when a foreign investor does not file a prior notice by relying on the exemptions from the prior notice obligation that would otherwise exist.

Similar to an inward direct investment, the government authority has the authority to order a foreign investor who is in violation of the regulations to take corrective measures.

Other regulated actions under the FEFTA

If a foreign investor intends to approve any of the following actions, a prior notice is required under the FEFTA:

1. substantive change in the business purpose of a domestic company, thereby expanding it to include any of the Specified Businesses, in the case where the voting ratio of a foreign investor is more than one-third of all voting rights;
2. an agenda item to appoint a foreign investor or its affiliated person as a director or statutory auditor of a domestic company that conducts any of the Specified Businesses; or
3. dispose of all or part of the businesses, merger, demerger, dispose of all or part of the shares in a subsidiary, dividend in kind, dissolution or close of the business, in each case, in relation to the Specified Businesses, if a relevant agenda item is proposed to a shareholders meeting by a foreign investor or through other shareholders.

With respect to (2) and (3), if a target domestic company is a listed company, a prior notice is not necessary if a foreign investor holds less than 1 per cent of the voting rights. The government authority reviews those actions as set out in (2) and (3) solely for the purposes of preventing leak of technology information or loss of certain business activities in relation to national security. The government authority is expected to issue a decision granting clearance

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within five business days if no concern is identified from a national security perspective.

This category of the prior notice is required separately from, and in addition to, the one required for a share acquisition. Contrary to a share acquisition, no exemption from the prior notice obligation applies to this category.

Foreign investment control under industry-specific regulations

In addition to the FEFTA, share acquisition by a foreign person or entity is also subject to industry-specific regulations.

For example, a licensed domestic air carrier must not be a foreign person or entity or a corporation where a foreign person or entity is a representative of, or constitutes one-third or more of the officers or holds one-third or more of all of the voting rights of, such domestic air carrier. If a licensed domestic air carrier violates this rule, its licence will be revoked by the relevant government authority. In this regard, a licensed domestic air carrier, when requested by a foreign person or entity to register the shares acquired by such person or entity in the shareholder registry of the air carrier, may refuse such request if it would result in the revocation of its licence in accordance with the rule mentioned above. Similar regulations apply in the fields of freight forwarding, radio stations or broadcasting (in the case of broadcasting the threshold with respect to the proportion of officers that can be foreign persons or entities or voting rights that can be held by such persons or entities is one-fifth rather than one-third).

There are other regulations on share acquisition regarding the financial industry. Namely, a person who holds more than 5 per cent of the voting rights of a bank or insurance company (including a holding company that has a bank or insurance company as a subsidiary) is required to submit a notification to the Commissioner of the Financial Services Agency. In addition, a person whose voting rights ratio is expected to reach or exceed the major shareholder threshold (meaning 20 per cent or, if such person is expected to have a material influence over the financial and commercial decisions of the target, 15 per cent) must obtain the prior approval of the Commissioner of the Financial Services Agency. There are also other regulations in connection with M&A transactions in the financial industry, and therefore parties carrying out

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such transactions need to exercise caution regarding the details of the requisite process and regulatory requirements.

Legal framework of merger control in Japan

The Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947, as amended) (the Antimonopoly Act) prohibits those mergers that may result in substantial restraint of competition in any particular field of trade and provides filing requirements for certain mergers. The Japan Fair Trade Commission (JFTC) is the sole authority that reviews merger control filings. The Guidelines to Application of the Antimonopoly Act Concerning Review of Business Combination (the Merger Guidelines) published by the JFTC describe an analytical framework used by the JFTC in its merger control review. In addition, the Policies Concerning Procedures of Review of Business Combination (the Review Policies) published by the JFTC set forth the JFTC's merger review procedures.

Triggers and thresholds

Triggers

The Antimonopoly Act takes a formalistic approach rather than using the concept of control to determine whether a transaction triggers a notification requirement. The following transactions are prohibited if they result in substantial restraint of competition:

- share acquisitions;
- joint share transfers (*kyodo-kabushiki-iten*);
- appointment of interlocking directorships;
- mergers;
- company splits (*kaisha-bunkatsu*);
- transfers of all or a significant part of the business;
- transfers of all or a significant part of the business's fixed assets;
- leases of all or a significant part of the business;
- delegations of management regarding all or a significant part of the business; and
- contractual arrangements to share business profits and losses.

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Among the types of transactions listed above, share acquisitions (only if the voting rights ratio held by the acquiring company group in a target company exceeds either 20 per cent or 50 per cent as a result of the share acquisition), joint share transfers, mergers, company splits, transfers of all or a significant part of the business and transfers of all or a significant part of the business's fixed assets are subject to prior notification requirements if certain thresholds are met. There are no filing requirements for other types of transactions, such as the appointment of interlocking directorships.

Thresholds

Different jurisdictional thresholds apply depending on the categories of the transaction structure, which are defined based on the Japanese Companies Act. As a result, in some cases it is not clear which category a given foreign transaction would fall under. Moreover, even for a transaction that could be understood as an acquisition of a business as a whole, the JFTC takes a formalistic approach by breaking down the transaction by structure to determine the transaction categories and the number of notifications required. For example, a global transaction could be recognised as a combination of multiple share acquisitions and business transfers.

Share acquisition

Prior notification is required for a share acquisition if all of the following thresholds are met:

- as a result of the share acquisition, the voting rights ratio held by an acquiring company group in a target company exceeds either 20 per cent or 50 per cent;
- the total Japanese turnover generated by the acquiring company group for the last fiscal year exceeds ¥20 billion; and
- the total Japanese turnover generated by the target company and its subsidiaries for the last fiscal year exceeds ¥5 billion.

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Joint share transfers

A joint share transfer is a type of transaction under the Japanese Companies Act in which two or more companies establish a new common holding company. Prior notification is required for a joint share transfer if all of the following thresholds are met:

- the total Japanese turnover generated for the last fiscal year by one of the company groups participating in the joint share transfer exceeds ¥20 billion; and
- the total Japanese turnover generated for the last fiscal year by one of the other company groups participating in the joint share transfer exceeds ¥5 billion.

Merger

Prior notification is required for a merger if all of the following thresholds are met:

- the total Japanese turnover generated for the last fiscal year by one of the company groups participating in the merger exceeds ¥20 billion; and
- the total Japanese turnover generated for the last fiscal year by one of the other company groups participating in the merger exceeds ¥5 billion.

Incorporation-type company split

Prior notification is required for an incorporation-type company split if any of the following thresholds are met:

- the total Japanese turnover generated for the last fiscal year by one of the company groups splitting all of its business exceeds ¥20 billion and the total Japanese turnover generated for the last fiscal year by the other company group splitting all of its business exceeds ¥5 billion;
- the total Japanese turnover generated for the last fiscal year by one of the company groups splitting all of its business exceeds ¥20 billion and the Japanese turnover generated from the corresponding business for the last fiscal year exceeds ¥3 billion if the other company group splits a substantial part of its business;

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- the total Japanese turnover generated for the last fiscal year by one of the company groups splitting all of its business exceeds ¥5 billion and the Japanese turnover generated from the corresponding business for the last fiscal year exceeds ¥10 billion if the other company group splits a substantial part of its business; or
- the Japanese turnover generated from the corresponding business for the last fiscal year exceeds ¥10 billion if one of the company groups splits a substantial part of its business and the Japanese turnover generated from the corresponding business for the last fiscal year exceeds ¥3 billion if the other company group splits all or a part of its business.

Absorption-type company split

Prior notification is required for an absorption-type company split if any of the following thresholds are met:

- the total Japanese turnover generated for the last fiscal year by the company group splitting all of its business exceeds ¥20 billion and the total Japanese turnover generated for the last fiscal year by the absorbing company group exceeds ¥5 billion;
- the total Japanese turnover generated for the last fiscal year by the company group splitting all of its business exceeds ¥5 billion and the total Japanese turnover generated for the last fiscal year by the absorbing company group exceeds ¥20 billion;
- the Japanese turnover generated from the corresponding business for the last fiscal year exceeds ¥10 billion if the company splits a substantial part of its business and the total Japanese turnover generated for the last fiscal year by the absorbing company group exceeds ¥5 billion; or
- the Japanese turnover generated from the corresponding business for the last fiscal year exceeds ¥3 billion if the group splits a substantial part of its business and the total Japanese turnover generated for the last fiscal year by the absorbing company group exceeds ¥20 billion.

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Business transfer or business asset transfer

Prior notification is required for a business transfer or business asset transfer if the following thresholds are met:

- the total Japanese turnover generated by the transferee's company group for the last fiscal year exceeds ¥20 billion; and
- the transaction involves any of the following:
    - acquiring all of the business of a company that generated total Japanese sales of more than ¥3 billion for the last fiscal year;
    - acquiring a substantial part of the business of a company, and the part of the business to be transferred generated a Japanese turnover for the last fiscal year of more than ¥3 billion; or
    - acquiring all or a substantial part of the business assets of a company, and the business assets to be transferred generated a Japanese turnover for the last fiscal year of more than ¥3 billion.

Value of transaction test

On 17 December 2019, the JFTC revised the Review Policies. Under the new policies, the JFTC encourages parties to consult the JFTC even if the transaction does not meet the above turnover thresholds if the value of the transaction exceeds ¥40 billion and falls under any of the following:

- the target company has a business base of operations or research and development facility in Japan;
- the target company is conducting marketing activities in relation to Japanese customers, including setting up a Japanese language webpage or preparing Japanese language leaflets; or
- the target company generated Japanese sales of more than ¥100 million.

Duration and timetables

Notification is compulsory if the thresholds are met. There is no deadline for notification, provided that the transaction is not implemented before the lapse of the 30-day waiting period.

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There is no clear rule as to the stage in the transaction timetable at which the JFTC will accept the notification. However, the outline of the transaction structure must be clear and the acquiring entity must be established and identified, as the filing form that needs to be used is different depending on the transaction category and the filing must be made by each acquiring company. Other than the above, in general, the JFTC will accept the notification if the parties can show a good faith intention to close the transaction. A copy of the definitive agreement is generally required to be submitted to the JFTC together with the notification as a supplemental document. Parties may, however, file on the basis of a less formal agreement such as a letter of intent or memorandum of understanding.

Once the notification is duly accepted by the JFTC, the JFTC will issue an acceptance notice setting out the case number and the date of the acceptance of the notification. The 30-day waiting period starts from the date of the acceptance of the notification (Phase I). Upon request from the parties, the JFTC may, at its sole discretion, shorten the 30-day waiting period and issue a decision granting clearance.

Within 30 days from the acceptance of the filing, the JFTC needs to decide whether to clear the transaction or move to Phase II. If the JFTC does not issue an information request (defined below) during Phase I, the transaction is deemed to have been cleared. In practice, pre-notification discussions are typically held between the JFTC and the relevant parties in relatively complex cases.

If the JFTC issues a formal request to one or more parties to the transaction to submit additional materials or information (information request) during Phase I, the review will move to Phase II. The JFTC will have until the later of 120 days from the date of the acceptance of the notification or 90 days from the date when the parties have completed their response to the information request to decide whether to clear or prohibit the transaction. Once the review moves to Phase II, the transaction is disclosed on the JFTC's website for public comment. In general, it takes at least two to three months for the parties to submit complete responses to the information request. In practice, parties often purposely do not complete their responses to the information request to give themselves more flexibility in terms of timing.

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Public announcements

The notification itself will not be made public. If the merger review proceeds to Phase II, the transaction will be made public on the JFTC's website for public comment. Additionally, if the merger review is completed after Phase II, the detailed competition analysis conducted by the JFTC will be made public.

Moreover, the JFTC makes public, on a quarterly basis, a list of the transactions that it has cleared. In addition, every June, the JFTC makes public a list of selected merger cases with summaries of its competition assessment. The merger parties are given a chance to review a draft summary prepared by the JFTC to make sure that the summary does not contain any business secrets that the merger parties do not wish to be disclosed to the public.

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Due Diligence Coverage, Process and Issues for M&A in Japan

Shigeki Tatsuno, Tsunemichi Nakano and Shogo Tsunoda[1]

This chapter provides specific M&A issues to be investigated by the attorney representing the buyer in an M&A transaction in Japan. Conducting the appropriate diligence review is important as it helps the client to identify any material risks or issues which adversely affect the proposed transaction. In order to appropriately conduct the due diligence exercise, it is very important, at least from a legal perspective, to know the typical risks or issues, or tips to conduct efficient diligence, which could differ from country to country. We hope that this chapter will be of use to foreign companies and lawyers considering an M&A transaction in Japan.

1 Shigeki Tatsuno and Tsunemichi Nakano are partners, and Shogo Tsunoda is an associate at Anderson Mori & Tomotsune.

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The chapter is divided into three parts:

- first, we set out an overview of the role of Japanese legal adviser in the diligence review process, due diligence coverage in Japan and the principal methods used to acquire a target company in Japan;
- second, we consider in detail the main areas of legal due diligence in Japan, including organisation, stock, contracts, assets and liabilities, intellectual property, labour and employment matters, regulatory licence and compliance matters, as well as litigation and disputes; and
- third, we discuss other specific issues of legal due diligence in Japan such as the Foreign Exchange and Foreign Trade Act and human rights due diligence.

Legal due diligence in Japan

Role of legal advisers in due diligence

In Japan, the due diligence review by the potential buyer (the buyer) generally involves investigating the target Japanese company (the target company) from legal, financial, tax and business perspectives. Depending on the nature and scope of the target company's business, the buyer may also include a diligence review of environment matters, information technology and human resources. Among these due diligences, a Japanese legal adviser (the Japanese legal adviser) mainly handles the legal due diligence under the laws of Japan.

In addition, when the target company has overseas subsidiaries, the buyer also needs to investigate whether the foreign subsidiaries have any material risks or issues that adversely affect the proposed transaction. Therefore, the Japanese legal adviser also organises the legal due diligence of foreign subsidiaries, which will be undertaken by local law firms. More specifically, the Japanese legal adviser serves as lead counsel, retains the local law firms that can provide the due diligence review of the target company's subsidiary located outside Japan and supervises the local firms' diligence from the viewpoint of the target company and the relationship therewith.

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Coverage of legal due diligence

The main areas of legal due diligence of the target company include organisation, stock, contracts, assets and liabilities, intellectual property, labour and employment matters, regulatory licence and compliance matters, litigation and disputes. Each area of diligence investigation under Japanese law is discussed under 'The main areas of due diligence'.

Differences in approach to legal due diligence

The approach to legal due diligence in Japan differs depending on the method used to acquire the target company. If the buyer is to acquire the target company, a straightforward and popular method in Japan, as in other jurisdictions, is to purchase shares in the target company by share acquisition through entering into an agreement with the seller. In addition to share acquisition, the Japanese Companies Act provides certain methods of acquiring the target company (or a certain business of the target company) including, among others, business transfer, company split (demerger), merger and share exchange. Under a share exchange scheme, the buyer normally issues its shares to the shareholders of the target company in exchange for the target company's shares.

Under share acquisition and share exchange, the buyer normally purchases all (or part in some cases of share acquisition) of the issued shares of the target company from its existing shareholders. A key difference between the two methods is that consideration for share acquisition in Japan is typically cash and consideration for a share exchange is typically shares of the buyer or buyer's parent company. The transfer of shares under these two methods only changes the composition of the shareholders and therefore does not directly affect the rights and obligations of the target company (eg, assets, liabilities, contracts and employees). As such, there is little need to investigate and analyse the procedures necessary for the succession of the rights and obligations of the target company.

Business transfer involves the individual transfer of bundle of rights and obligations as well as contractual status of parties to the contracts, which constitutes a business of the target company to another entity. During this process,

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the buyer acquires the rights and obligations of the target company that are identified in the business transfer agreement. Because the rights and obligations are transferred individually pursuant to general law principles, certain succession procedures may be required to succeed the contractual status of parties to the contracts as well as the rights and obligations of the target company accordingly (eg, obtaining prior written consent from, or providing notice to, counterparties to the contracts).

A company split or merger is a reorganisation procedure pursuant to the Japanese Companies Act and involves transferring the business as a whole of the target company comprehensively to another entity; the difference between them is that under a company split, certain scope of a company specified by a party is transferred whereas the entire company is transferred under a merger. Unlike a business transfer scheme, all of the relevant rights and obligations are transferred comprehensively (ie, automatically) without any succession procedure or transfer requirements (eg, for consent or notice) unless otherwise provided for in individual contracts or in laws and regulations for regulatory permits.

In this chapter, we focus mainly on legal due diligence for the purpose of acquiring all the shares in a target company through share acquisition unless otherwise provided (for example, under 'Matters to be noted for transactions involving business transfer or company split', we discuss some of the issues that commonly affect M&A transactions involving a business transfer or company split).

Details of legal due diligence in Japan

The main areas of due diligence

Organisation

The first step of the due diligence with respect to the target company's organisation is to review the contents of its company register. A certified copy of the company register is available to the public at the local branch of the Legal Affairs Bureau for the area in which the target company has its principal business office.

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Another fundamental document that a buyer acquiring a Japanese company needs to review is the articles of incorporation. Under the laws of Japan, Japanese stock companies are required to have articles of incorporation. Although some of the necessary items that are required to be included in the articles of incorporation overlap with the company register, in practice, Japanese stock companies may stipulate in the articles of incorporation further items related to the organisation and operation of the company (eg, quorum, requirements for resolutions, matters for resolutions of shareholders' meetings and board of directors' meetings, definition of the fiscal year, tenures, powers of directors and auditors, and procedures related to paying out dividends).

The table sets out the statutory contents of the company register and articles of incorporation, plus voluntary items that are typically included in the articles of incorporation.[2]

Contents of company register and articles of incorporation

	Company register	Articles of incorporation
Company's business purpose	√	√
Trade name	√	√
Location of head office and branch office	√	√
Amount of stated capital (capital requirement)	√	
Total number of shares issuable by a Japanese stock company	√	√
Details of class of shares (eg, priority of dividend of surplus, priority of distribution of residual assets)	√	√
Total number of issued shares, classes of shares and number of shares in each class	√	
Names of directors	√	
Name and address of representative director	√	

2 Article 911, paragraph 3 of the Companies Act.

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	Company register	Articles of incorporation
Organisational structure in the company (there should be at minimum a shareholders' meeting and a director in a Japanese stock company)	√	√
Provisions for transfer of shares (if the transfer requires the approval of the company)	√	√
The way the company provides public notices	√	√
Quorum, requirements for resolutions, matters for resolutions of shareholders' meetings and board of directors' meetings		√
Timing, procedures, method of resolutions of shareholders' meetings and board of directors' meetings		√
Definition of the fiscal year		√ (V)†
Number of directors and auditors		√ (V)†
Tenure of directors and auditors		√
Powers of directors and auditors		√ (V)†
Procedures related to paying out dividends		√
†(V) – voluntary item		

Although the company register and the articles of incorporation provide fundamental information regarding the target company, the information is not comprehensive. The buyer needs to further request necessary information from the target company (or the seller) with respect to its organisation so that the buyer can conduct the necessary diligence. For example, it is recommended that the buyer request from the target company (or the seller):

- the shareholder register, as the names of the shareholders of the target company are not included in the company register; and
- the minutes of shareholders' meetings and board of directors' meetings to investigate what has been discussed at these meetings.

Stock

In an M&A transaction involving share acquisition, it is important to confirm through the due diligence whether the seller validly holds all of the shares

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in the target company, by tracing the history of the shareholders since the incorporation of the target company. In order to conduct such diligence, it is necessary to understand two aspects of the laws of Japan in relation to share acquisition and incorporators.

First, in the case of a private company, the approval of the general meeting of shareholders (or the board of directors if the company has a board of directors) is required for the transfer of shares.[3] In addition, in the case of a share certificate-issuing company, the transfer of shares is not effective unless the share certificates are delivered to the transferee.[4] Therefore, in order to confirm that the transferee validly holds the shares through the proper transfer procedure, it is necessary to investigate that a resolution approving the share acquisition has been passed at a general meeting of shareholders (or the board of directors) of the private company, and that the transferee has received share certificates in the share certificate-issuing company. This can typically be confirmed through reviewing relevant minutes of shareholders' meetings or board meetings.

Second, before the 1990 amendment to the Commercial Code (which was the main law governing Japanese companies until the Companies Act took effect in 2006), Japanese companies were required to set up at least seven incorporators for incorporation, therefore relatives or friends of the incorporators or employees of a company sometimes became nominal shareholders, especially in the company established by family members. Since bona fide shareholders (who are not nominal shareholders) validly hold shares in Japanese companies under the laws of Japan, the buyer needs to carefully analyse who the bona fide shareholders of the target company are (if the company was incorporated before the 1990 amendment to the Commercial Code, as the Commercial Code is still effective for the purpose of analysing the legality of relevant corporate actions when the Code was in effect), taking into account who paid for stock, who receives dividends for stock, who are involved in the management of the target company, among other factors.

3 Article 139, paragraph 1 of the Companies Act.

4 Article 128, paragraph 1 of the Companies Act.

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Contracts

Under the due diligence for the purpose of conducting a transaction that involves change of control of the target company, it is important to confirm whether the change of control provisions are included, especially in contracts that are material for the business of the target company. For example, certain contracts executed by the target company may contain change-of-control provisions allowing the counterparties of the target company to terminate the contracts when a significant change occurs in the composition of the shareholders of the target company. In this case, the consent of the counterparties regarding transfer of shares must be obtained. In this regard, it should be noted that contracts entered into by and among Japanese companies are occasionally written in a quite simple form lacking sufficient provisions, and often include abstract and broad language, among other things, in the change-of-control provisions. Thus the buyer must carefully analyse whether the transaction triggers events described in change-of-control clauses of material contracts entered into by the target company.

The buyer also needs to identify in the due diligence process whether material contracts have a non-assignment provision, which does not permit assignment of all or part of rights and obligations under a contract, or specifies that consent is required for doing so. Since there is no uniform interpretation under Japanese law as to whether succession under a company split constitutes an assignment to any third party all or part of its rights or obligations under such provision, it is important to carefully consider the non-assignment provision in the transaction involving company split.

Furthermore, in Japan, there are many cases in relatively small companies where oral promises that are agreed upon without a written contract or documents (such as purchase order or order receipt), which make the diligence review of contracts quite difficult. In addition, even when written contracts exist, certain terms and conditions of the contract between the target company and its business partners are often not elaborated in detail. In this case, it is necessary to analyse them according to the principles under the Civil Code and the Commercial Code.

Moreover, in Japan, there are often strong business ties between affiliated companies, especially when they are owned by an individual owner. If the target

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company has transactions with its parent company or other affiliated companies, including companies owned by the owner's family members or relatives, it is necessary to confirm whether the transactions are conducted at arm's length, and to analyse the necessity of contract modification or termination before the transactions are completed.

Finally, the buyer also needs to investigate in the due diligence process whether there are any contracts that adversely affect the operation of the business after the acquisition is completed. Examples of such contracts typically include those that contain non-compete provisions.

Assets and debts

If the target company leases buildings, generally speaking, the lessee is protected under Japanese law and there is a risk that the target company may not be able to evict the lessee even after the agreed lease period has expired. For instance, if the target company conducts a retailing business such as supermarket business, the target company rents a suitable building from its owner to operate a supermarket, then subleases a portion of the building to another retailer (eg, a flower shop operated by another company inside the supermarket). In this case, there is a risk that the target company may not be able to evict the lessee (eg, another retailer) at will as the Japanese law is quite lessee-friendly in terms of renewal of building lease contracts.

For example, article 26, paragraph 1 of the Act on Land and Building Leases (the Act on Leases) stipulates that in cases where a period has been prescribed for a building lease, when, from between one year to six months prior to the expiration of said period, the parties fail to notify the other party to the effect that the lease shall not be renewed, it shall be deemed that the contract has been renewed with conditions identical to those of the existing contract, provided that said period is not prescribed.

Further, article 28 of the Act on Leases states that the non-renewal notice set forth in article 26, paragraph 1 of the Act on Leases may not be given, and a request to terminate a building lease may not be made, unless it is found that there are justifiable grounds for doing so. When determining the justifiable grounds, the following factors are considered:

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- the circumstances pertaining to the necessity of using the buildings on the part of lessor and the lessee (including the sub-lessee);
- the history of the building lease contract;
- the conditions of the building's use;
- the current state of the building; and
- in cases where the lessor has offered payment to the lessee as a condition for surrendering the buildings, the consideration of such offer.

Based on the above factors, it is necessary to conduct a detailed fact-finding investigation to analyse whether there are justifiable grounds and that the tenant can be evicted. However, it is usually very difficult to prove that justifiable grounds exist.

Intellectual property

Similar to the diligence review in other jurisdictions, it is important to analyse whether the target company actually owns the intellectual property that the target company claims to own or is important to its business. Careful attention needs to be paid especially for a jointly owned patent as, under the laws of Japan, if the target company jointly owns a patent right with a third party, exercising such patent right is more restricted than exercising the solely owned patent. For example, under the Patent Act, where a patent right is jointly owned, although each of the joint owners of the patent right may work[5]

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5 Working of an invention in the Patent Act means the following acts:

- in the case of an invention of a product (including a computer program, etc, the same shall apply hereinafter), producing, using, assigning, etc (assigning and leasing and, where the product is a computer program, etc, including providing through an electric telecommunication line, the same shall apply hereinafter), exporting or importing, or offering for assignment, etc (including displaying for the purpose of assignment, etc, the same shall apply hereinafter) thereof;
- in the case of an invention of a process, the use thereof; and
- in the case of an invention of a process for producing a product, in addition to the action as provided in the preceding item, acts of using, assigning, etc, exporting or importing, or offering for assignment, etc the product produced by the process.

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the patented invention without the consent of the other joint owners,[6] unless otherwise agreed upon by a contract, no joint owners of a patent right may:

- assign or establish a right of pledge on his or her own share of the patent right;[7] or
- grant an exclusive licence or non-exclusive licence to the patent right to any third party without the consent of all other joint owners.[8]

In the case of an invention of a product, a subcontractor of one of the joint owners of the patent right may work the patented invention without the consent of all other joint owners, if such subcontractor acts solely for such joint owner and manufactures the product under the control and supervision of such joint owner.

During the due diligence review with regard to intellectual property, it is also important to confirm whether the target company has paid reasonable compensation for an employee invention. Under the Patent Act, if an employee creates an invention that falls within the scope of the business of the employer and was achieved by acts categorised as a present or past duty performed by the employee for the employer (the employee invention), the employer will automatically own the employee invention from the time the employee invention was created if, and only if, the employer entered into an agreement or stipulated in its rules of employment in advance that the employer will own the employee invention. If the employer owns the employee invention, the employee will have the right to claim reasonable compensation for such employee invention, which could adversely affect the cash flow and valuation of such company. If the employer pays reasonable compensation in accordance with its rules of employment, the employer does not have to give any additional benefit. Therefore it is necessary to confirm whether the rules of employment that contain the provisions relating to compensation for the employee invention are reasonable and whether the employer (ie, the target company) has actually paid reasonable compensation in accordance with such rules.

6 Article 73, paragraph 2 of the Patent Act.

7 Article 73, paragraph 1 of the Patent Act.

8 Article 73, paragraph 3 of the Patent Act.

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Labour and employment

Among various issues related to labour and employment aspect of Japanese companies, the issue of unpaid wages such as overtime allowance is one of the most commonly seen issues that require careful investigation. It is also one of the typical reasons for potential liability for companies in Japan, which could turn out to be a significant amount, since overtime work has been quite common practice in Japan. Therefore the buyer is strongly recommended to investigate whether the target company has any unpaid wages through the due diligence review. There are two particular aspects of unpaid wages in Japan, as follows.

Under the Labour Standards Law, a working hour (for employees in Japanese companies) is set at eight hours a day and 40 hours a week, and there must be one non-working day a week.[9] For any overtime work outside this period and any work during holidays, the employer is obliged to pay extra wages.[10] In addition, if an employee had to work during late-night or early-morning hours (ie, from 10pm to 5am), the employer is obliged to pay extra wages.[11] Thus, it is important to manage and calculate the precise number of working hours for employees, including the number of hours for their overtime work, to precisely assess the financial risk. If the target company does not have a good system to track employees' working hours (eg, employees merely record their working hours on their own), the target company is likely to be obliged to pay out a certain amount of unpaid wages, which could sometimes be significant.

On the other hand, if an employee of the target company is objectively classified as a manager or supervisor, he or she is exempted from some of the provisions of the Labour Standards Law concerning working hours, overtime work and work during holidays.[12] In such cases, employers are not obliged to pay managers or supervisors extra wages for overtime or work during

9 Article 32 and 33, and article 35, paragraph 1 of the Labour Standards Law.

10 Article 37, paragraph 1 of the Labour Standards Law, and the Cabinet Ordinance concerning Minimum Rate of Wages for Overtime Work and Work on Holidays under article 37, paragraph 1 of the Labour Standards Law.

11 Article 37, paragraph 4 of the Labour Standards Law.

12 Article 41, item 2 of the Labour Standards Law.

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holidays (although they are obliged to pay extra wages for late-night or early-morning work).

However, although Japanese companies typically nominate a large number of managers or supervisors among their employees, there are strict requirements as to whether such employees actually can be treated as managers or supervisors under Japanese laws and regulations. These factors include whether he or she:

- is in an integrated position with management with respect to the determination of working conditions and other labour management;
- has important duties and responsibilities that require him or her to operate beyond the framework of regulations regarding working hours, overtime and work during holidays; and
- is in a position where his or her actual working conditions do not conform to regulations regarding working hours.

A comprehensive judgement should be made based on the job description, responsibility and authority, working conditions and compensation package. If the target company inappropriately determined that a certain employee was a supervisor or manager, he or she will be deemed an employee fully entitled to extra wages for overtime or work on holidays as well as late-night or early-morning work and the target company is likely to be obliged to pay unpaid wages for the overtime work of the employee concerned.

Regulatory licence or permit and compliance

In M&A transactions in Japan, due diligence with respect to the regulatory licence or permit owned by the target company requires confirmation of the necessary procedure to maintain such licence or permit post-transaction. This item is especially important in a business transfer or company split, either of which is used to carve out a business of companies, and careful confirmation as to whether such licence or permit can be transferred from the target to the buyer is necessary in such cases. Generally speaking, while under a business transfer scheme the regulatory licences or permits held by the target company may not be transferred and therefore the transferee (or the buyer) would ordinarily have to obtain such licences or permits, under company split scheme certain licences or permits may be transferred to the transferee (or the buyer).

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In this section, we discuss aspects of the Act on Securing Quality, Efficacy and Safety of Products including Pharmaceuticals and Medical Devices (the PMD Act) that allow the transfer of certain regulatory licences or permits but not others in the pharmaceutical industry.

Under the PMD Act, a person who conducts a marketing business of pharmaceuticals in Japan must obtain a marketing licence for pharmaceuticals (marketing business licence).[13] In addition, when the holder of a marketing licence for pharmaceuticals intends to market a particular pharmaceutical item in Japan, the holder must receive marketing approval for such pharmaceutical item individually.[14] On the other hand, a person who conducts a manufacturing business of pharmaceuticals in Japan must obtain a manufacturing licence for each manufacturing facility of pharmaceuticals (manufacturing business licence).[15]

Under the PMD Act, when a person holding marketing approval for a pharmaceutical item transfers the marketing business of such pharmaceutical item (along with the marketing materials for such pharmaceutical item) through business transfer or company split, the transferee (or the buyer) will be able to inherit the marketing approval for such pharmaceutical item,[16] provided that the transferee (or the buyer) files a statement of the transfer with the Pharmaceuticals and Medical Devices Agency around one month prior to the transfer. However, neither the marketing business licence nor the manufacturing business licence can be transferred under the PMD Act through a business transfer or company split, and therefore the transferee (or the buyer) must hold or obtain the necessary marketing business licence or manufacturing business licence.

13 Article 12, paragraph 1 of the PMD Act.

14 Article 14, paragraph 1 of the PMD Act.

15 Article 13, paragraphs 1 and 2 of the PMD Act.

16 Article 14-8 of the PMD Act.

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Litigation and disputes

The number of litigation cases in Japan is fewer than in other countries. It is, however, still important to investigate whether the target company has any ongoing litigation cases to which the target company is a party. In addition, the average trial period for civil cases among Japanese companies is usually long, and sometimes judgment will be rendered after expiry of the indemnity clause set in the definitive agreements. Therefore, the buyer should consider using special indemnity clauses in the definitive agreement of the transaction (eg, with the higher cap amount and the indefinite indemnity period) with respect to ongoing civil cases to which the target company is a party. In addition, the buyer should also identify disputes and other claims that have not led to litigation.

Matters to be noted for transactions involving business transfer or company split

In Japan, while Japanese companies were aware of the importance of reviewing and reorganising their business portfolios regularly in order to increase their corporate value, transactions to sell and carve out a certain business materialised relatively less frequently in the past than now. However, with the spread of covid-19, Japanese companies have been placed in an extremely difficult situation as they have faced a temporary decline in demand and a rapid deterioration in cash flow due to the disruption of cross-border supply chains. In such a situation, the Japanese companies have been forced to implement structural reforms including reorganising their business portfolios in order to increase corporate value and sustainable growth. In addition, due to the revision of the Corporate Governance Code for listed companies[17] and other governmental guidelines,[18] the listed Japanese companies are now required to formulate the policy for reorganising their business portfolios; in addition, the listed

17 Tokyo Stock Exchange, Inc 'Corporate Governance Code', Supplemental Principles 4.2.2 and 5.2.1.

18 Ministry of Economy, Trade and Industry 'Practical Guidelines for Business Transformations - Toward Changes to Business Portfolios and Organizations'.

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Japanese companies are also required to provide their shareholders with easy-to-understand explanation of such policy and the status of reorganization of their business portfolios. Therefore, we anticipate that Japanese companies will enter into many more transactions to carve out a certain business and conduct related M&A at a greater pace in the future.

In order to conduct the appropriate diligence review for transactions involving business transfer or company split to carve out a certain business, it is important to consider whether rights transferred from the target company (ie, contracts, assets, intellectual property, systems, employees and insurance) are both necessary and sufficient for the operation of the transferred business after the succession. If they are not sufficient, stand-alone issues may arise.

In the event that certain rights or agreements are also necessary for the target company's business operations and will not be transferred to the buyer, it may be necessary that the target company and the buyer enter into transition service agreements, preferably at the same time as the definitive agreements of the transaction are concluded or when the transaction is completed at the latest, so that the buyer may continue to receive necessary services after the transaction is completed (ie, to resolve the stand-alone issues). For example, the transition service agreement stipulates that the target company may license its patents, trademarks, copyrights and know-how to the buyer after the transaction is completed. For another instance, if raw material supplier agreements are necessary for both the target company and the buyer but cannot be transferred to the buyer for a legal reason or economic reason, the transition service agreement may stipulate that the target company buys from the supplier a certain amount of raw materials necessary for its business and the transferred business and resell such raw materials to the buyer on a back-to-back basis (ie, at the same price purchased from the supplier) after the transaction is completed. Accordingly, from the due diligence perspective, it is important to investigate and identify possible stand-alone issues that need to be covered under the transition services agreements.

One of the most important issues in a transaction involving a company split is the succession of employees under the Act on the Succession to Labour Contracts upon Company Split. When a company is split, the splitting company is required follow certain procedures in order to protect the affected employees. For example, pursuant to the Act, the splitting company is required to give

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written notices to employees who are primarily engaged in the business to be succeeded and are included in the succession. Such notices must also be given to trade unions. Furthermore, the following employees must be given the opportunity to object to such inclusion or exclusion:

1. those who are primarily engaged in the business to be succeeded but are excluded from the succession; and
2. those who are not primarily engaged in the business to be succeeded but are included in the succession.

In the case of (1), the employees are entitled to be included in the succession, and in the case of (2), the employees are entitled to not be included in the succession. For the above purposes, it is important to properly determine during the diligence review whether the employees are mainly engaged in the business to be succeeded.

Other specific issues of legal due diligence in Japan

On the Gun-jumping Regulation from a competition law perspective (which is a very important point for the transactions especially between competitors), please refer to the 2021 edition of this chapter.

Foreign Exchange and Foreign Trade Act

Under the Foreign Exchange and Foreign Trade Act, which governs foreign investments, when a foreign investor acquires more than a certain percentage of shares or voting rights in a Japanese company engaged in certain designated industries (discussed below), the investor is required to submit prior notification to the minister having jurisdiction over the business and the Minister of Finance. In particular, the foreign investor must submit prior notification at least 30 days before making the investment in each of the following cases:

- a foreign investor acquiring 1 per cent or more of the shares or voting rights of a listed company (the threshold has been lowered from 10 to 1 per cent in accordance with the 2020 reform of the Foreign Exchange and Foreign Trade Act);
- a foreign investor acquiring any shares or equity in an unlisted company; or

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- a foreign investor acquiring a business from a domestic corporation engaged in a designated industry, through business transfer, an absorption-type company split or merger.

Upon its review of notification, the Minister of Finance or the competent minister may recommend a change to the transaction structure or cancellation of the foreign investment. In addition, because the investment cannot be made until prior notification has been submitted and reviewed by the competent authorities, this has significant impact on the transaction schedule and structure. Therefore it is important to consider during the due diligence review whether the investment falls within any of the designated industries, including aircraft, weaponry, nuclear power, space development, energy, leather goods and information processing.

It is necessary to determine whether an investment falls under a designated industry by reviewing its actual business activities as well as the business purpose in the articles of incorporation of the target company. Therefore, during the due diligence review, it is important not only to confirm whether the designated industry is listed in the business purpose in the articles of incorporation, but also to confirm whether the target company actually operates its business in the designated industry.

Exemptions to prior notification have not been described in detail in this chapter.

Human rights due diligence

In 2011, the United Nations Human Rights Council endorsed 'Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework' (the Guiding Principles), which states that business enterprises should respect human rights and have in place policies and processes appropriate to their size and circumstances, including a human rights due diligence process. According to the Guiding Principles, a human rights due diligence means a process that business enterprises should continuously carry out in order to identify, prevent, mitigate and account for how they address their actual and potential adverse human rights impacts that they may cause or contribute through their own activities, or which may be directly linked to their operations, products or services by their business relationships. The Guiding Principles encourage the business enterprises, in

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conducting human rights due diligence, to pay special attention to potential adverse human rights impacts on individuals or populations that may be at heighted risk of vulnerability (eg, indigenous people, women, national or ethnic minorities, religious and linguistic minorities, children, persons with disabilities and migrant workers and their families). The Guiding Principles triggered a global increase in interest in human rights due diligence.

In Europe, a proposed directive making human rights due diligence mandatory has been announced, and legislation to make human rights due diligence mandatory is under way in various countries. On the other hand, initiatives in Japan have been in progress. In September 2022, the Japanese government issued the Guidelines on Respecting Human Rights in Responsible Supply Chains to assist Japanese companies in identifying and addressing human rights concerns (eg, forced labour and child labour) in their supply chains through the following steps:[19]

1. to identify the business areas where the likelihood of adverse human rights impacts is high and where there are significant risks (including the following risks);
   - sector risks: risks that are globally prevalent within a sector due to the characteristics of the sector, its activities, its products, and production processes;
   - product and service risks: risks associated with the materials used in the development or use of specific products and services, and risks associated with the development or production process;
   - geographic risks: conditions in a particular country that may increase the likelihood of sector risks; and
   - enterprise-level risks: risks associated with a particular business enterprise, such as weak governance and a poor human rights record;
2. to identify how adverse human rights impacts may occur (ie, who suffers adverse impacts on which human rights) in each process of the business enterprise's operations;

19 The Inter-Ministerial Committee on Policy Promotion for the Implementation of Japan's National Action Plan on Business and Human Rights 'Guidelines on Respecting Human Rights in Responsible Supply Chains'.

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3 to assess the business enterprise's involvement in adverse human rights impacts in order to determine an appropriate response; and
4 to consider prioritising responses if it is difficult to immediately address all identified and assessed adverse human rights impacts.

In practice, human rights due diligence process is required as a process that companies should carry out on a regular basis, making it difficult to calculate the risk assessments in the event that human rights risks are discovered. However, the risk of monetary expenditures such as large fines due to human rights violations of increasingly strict laws and regulations on human rights, as well as the reputational risk associated with public criticism of human rights violations are important factors in calculating the corporate value of the target company, and the reputational risk of the target company which will be included in the buyer's group as a result of an M&A transaction will affect the value of the buyer's group post transaction. Therefore, in the M&A transactions, it is desirable to conduct the human rights due diligence to detect human rights violations (eg, forced labour in supply chains).

Since human rights risks are innumerable and vary depending on the target company's business, products and services, the countries and regions in which the target company operates, it is necessary to conduct an investigation focusing on human rights risks that are assumed to be the most serious in the target company with reference to the above steps. For example, if the target company is the manufacturing company with a global supply chain, the investigation should focus on the existence of forced labour and child labour, etc. In this case, it would be important to understand the overall picture of the supply chains and then prioritise based on the products, components and countries that are most likely to be problematic. However, it is often difficult for the seller to extend the scope of the diligence investigation to the supply chains of the target company at a stage of due diligence from the perspective of information management. In such case, it is at least desirable to confirm the target company's policy on human rights, and confirm whether it is consistent with the buyer's policy. Once the target company is under the control of the buyer after the acquisition, it is highly recommended for the buyer to have the target company conduct human rights due diligence in more detailed and comprehensive manner during the post-merger integration process.

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Corporate Governance Issues around M&A in Japan

Daiki Ishikawa, Aritsune Miyoda and Hiroko Kasama[1]

Environments surrounding M&A transactions and corporate governance

Since the early 2000s, the Japanese M&A market has continued to grow almost steadily. These days, M&A has become one of the normal strategic options not only for large listed companies but also for medium-sized or small companies. As an M&A transaction involves complex considerations from various perspectives including business, financial, accounting, tax and legal, and relates to various stakeholders including shareholders, employees, business partners and sometimes the public, it is important that the corporate governance mechanisms within the company function properly. Corporate governance issues are particularly critical in a public deal given the complexity of the deal and the number of relevant stakeholders, but they cannot be ignored in a private deal.

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Corporate governance issues in M&A transactions are strongly recognised in deals where the interests of directors may conflict with the interests of shareholders. In the late 2000s, several hostile takeover attempts captured the public's attention, and anti-takeover measures taken by the management of the subject companies stimulated broad controversial discussions from a corporate governance perspective. In the 2010s, several court decisions regarding the fairness of management buyouts and privatisation by controlling shareholders of public companies formulated the basic framework for the processes to be taken by the management of the target companies in transactions with potential conflicts of interest.

For M&A transactions that do not entail conflict-of-interest issues, however, it is understood that the 'business judgement rule' generally applies to directors' decisions. Where the business judgement rule under the Japanese Companies Act applies, as long as directors make reasonable, informed business decisions based on sufficient information, including obtaining expert advice and information through due diligence, the courts would normally defer to the judgement of the board of directors. Therefore, there are not many Japanese court cases where the directors' decisions were stringently scrutinised. There are more details of case law in Japan regarding due diligence and companies' decisions in M&A transactions in this chapter.

Strong calls for enhanced corporate governance in Japanese companies have been made for a long time from inside and outside Japan. Several large scandals involving famous Japanese companies in the middle and late 2010s fuelled calls for significant reforms in corporate governance in Japan. The importance of proper governance in each step of an M&A transaction, including due diligence, negotiations and post-merger integration processes, has even been strongly acknowledged in actual cases where Japanese companies faced crises resulting from problems caused by overseas group companies they acquired through cross-border mergers and acquisitions.

In response to these calls, the Japanese legislature, as well as relevant authorities such as the Ministry of Economy, Trade and Industry (METI) and the Japanese Financial Services Agency (FSA), as well as the Tokyo Stock Exchange (TSE), which govern the listing rules for Japan-listed companies, adopted new regulations to implement mechanisms to enhance corporate governance and to eliminate major problems that may prevent such mechanisms from

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functioning, such as cross-shareholding. Some of the recent Japanese corporate governance regulations recognised and addressed the importance and risks of M&A transactions.

Following these reforms and changes to the corporate environment, the corporate governance of Japanese companies has become closely reviewed by their shareholders and potential investors. In this regard, an interesting phenomenon in the corporate world is the increase in the number of unsolicited takeovers of Japanese listed companies. While those unsolicited takeover attempts in Japan were historically made by activist funds and were mostly unsuccessful, some recent successful unsolicited takeovers were initiated by large Japanese companies. For example, in March 2021, Nippon Steel Corporation acquired a nearly 20 per cent stake in Tokyo Rope Mfg Co Ltd through an unsolicited tender offer. In these recent cases, the buyer often highlights poor governance by incumbent management members, which tend to generate support from minority shareholders compared with prior takeover attempts. Another instance involved the unsolicited tender offer of shares in Shinsei Bank, Limited initiated by SBI Holdings, Inc in September 2021. Here, even the Japanese government, as a major shareholder of Shinsei Bank, expressed a negative view against the anti-takeover measures that the bank's management contemplated, eventually leading to a settlement between the parties in which Shinsei Bank accepted the acquisition by SBI Holdings.

Recent developments in Japanese corporate governance in M&A transactions

Amendment to the Companies Act

A recent law amending the Companies Act (the Amendment) came into full effect in June 2021. The Amendment focuses on enhancing corporate governance in general, including reforms regarding shareholders' meetings (such as the requirement to make meeting materials available online), the requirement to enhance transparency in directors' remuneration and the requirement for listed companies to appoint at least one outside director. Envisaging the expanded role of outside directors in decision-making, particularly in transactions involving conflicts of interest of management directors, the Amendment makes clear that outside directors will not lose their outsider status even if they

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are delegated the management of the company (such as deciding proposals for management buyouts) in transactions that entail conflicts of interest between the company and its management.

Corporate Governance Code and Stewardship Code

The corporate governance of listed companies is also regulated by the Corporate Governance Code (the Governance Code) and the relevant guidelines established by the TSE. Adopted in June 2015 and revised in June 2018, the Governance Code was further revised in June 2021.

The Governance Code contains important principles on the corporate governance of listed companies, taking the comply-or-explain approach that is similar to equivalent codes of the United Kingdom. It also addresses matters relating to mergers and acquisitions conducted by listed companies, such as requiring listed companies to carefully consider and explain to shareholders the necessity and reasonableness of anti-takeover measures and measures that could result in a change of control or significant dilution. Also, the revision of the Governance Code in 2018 emphasised the importance of the cost of capital in determining the company's business portfolio and resource allocation. Such emphasis on the cost of capital may urge Japanese listed companies to consider restructuring their business portfolio and thus encourage them to dispose of their non-core businesses to focus on their competitive businesses.

On the investor side, the FSA established the Japanese version of the Stewardship Code in 2014, which was revised in 2017 and 2020. The Stewardship Code requires institutional investors who opt to comply with it to act for the benefit of its beneficiaries, to closely monitor the investee companies, and to exercise their voting rights in accordance with clear and publicly disclosed policies. The Stewardship Code is expected to enhance the monitoring functions of institutional shareholders in relation to company management.

Discussions on listed subsidiaries

In the Practical Guidelines for Group Governance Systems released by the METI in 2019, the METI indicated its concern on the existence of conflicts of interest between the parent and the minority shareholders of listed subsidiaries and

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requested parent companies to reconsider the grounds for maintaining the listing status of their subsidiary and disclose to investors measures to ensure an effective governance system of the listed subsidiary. In the 2021 revision of the Governance Code, TSE urged subsidiaries listed on its 'Prime' section to make a majority their board members independent outside directors.

Overhaul of guidelines on M&A transactions with conflict of interest

Previously, the METI's guidelines for management buyouts (MBOs), the Guidelines for Management Buyout to Enhance Corporate Value and Ensure Fair Procedures, had a substantial impact on Japanese MBO practices. The METI has substantially updated the foregoing guidelines and formulated the Fair M&A Guidelines; Enhancing Corporate Value and Securing Shareholders' Interests in June 2019 (the Fair M&A Guidelines). The guidelines illustrate certain measures to ensure best practice to be taken not only in MBOs but also in acquisitions by controlling shareholders. While the guidelines do not have any mandatory effect, they are broadly considered to be in accordance with, and in furtherance of, the rules established by case law to date, and are likely to be referred to by courts in the future. See the following section for details.

In light of the recent trends regarding M&A transactions in Japan including the increase in unsolicited takeovers and related judicial decisions as well as changes in social and economic circumstances surrounding listed companies, the METI launched the Fair Acquisition Study Group in November 2022 to analyse the behaviour of related parties in acquisitions with the goal of promoting M&A transactions that enhance corporate value. The Fair Acquisition Study Group aims to release revised guidelines for M&A transactions in the spring of 2023.

Conflict of interest between controlling shareholders and minority shareholders

Relationship between controlling shareholders and minority shareholders

As the METI updated its guidelines, similar to MBOs, there can be a significant conflict of interest between controlling shareholders and minority shareholders when controlling shareholders acquire all the shares of the target

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company from minority shareholders. Such controlling shareholders have an incentive to buy the shares at a lower price, while the minority shareholders would like to sell their shares at a higher price. Further, by dispatching directors to the target company or by exercising voting rights at the shareholders' meeting of the target company, controlling shareholders tend to have considerable influence over the decision of the target company. So an asymmetry of information regarding the target company tends to exist between the controlling shareholders and minority shareholders and it is unlikely for controlling shareholders to voluntarily transfer such information to minority shareholders. As explained below, the Fair M&A Guidelines handle such inherent conflict of interest by incorporating an influential 2018 Japanese Supreme Court decision generally referred to as the *JCOM* decision.

M&A transactions and fiduciary duties

The duties of the target company's management in M&A transactions with conflicts of interest have long been discussed. In the *Lex Holdings* case in 2013 involving a breach of fiduciary duty claim with respect to an MBO, the Tokyo High Court held that, while the decision to conduct the MBO itself should be a business judgement, the directors' duty of care must be exercised for the common interests of the shareholders, and the directors must perform their fiduciary duties to ensure that fair value is transferred among the shareholders and to disclose adequate information necessary to ensure informed decision-making by the shareholders to determine whether to tender their shares in a tender offer. Although some academics and practitioners view that this court decision imposes a stricter standard of review for conflicted transactions that more or less resembles *Revlon Duties*, it is unclear whether this is indeed the case and there is no clear Supreme Court case that addresses this issue.

The legal framework of the JCOM decision

How the company and its management (and the acquirer) should act in conflicted M&A transactions is more closely analysed in appraisal cases where the minority shareholders objected to the acquisition prices. On 1 July 2018, the Supreme Court introduced an important legal framework to decide what is

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fair value for cashing out minority shareholders in public M&A transactions. In this case, the controlling shareholders, who owned more than 70 per cent of the voting rights of Jupiter Telecommunication Co Ltd (JCOM), made a tender offer followed by a squeeze-out of JCOM's minority shareholders. After the controlling shareholders completed the transaction, the minority shareholders exercised their appraisal rights under Japanese corporate law and asked the court to determine whether the cash-out price, which was the same price as the tender offer price, was fair value.

The Supreme Court held that if the tender offer was conducted through a process that is generally accepted as fair, then the cash-out price, which was the same as the tender offer price, should be considered fair value. This decision stands out from previous lower courts' decisions, since it highlights the importance of the M&A process itself. Before the *JCOM* decision, there were some Japanese lower court decisions that stepped into the price determination itself by dividing fair value into two, namely, the value if there had been no M&A and the increased value resulting from the M&A. This method gave courts the opportunity to make their own determination of fair value and the minority shareholders the chance to seek a higher price after the acquisition regardless of the valuation process taken by the company. Thus there were concerns among practitioners that the methods taken by those lower courts created uncertainty for M&A transactions. The *JCOM* decision changed that legal framework by highlighting the M&A process itself in determining the fair value of the cash-out price. Further, the *JCOM* decision illustrated what constitutes a generally accepted fair process, such as obtaining opinions from an independent committee and an external expert in order to prevent arbitrary decision-making concerning the cash-out price due to the conflict of interest between majority shareholders and minority shareholders. The decision also emphasised the need for an express disclosure to the shareholders that the cash-out price will be the same as the tender offer price to prevent possible pressure on the shareholders to make a forced tender. The Japanese lower courts have followed the legal framework in the *JCOM* decision when deciding the fair value regarding the cash-out price, even though there have been only a few cases to date.

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Impact of the METI's Fair M&A Guidelines

After the above JCOM Decision was promulgated, the METI significantly updated its previous guidelines for MBO and formulated the Fair M&A Guidelines. The new guidelines specifically explain what process or measures constitute fair process for conducting MBOs and acquisitions by controlling shareholders. According to the Fair M&A Guidelines, these measures may be regarded as securing a fair process:

- establishing an independent committee;
- obtaining an external expert's opinion;
- doing a market check;
- imposing a 'majority of minority' requirement;
- implementing disclosure and transparency of the process; and
- exclusion of compulsory pressure.

Among these measures, the existence of an independent committee is especially regarded as important, since an independent committee is expected to directly represent the interests of both the target company and its minority shareholders. In practice, generally for tender offerors, negotiations with an independent committee are important with regard to a decision on the tender offer price and the ultimate success of the takeover bid (TOB). In addition, as to fair value for cash-outs, considering that the *JCOM* decision expressly mentioned the importance of an independent committee in securing a fair process, it is generally considered that courts would put weight on the opinion of an independent committee, such as whether the committee approved an opinion in favour of the tender offer and whether the committee made a recommendation for shareholders to tender an offer.

On the other hand, at the time of writing, courts have generally not given attention to the 'majority of minority' requirement (ie, the approval of the majority general shareholders as a condition for the TOB) in their decisions on fair value. Some lower courts have mentioned this requirement in response to minority shareholders' argument that even if the 'majority of minority' requirement has not been set, the fairness of the M&A process is not necessarily destroyed. Lower courts' unwillingness to consider the 'majority of minority' requirement is partly because this requirement previously had no regulatory basis. Another reason is the concern that activists can easily block desirable

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M&A transactions by acquiring a relatively small number of the target company's shares, given that in Japan certain investors such as passive index funds and individual shareholders would typically not tender an offer irrespective of the tender offer price. Given such lower courts' tendency, not many TOB cases set this requirement. However, since the Fair M&A Guidelines expressly mentioned the 'majority of minority' requirement as among the measures for securing fair process, this court tendency could change in the near future.

In addition to the 'majority of minority' requirement, it is necessary to keep a close eye on the future development of M&A transaction practices especially those involving conflicts of interest between controlling shareholders and minority shareholders in response to the inclusion of such transactions in the METI's Fair M&A Guidelines.

Issues surrounding company decisions to be M&A purchasers

A company's decision to acquire a company or business may under certain circumstances be perceived by a court as a violation of the fiduciary duty of the company's directors who approved the decision. There are court precedents that have tested a director's decision to acquire another company (including the decision on the acquisition price). As discussed below, due diligence is an important factor when Japanese courts test such director's decision.

Although the number of court precedents regarding a director's decision for the company to pursue an M&A transaction as purchaser is fairly limited compared with other types of director's fiduciary duty in the context of M&A transactions, these cases are gradually increasing. As discussed, Japanese courts tend to allow directors wide discretion and apply the business judgement rule unless there is a conflict of interest affecting the directors. Court precedents have in general applied the business judgement rule to decisions of directors for the company to conduct an M&A transaction as a purchaser.

For example, in the *TOC Co Ltd* case, a company invested in a start-up company as well as acquired shares of two other companies. All these target companies went out of business. The directors' decision was tested before the Tokyo District Court in 2015 and the Tokyo High Court in 2016. Both courts applied the business judgement rule and decided in favour of the directors. Both court decisions considered the fact that the company conducted due diligence.

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On the other hand, there are precedents where the Japanese courts conducted a strict review of the acquisition process by the company or its directors and concluded that the decision of the directors to acquire a company was in violation of their fiduciary duty.

For example, in the *Apaman Shop* case, where a listed company decided to change a partially owned subsidiary into a wholly owned subsidiary by purchasing the shares of the subsidiary at a price that was five times the market price, the Tokyo High Court in 2008 decided that the directors' decision to conduct the transaction was in violation of their fiduciary duties since they did not conduct adequate diligence and deliberation. However, it should be noted that the Supreme Court in 2010 overturned this decision and applied the business judgement rule, taking into account the process taken by the directors.

Many of the court precedents that have looked into the decisions made by directors to conduct an M&A transaction as a purchaser are slightly outdated and there have not been any Supreme Court cases in this area since the *Apaman Shop* case. As discussed, Japanese M&A practice has been evolving rapidly and it has been the norm in Japanese M&A transactions to conduct due diligence on the target company at a global standard. In this regard, the more recent court precedents tend to require directors to conduct, not only by themselves but also through external experts including lawyers, accountants and tax advisers, a detailed collection of information necessary to make a decision on whether to proceed with an M&A purchase and careful deliberation before making such a decision, which are among the aspects that the courts consider when deciding whether to apply the business judgement rule to a directors' decision. Given that it has become the practice to conduct a thorough due diligence on target companies, it can be said that Japanese courts will continue to require directors to conduct a detailed collection of necessary information and careful deliberation. It would be difficult for directors to meet such requirements without conducting a thorough due diligence of the target company by retaining external advisers, and thus a thorough due diligence of the target company will continue to be an important aspect in a director's decision to move forward with an M&A purchase.

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Issues to be considered for post-merger integration

In addition to pre-acquisition strategic planning and due diligence, post-merger integration (PMI) is essential for meeting the objectives of successful M&A transactions. Even in Japan, PMI should cover a wide range of areas such as management strategy, institutional design, capital policy, accounting, taxation, human resource systems, intellectual property and IT systems. Two especially important areas of PMI are human resource systems and uncovering fraud or misconduct at the absorbed or acquired company after the transaction.

Human resource systems

For two different companies to create synergy, the employees of both companies must seek to share a common corporate culture as soon as possible. In Japan it is often the case that the corporate culture itself is closely intertwined with the company's HR systems. Therefore, these systems must be carefully designed after the M&A transaction is completed in order to foster a shared corporate culture and philosophy. Although Japan's labour laws are advancing to allow diverse work styles, the current situation still favours the employee, as is evident in the strict restrictions on dismissal, making it difficult for an employer to freely design its HR systems. In principle, individual employee consent is required for making any adverse changes in the working conditions in Japan, and therefore it is not always possible to freely reduce the number of employees in accordance with the terms and conditions of an M&A transaction. After the merger or acquisition, there is a need to unify the HR systems within the group, but a careful strategy is needed for any post-transaction reorganisation and consultation with labour unions and employees in order to make the systems consistent with management policy. Companies must also remember that, after the major rulings by the Supreme Court in October 2020 (ie, the *Japan Post*, *Metro Commerce* and *Osaka Medical and Pharmaceutical University* cases), the principle of equal pay for equal work is being enforced as stipulated by applicable laws.

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Fraud or misconduct uncovered post-transaction

In Japan there is an increasing number of cases where accounting fraud, cartel, bribery, data falsification and other irregularities have been uncovered at the absorbed or acquired companies after the merger or acquisition. Unfortunately, it is difficult to uncover those irregularities during the due diligence process because disclosed information is inevitably limited. However, even if the fraud existed before the M&A transaction transpired, the Japanese public tends to consider it as a fraud of the acquirer's entire corporate group. Also, stakeholders and society as a whole see fraud differently depending on whether the company itself discovers and publicises it or whether external organisations such as the press report it first. In the latter case, the company is criticised for failed self-regulating systems or concealment. Therefore, it is extremely important to conduct an audit immediately after an M&A transaction, including any areas that were not covered in the preliminary due diligence. If such an audit is conducted, then it is possible to claim compensation based on the representations and warranties clause of the transaction agreement. In our experience, there is still a sense that whistleblowing is seen in Japan as an act of betrayal. Although the revised Whistle-blower Protection Act became effective on 1 June 2022 and strengthened the rights and protection of whistle-blowers, it is still difficult to expect the whistle-blower system to swiftly expose fraud immediately after M&A transactions are completed. However, one method that has been successful at many Japanese companies is to conduct a questionnaire survey of all the employees to find out whether they or their colleagues have committed fraudulent or illegal acts. This method, rather than using a whistle-blower system that relies on a particular employee's sense of justice or motivation, gives a sense of security that 'all employees are answering the same questionnaire' and is thus much more likely to expose fraud or misconduct in Japan's collectivist society.

Role of legal counsellors

These are just two of the many issues that must be considered regarding PMI. In Japan, as elsewhere, there is a growing belief that PMI itself is at the core of realising synergies through M&A, and the role of legal departments and outside counsel is increasingly expanding in this context. Therefore it is not

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enough for them to simply provide legal knowledge, they must also play the role of counsellors who harmonise different corporate cultures.

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Transaction Structures for Private Company M&A – Carve-outs and Other Deals

Yoshiyuki Kizu, James Campbell and Yuki Takada[1]

In this chapter we describe common transaction structures used in Japan for acquisitions of private Japanese companies or businesses, including by means of carve-out transactions.[2] These transaction structures include:

- share purchase transactions;
- carve-out transactions via incorporation-type company splits;
- carve-out transactions via absorption-type company splits; and
- carve-out transactions via business transfers.

1 Yoshiyuki Kizu and James Campbell are partners, and Yuki Takada is an associate at Nishimura & Asahi.

2 In this analysis, we have assumed 'company' to be a stock company (*kabushiki kaisha* – KK), which is the most common company type in Japan, not only for listed companies but also for private companies. Shareholders may transfer shares of KK entities freely pursuant to the default rules under the Japanese Companies Act, article 127. However, a KK can provide for restrictions on the transfer of its shares in its articles of incorporation, in which case the transfer of shares may require consent from the shareholders or board of directors.

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For each of these transaction structures, we outline certain key aspects to consider in connection with the relevant structures, such as the general timelines, the requirements for notice to creditors, the requirement to obtain consent from contract counterparties, the ramifications of the transaction on employees and requirements for shareholder approval. Although less common in Japan for private transactions, we also provide a brief explanation of merger transaction structures, as well as squeeze-out transactions.

This chapter focuses on private target transactions. Tender offers and other transaction structures that are relevant to the acquisition of publicly listed companies are beyond the scope of this chapter, as is the evaluation of tax- or accounting-related structuring issues.

Share purchase structures

As in many other jurisdictions, share purchase transactions, whereby a buyer purchases shares of a target company directly from a selling shareholder or shareholders, are a common transaction structure in Japan. This type of transaction is a perfect fit for situations where the entire business of the target company is to be sold to the buyer.

Outline of basic steps

In a share purchase transaction, the buyer and selling shareholder or shareholders enter into a share purchase agreement, pursuant to which the buyer purchases shares of the target company.

Standard time frame

Generally, the time frame for a share purchase transaction depends on the need to obtain third-party, antitrust, regulatory or other approvals, or to make any notifications that may be required in connection with the transaction.

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Notice to creditors

Unlike company splits (described below), no notices to creditors are required.

Consents from contract counterparties

Except as required by the terms of a particular contract (eg, contracts requiring consent in connection with a change in control of the target company), no consents from contract counterparties are required.

Employee arrangements

Generally, no consents or other employment-related steps are required with respect to employees or unions in the event of a share purchase.

Shareholder approval

As a share purchase transaction is a transaction directly with the selling shareholders, the agreement of such selling shareholders to the share purchase agreement will be required. Furthermore, in the event that the target company has restrictions on the transfer of its shares in its articles of incorporation that require shareholder approval for transfers of shares, such shareholder approval will be required.

Company splits and business transfers

Company splits and business transfers are most commonly used in Japan in connection with carve-out transactions (ie, where only part of a business is transferred by the target company). Two types of company split transaction structures are provided for under the Japanese Companies Act:

- incorporation-type company splits, which involve the following:
    - the transfer of the target business by the seller to a newly incorporated receiving company by means of a company split with the shares of such receiving company initially being owned by the seller; and

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    - following the transfer of the target business to the receiving company, the seller will sell and transfer the receiving company's shares to the buyer;
- absorption-type company splits, which involve the following:
    - the transfer of the target business by the seller directly to the buyer by means of company split; or
    - the transfer of the target business by the seller directly to a pre-existing receiving company owned by the buyer by means of company split.

A business transfer transaction structure involves the following:

- the transfer of the target business by the seller directly to the buyer by means of business transfer; or
- the transfer of the target business by the seller directly to a receiving company owned by the buyer by means of business transfer.

Each of the types of company split transaction structures and the business transfer transaction structure are described further below.

Outline of the basic steps for company splits and business transfers

The biggest difference between company splits and business transfers is whether the consent of third parties is required for the transfer of the debts, liabilities and contracts, or whether they transfer automatically. In principle, under Japanese law, transferring debts, liabilities and contracts to a buyer requires the consent and approval of the relevant creditors and counterparties.[3] This default rule applies to business transfers, but not to company splits,

3 With a few exceptions, licences and permits are not automatically transferable to a receiving company via company splits, unlike debts, liabilities and contracts. Therefore the receiving company may need to apply for new licences and permits in order to operate the target business, unless the receiving company already holds the required licences and permits. To conduct an absorption-type company split, sometimes the seller forms a newly incorporated company and, at a later date after such incorporation, the newly incorporated company absorbs the target business and the shares of the newly incorporated company are transferred to the buyer. Generally, this arrangement is used in order to avoid the situation where the newly incorporated company cannot start the

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since a transfer by company split involves the target business being succeeded to by the receiving company without consent. Thus, in order to protect the creditors and counterparties, the Japanese Companies Act establishes various protections, detailed under 'Notice to creditors' below.

Incorporation-type company split

Generally, an incorporation-type company split is used where a buyer wants to acquire a newly incorporated company upon closing of the transaction, to minimise the risk of assuming unknown liabilities. The first step in an incorporation-type company split is the seller's execution of a company split plan.[4] This plan sets out important items, such as fundamental information about the newly incorporated company,[5] assets, liabilities, contracts and other obligations to be transferred via the company split, the number of shares of the newly incorporated company to be issued to the seller, the amount of stated capital and capital reserves of the newly incorporated company and other necessary items required under the Japanese Companies Act.[6] Next, the target business (including relevant assets, liabilities and contracts) is transferred by the seller to the new subsidiary on the date of its incorporation, pursuant to the company split plan. In the last step, the shares of the new subsidiary are sold to the buyer in exchange for payment of the purchase price. Typically, a primary share purchase agreement will be entered into between the buyer and the seller, and the company split plan is attached to that agreement, and the completion of the company split process is set as a condition precedent to the

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target business from the effective date of the company split where conducting the target business requires licences or permits, since by using the incorporation-type company split, the newly incorporated company can only apply for the necessary licences or permits after the effective date of the company split.

4 A company split plan must be disclosed for public inspection by interested third parties (item 2, paragraph 1, article 803 of the Japanese Companies Act).

5 For example, company name, purpose of business, location of head office, total number of authorised shares to be issued, names of the directors at incorporation and other matters to be provided for in the articles of incorporation of the newly incorporated company.

6 Paragraph 1, article 763 of the Japanese Companies Act.

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purchase and sale of shares, or as a closing action, under the primary share purchase agreement.

Absorption-type company split

In contrast to the incorporation-type company split, generally, an absorption-type company split is used where it is necessary to obtain licences or permits to operate the target business. Since the receiving company already exists prior to the closing of the transaction, it is able to apply for the relevant licences and permits before the target business is transferred.[7] In an absorption-type company split, the seller directly transfers the target business (including relevant assets, liabilities and contracts) to the buyer (or the receiving company, such as a subsidiary of the buyer specifically formed for the transaction) pursuant to a company split agreement. The company split agreement sets out important matters in relation to the company split, such as the company names, location of the head offices of both parties, the effective date of the company split and the amount or calculation method of the consideration (if the consideration is provided), as well as the assets, liabilities, contracts and other obligations to be transferred upon the effectiveness of the company split.[8] On top of the legally required items, standard terms used in transactions (eg, representations and warranties, indemnity clauses) can be included in the company split agreement or in a separate integration agreement.

Business transfer

In a business transfer transaction, the seller and the buyer enter into a business transfer agreement and, at the closing, the target business (including relevant assets, liabilities and contracts) is transferred to the buyer in exchange for the payment of consideration. Unlike a company split, a business transfer is not a

7 Obtaining relevant licences and permits from the relevant authorities would normally be included in the definitive agreement as a closing condition.

8 The company split agreement will be disclosed for public inspection by interested third parties (paragraph 1, article 794, item 2, paragraph 1, article 782) of the Japanese Companies Act.

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strictly regulated form of reorganisation under the Japanese Companies Act, and there are no statutory creditor protection provisions under the Japanese Companies Act which apply to business transfers. As such, the timeline of the transaction is generally more flexible. In addition, in the case of a transfer of only part of a business by the seller, it is not necessary to obtain the approval of the shareholders of the receiving company; however, it is necessary to obtain the approval of the shareholders of the seller. From this perspective, if the transferred business represents only a part of the transferring company's business, a business transfer is favourable in terms of cost and time. This is especially the case if the receiving company has numerous shareholders and holding a shareholders' meeting would be difficult. However, unlike company splits, there is no mechanism under Japanese law to avoid obtaining consent from the counterparties to relevant contracts that are to be transferred. Thus the business transfer does not suit transactions involving many contracts or counterparties with different interests.

Standard time frame

Company splits

Since the procedures involved in incorporation-type company splits and absorption-type company splits are complicated, such company splits normally take approximately one and-a-half to two months[9] to complete (or longer, especially if a listed company is involved and shareholder approval is required). The timeline also tends to depend on other third-party, antitrust or regulatory approvals or notifications that may be required in connection with the transaction.

9 At least a one-month objection period must be allotted for creditors, between the date of the public notice and the effective date of the corporate split, under paragraph 2, article 789, paragraph 2, article 799 and paragraph 2, article 810 of the Japanese Companies Act.

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Business transfer

Assuming no shareholder approval is required, there are no specific time requirements under Japanese law for business transfers. Generally, the timeline will depend on the speed and timing of procedures to obtain consent from any counterparty or antitrust regulator, or for other regulatory filings. In addition, like company splits, it is not unusual for the receiving company to need to apply for relevant permits or licences that are required to conduct the business.

Notice to creditors

Incorporation-type company split

For the seller

The seller is required to make a public notice and, subject to certain exceptions described below, to send individual notices to creditors of the target business, at least one month prior to the effective date of the company split. If, in addition to publishing a public notice in the official gazette, the public notice is published in a daily newspaper or in an electronic manner as specified in the articles of incorporation of the seller, individual notices to creditors may be omitted, but if the public notice is published only in the official gazette, individual notices cannot be omitted. In order for the seller to avoid remaining liable for tort liabilities, however, individual notices to the creditors of such tort liabilities may not be omitted, regardless of the seller's awareness of the existence of the relevant liabilities. Where any contingent tort liabilities exist, if individual notices of the relevant tort liabilities are not provided to creditors, by operation of law, the seller will remain liable for the tort liabilities up to the value of the assets of the seller as of the effective date upon consummation of the company split, even if the company split plan provides that the seller will not remain liable for any tort liabilities.[10]

10 Paragraph 2, article 764 of the Japanese Companies Act.

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For the buyer

The buyer is not obliged to make public notice or individual notices to creditors of the target business. However, if the individual notices of tort liabilities are not provided to creditors by the seller, the receiving company will also assume the tort liabilities by operation of law, up to the value of the acquired assets, upon consummation of the company split, even if the company split plan provides that the receiving company will not assume any tort liabilities.[11]

Absorption-type company split

For the seller

The same as with an incorporation-type company split.

For the buyer (or the receiving company)

The buyer (or if the buyer is not the receiving company under the company split, the receiving company) is required to make a public notice and to send individual notices to all creditors of the buyer or receiving company, as the case may be, at least one month prior to the effective date of the company split. However, if, in addition to making a public notice in the official gazette, the public notice is published in a daily newspaper or in an electronic manner as specified in the articles of incorporation of the buyer or the receiving company, as the case may be, individual notices may be omitted. However, if the public notice is published only in the official gazette, individual notices cannot be omitted. If the individual notices of tort liabilities are not provided by the seller to creditors, however, the buyer or the receiving company, as the case may be, will also assume the tort liabilities by operation of law, up to the value of the acquired assets, upon consummation of the company split, even if the company split agreement provides that the buyer or the receiving company, as the case may be, will not assume any tort liabilities.[12]

11 Paragraph 3, article 764 of the Japanese Companies Act.

12 Paragraph 3, article 759 of the Japanese Companies Act.

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Business transfer

As mentioned above, no specific requirements are imposed under Japanese law on the seller or the buyer with respect to notices to creditors in the case of a business transfer. However, no liabilities will be transferred automatically by operation of law; therefore the seller and the buyer must come to an agreement with each creditor if the relevant liabilities are to be transferred with the business. As a result, regardless of the lack of legislation, in effect, the seller is obliged to notify creditors in order to transfer liabilities to the buyer as part of a business transfer. Thus, regardless of whether the transfer of liabilities occurs via a company split or a business transfer, the creditors will be given notice.

Consents from contract counterparties

Company splits

Neither incorporation-type nor absorption-type company splits require the seller to obtain individual consent from the counterparties for the transfer of contracts because, in principle, contracts are transferred by operation of law through the company split. However, individual consent from a counterparty may be required if the contract is not governed by the laws of Japan (but by laws of a jurisdiction that prohibit the transfer of contracts without the advance consent of the counterparty) or where the relevant contract contains a specific prohibition or restriction on the transfer of the contract by company split.[13]

Business transfer

With respect to contracts governed by Japanese law, unless the contract states that it may be transferred without the counterparty's consent, the seller is

13 Generally, it is understood that most contracts governed by Japanese law can be transferred, regardless of any restrictions on transfers by company split that may be set forth in the relevant contracts; however, this constitutes a breach of the restriction and the assigning party will be exposed to a damages claim. Therefore, if the damages claim is expected to be detrimental, it is prudent to obtain the prior consent of the counterparty to transfer of the contract.

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required to obtain individual consent from each contract counterparty prior to transfer of the relevant contract to the buyer.

Employees and employment arrangements

Company splits

The following requirements apply with respect to incorporation-type and absorption-type company splits under the Act on the Succession to Labour Contracts upon Company Split of Japan (the Succession Act) and relevant regulations:

Labour requirements with company splits

Necessary actions for the seller[14]
Prior consultations with existing labour organisations (eg, unions, if any) or, in the absence of a labour union, with employees representing the majority of the workforce, to obtain their understanding and cooperation regarding the company split.[15]
Prior to the written notice to employees described below, to hold a consultation with each employee who is engaged in the target business (regardless of whether the labour agreement with such employee is among the agreements to be transferred to the receiving company in the company split plan or company split agreement).[16]
Written notice to each employee mentioned above and each employee who is not engaged in the target business but whose labour agreement is listed in the company split plan or company split agreement as being transferred to the receiving company (including part-time working) more than two weeks in advance of the date of the shareholders' resolution approving the company split.[17]
Employees' rights

14 There are no specific actions required for the receiving company or the buyer under the Succession Act.

15 Article 7 of the Succession Act.

16 At the consultation, the seller needs to explain to each employee a description of the employee's work after the company split, including his or her responsibility, contemplated work to be assigned and workplace.

17 Paragraph 3, article 2 of the Succession Act.

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Employees who are primarily engaged in the target business, but who are not included in the scope of transfer (eg, because the seller and the buyer agreed to exclude such employees from the scope), have the right to opt in (ie, the right to cause the seller to transfer its employment agreement to the party succeeding to the target business).[18]
Employees who are not primarily engaged in the target business, but who are included in the scope of transfer (eg, because the seller and the buyer agreed to include such employees in the scope), have the right to opt out (ie, the right to cause the seller not to transfer its employment agreement to the party succeeding to the target business).[19]
If any employee exercises the opt-in right, that employee's employment contract will be transferred to the party succeeding to the target business. If any employee exercises the opt-out right, that employee's employment contract will not be transferred to the party succeeding to the target business.

Business transfer

There are no specific procedural requirements with respect to the transfer of employee contracts with a business transfer under Japanese law. The individual consent of each employee is required in order for the employee's employment or contract to be transferred in the business transfer.

Disadvantageous changes to working conditions of transferred employees

With respect to company splits and business transfers, if the buyer wishes to make any disadvantageous changes to the working conditions of the employees transferred by the seller, to match the less advantageous work conditions at the buyer's company, in general it is necessary to obtain consent from each employee who will be affected by the changes, pursuant to the Labour Contracts Act.

18 Article 4 of the Succession Act.

19 Article 5 of the Succession Act.

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Shareholder approval requirements

Incorporation-type company split

For the seller

Generally, a special resolution[20] by the shareholders of the seller is required unless the aggregate book value of the target business does not exceed one-fifth of the total assets of the seller.

For the buyer

Generally, a buyer that is a Japanese company is not required to obtain shareholder approval with respect to the company split itself.

Absorption-type company split

For the seller

Generally, the same as with an incorporation-type company split.

For the buyer (or the receiving company)

Generally, a special resolution by the shareholders of the Japanese buyer (or the Japanese receiving company, as the case may be) is required unless the total amount of the consideration paid or granted to the seller does not exceed one-fifth of the total net assets of the Japanese buyer (or the Japanese receiving company, as the case may be).

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20 A special resolution is a resolution adopted by two-thirds or more of the votes of the shareholders present at a shareholders' meeting where holders of a majority of the votes are present (paragraph 2, article 309 of the Japanese Companies Act).

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Business transfer

For the seller

Generally, a special resolution by the shareholders of the seller is required unless the aggregate book value of the target business does not exceed one-fifth of the total assets of the seller.

For the buyer

The buyer is not required to obtain shareholder approval if the target business is only a portion (and not substantially all) of the seller's business. If the target business constitutes all or substantially all of the seller's business, a special resolution of the shareholders of the buyer is required if the buyer is a Japanese company.

Mergers and squeeze-outs

Mergers

A merger is a type of corporate reorganisation under the Japanese Companies Act that is distinct from the structures described above. Two types of mergers exist under the Act:

- absorption-type mergers, in which one company survives the merger and the other company is merged into the surviving company and ceases to exist; and
- incorporation-type mergers, in which both merging companies cease to exist and a new company is established.

Both structures result in all of the rights, obligations, assets, liabilities, agreements and employees of the merging parties being assumed by operation of law by a single company (in the case of an absorption-type merger, the surviving company, and in the case of an incorporation-type merger, the newly incorporated company). On the effective date, the shareholders of a merged company are delivered consideration in lieu of their shares, and if the consideration is shares in the surviving company or a newly incorporated company, the former shareholders of the merged company will become shareholders of the surviving company or the newly incorporated company. In general, a

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special resolution by the shareholders of each merging company is required for a merger.

Under Japanese market practice, when selecting a transaction structure for the acquisition of a Japanese company, parties will typically choose to structure the transaction as a share purchase transaction as opposed to a merger. Principally, this is due to fact that mergers tend to be more complicated, take more time as a result of the shareholder approvals that are required and, accordingly, are more expensive to implement. However, a merger may be considered where, for example, there are minority shareholders whose consent the parties are unable to obtain for a share purchase transaction structure since a merger transaction structure effectively permits the parties to effect the transaction as long as a special resolution by the shareholders of each merging company is obtained.

Squeeze-outs

If the parties determine to structure a transaction as a share purchase transaction but minority shareholders remain after the completion of such share purchase transaction, the buyer may determine to acquire the remaining shares from these shareholders pursuant to a squeeze-out transaction. According to the market practice in Japan, there are two popular methods of squeezing out[21] the minority shareholders of a Japanese company: a demand for cash-out and share consolidation. If the buyer has acquired 90 per cent or more of the voting rights of the target company through the share purchase transaction, it would be more common to proceed with a squeeze-out through a demand for cash-out. If the buyer has acquired two-thirds or more, but less than 90 per cent, of the voting rights of the target company through the share

21 Other than these two options, there are a few other squeeze-out options under the Japanese Companies Act. However, under the current Japanese Companies Act, performing a squeeze-out using the demand for cash-out or share consolidation options is simpler than other available options; therefore these two options have become the market standard for squeeze-outs in Japan.

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purchase transaction, then it could proceed with a squeeze-out through share consolidation.

Demand for cash-out

When a buyer who has acquired 90 per cent or more of the voting rights of the target company desires to make a demand for cash-out, such buyer may notify the target company to that effect, stating the price at which it demands to purchase the minority shareholders' shares. The directors of the target company must then make a decision as to whether to approve the demand. If the directors of the target company do not approve the demand for cash-out, the buyer cannot proceed with the process and the demand for cash-out will not take effect.

Share consolidation

Under the Japanese Companies Act, a company may consolidate its shares by approval of a special resolution of a shareholders' meeting. If a shareholder of the target company holds two-thirds or more of the voting rights of the target company, they may cash out the minority shareholders by adjusting the consolidation ratio, so that a large number of existing shares converts to one new share, with the numbers resulting in only fractional shares being allocated to the minority shareholders (ie, after such consolidation, the majority shareholder would own more than one share and each of the minority shareholders would own less than one share). Thereafter, the target company pays out cash to the holders of fractional shares (ie, the persons or entities who were minority shareholders prior to the share consolidation) instead of providing them with fractional shares.

On the effective date of the share consolidation, the minority shareholders will become holders of fractional shares only. Under the Japanese Companies Act, the target company is required to sell the number of shares equivalent to the

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total sum of such fractional shares. The default method for such a sale is an auction process supervised by the court.[22] Alternatively:

if the sale is with respect to shares with a market price,[23] the sale may instead be effected as a sale to the purchasing party (which would usually be the target company itself or the majority shareholder) at a price equal to the market price calculated pursuant to applicable law; or

if the sale is with respect to shares without a market price, the sale to the purchasing party (which would usually be the target company itself or the majority shareholder) may instead be effected pursuant to a sale approved by the court.[24]

The proceeds of this sale would then be used to cash out the minority shareholders holding fractional shares.

Conclusion

While there are many considerations that are relevant to the selection of a transaction structure, the most common form of transaction to acquire a Japanese company is through a share purchase transaction, whereas, in the case of carve-out transactions, the parties will typically structure the transaction as an incorporation-type company split, absorption-type company split or business transfer. Care should be taken in selecting the transaction structure that is most appropriate for the particular facts and circumstances of the seller, the target and the buyer.

22 Paragraph 1, article 235 of the Japanese Companies Act.

23 Generally, a sale at market price would only apply in respect of a target company whose shares are publicly listed.

24 In order to sell fractional shares that do not have a market price (eg, shares of a private company) by using a method other than an auction, it is necessary to obtain the permission of the court and the petition for such permission requires the consent of all of the directors of the target company.

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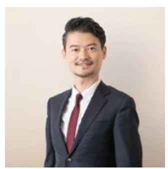

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Tax issues arising from M&A in Japan

Norio Mitsuuchi, **Harold Godsoe** and **Kohei Honda**[1]

Introduction

This chapter focuses on tax issues of importance to M&A dealmakers working with corporations in Japan. It is divided into three sections. M&A dealmakers might not be familiar with tax matters in Japan, so first we summarise the relevant basic tax information and recent amendments to Japanese laws important in the M&A tax landscape.[2]

1 Norio Mitsuuchi is a partner, and Harold Godsoe and Kohei Honda are associates at Kojima Law Offices. Although Norio Mitsuuchi worked for the Tokyo Regional Taxation Bureau while contributing to the 2021 version of this article, any opinions expressed here are not supported by the tax authorities and are the personal opinion of the authors.

2 This article is written based on Japanese law effective on 1 March 2023. (2023 amendments for Japanese tax laws are not in force at the time of writing.) For ease of reference, in principle, we use legal terms as defined in Japanese laws (whether tax laws or otherwise) in line with the translations adopted by the Japanese Law Translation Database System: see www.japaneselawtranslation.go.jp.

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Second, we outline the main tax issues to be considered in a deal, organised by phases. To optimise taxation, an M&A dealmaker should engage a tax adviser very early and examine all issues at all phases at the earliest stage of the deal.

Third, as with the deal structure, we outline international tax issues relevant to cross-border investments involving Japanese companies by phases, but all issues at all phases should be considered and kept in sight at the time the investment begins.

The tax landscape for M&A in Japan

General tax framework

Income taxes

A corporation is a taxable entity under the Japan Corporate Tax Act (CTA). A domestic Japanese corporation, which is defined as a corporation that has a main, registered office in Japan, is taxed by the national and local governments based on its amount of worldwide net income in its fiscal year. A foreign corporation is defined as a corporation other than a domestic corporation. A foreign corporation without permanent establishment in Japan is taxed only by the national government, and only on the amount of its Japanese source income, as defined in Japanese tax law, in a given fiscal year of the corporation.

Similarly, Japan-resident individuals are taxed under the Income Tax Act (ITA). A Japan-resident individual is, in principle, taxed by the national and local governments on its worldwide net income in a calendar year, while a non-resident in Japan is taxed only by the national government on specific Japanese-source income in a calendar year.

A corporation's taxable income is calculated based on the corporation's own corporate financial accounting, with some tax adjustments applied under the CTA. The current effective tax rate for a domestic corporation is approximately 30 per cent, combining the national corporate income tax rate (currently 23.2 per cent) and local tax rate (which depends on local governments).

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Transfer taxes

Transaction taxes capture some percentage of the value of property for the national or local government when property changes ownership. Among transfer taxes, Japan's consumption tax (similar to EU VAT) is of great importance to M&A dealmakers, as it may result in significant additional expense for the buyer in an asset deal. The current rate is 10 per cent of the consideration paid for taxable assets and taxable provision of services.

At the time of deal structuring, M&A dealmakers should also consider whether and how much impact may be incurred from other transfer taxes: stamp duties, corporate registration taxes, real estate registration taxes and real estate acquisition taxes.

Recent amendments to tax law

2020 amendments

Under the 2020 tax amendments, two changes were passed with particular importance for M&A dealmakers: the group tax relief system and, in the area of international taxation, a new specific anti-avoidance rule (SAAR).

The group tax relief system replaced the then-effective consolidated tax return system. Under the new group relief system, which applies to companies in which the group parent's fiscal year starts on or after 1 April 2022, each corporation in a 100 per cent wholly owned group files a tax return after transferring losses within the group corporations. The method of adjusting the book value of investments was changed by this amendment and further amendment in 2022.

The new SAAR was introduced to prevent companies from inappropriately creating capital losses by first distributing dividends of 10 per cent or more of the value of a subsidiary and then selling shares in that subsidiary by a reduced amount. Softbank Group (a major Japanese company) generated capital losses in this manner in relation to an M&A deal with Arm Ltd (a British corporation) in 2018, and this SAAR was purposely introduced to prevent this type of tax burden optimisation in the future. After this amendment, excessive pre-deal

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dividend distribution from subsidiaries to a parent cannot be used to optimise taxation. See 'Pre-deal' below.

2021 amendments

Under the 2021 amendments, two additional relevant changes to the laws were passed: a special tax-free treatment on share delivery and special measures to aid small and medium-sized enterprises (SMEs) to mitigate against hidden, out-of-book debts after a share purchase.

Share delivery is a variant of a corporate reorganisation by share exchanges introduced in the Japan Companies Act. Special tax-free treatment for this kind of transaction encourages share-compensated M&A transactions (both arm's length M&A transactions and takeover bids (TOBs)). See 'Deal structuring' below.

Special measures to aid SMEs allow the buyer of an SME special taxation benefits on special reserve funds set aside to compensate for the specific risks of acquiring SMEs that may only arise after an M&A transaction (off-balance-sheet liabilities, contingent liabilities, etc). For Japanese tax purposes, SMEs are corporations with a capital amount of ¥100 million or less. (A corporation with a capital amount of more than ¥100 million is classified as a large corporation.) See 'Post-deal' below.

2022 amendments

Under the 2022 amendments, two changes in the 2020 amendments mentioned above were reviewed and changed further: (1) the method of adjusting the book value of investments in accordance with introducing a group relief system and (2) the prohibition on excessive pre-deal dividend distribution from subsidiaries to a parent.

When selling shares of a subsidiary out of a group, the gain on the transfer will be calculated based on the net book value (or net asset value) at the time of sale, for tax purposes, regardless of the acquisition price, provided that, when calculating the net book value, the selling company can include acquisition

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premiums (ie, goodwill) in the net book value. By this amendment, that concern at the time of the 2020 amendment was removed.

In the 2020 amendment, the prohibited excessive pre-deal dividend distribution is a dividend distribution of retained earnings only before the parent company got control of the subsidiaries. In the 2022 amendment, in order to crystallise the purpose of this SAAR, companies will be allowed to include retained earnings generated during the fiscal year of distributing the dividends in the permitted portion of dividend distribution.

New 2023 amendments

Under the 2023 amendments, (1) the limits of tax-free spin-offs will be relaxed to promote their wider use and (2) the use of share delivery (defined below) will be limited.

Current tax law allows for a tax-free spin-off only if all of the shares of a wholly owned subsidiary shall be distributed to shareholders. With the new 2023 amendment, even if less than 20 per cent of the shares of the wholly owned subsidiary remain, and are not distributed to the parent company, the spin-off can still be tax-free.

On or after 1 October 2023, the scope of a special exception was limited on the calculation of income on the transfer of shares with consideration of shares, etc. Under the new amendment, if the parent company to which shares are delivered falls under the category of a 'family corporation' (one in which fewer than three shareholders own 100 per cent of the shares of the company) after the share delivery, the company can no longer use the special exception.

M&A-related tax issues in Japan by deal phase

All parties to M&A transactions in Japan should look at all phases of the deal as a whole in the early days of a deal's conception, in order to optimise taxation. This is generally true in any jurisdiction, but is particularly important in Japan, where the tax authority's respect for the formalism of the rules means that moves in the deal must be made with precision to satisfy those rules. We

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consider the issues by phases, but a tax adviser should be engaged early, and all issues in all phases should be considered before the deal begins.

Pre-deal

The first pre-deal phase anticipates the main acquisition transaction. There are two common actions that M&A dealmakers can consider, in any jurisdiction, to minimise taxation on the value received by the seller in the main acquisition transaction.

Dividends before the deal

A parent company's domestic dividend income from a subsidiary is exempt from taxation as corporate income, in proportion to the percentage of shares held (eg, where 100 per cent of shares are owned, this is a full exemption; where more than one-third of shares are held, the exemption is the dividend amount minus interest on debt, etc). This is similar to many countries' tax laws, and so an experienced seller may be inclined to receive part of the value of a deal in pre-sale dividends, rather than as proceeds from the main acquisition transaction. As noted above, owing to recent amendments to the tax law in 2020 and 2022, this action is still effective, but the scope has been narrowed.

Carve-outs

It is also common before the main acquisition transaction that the parties carve out specific business assets that the buyer may intend to be divested or otherwise spun off afterwards. Compared with completing the full transaction with a target corporation wholly intact, a carve-out will save a seller from paying taxes on that part of the target corporation that effectively avoids being sold. A seller might achieve a tax-free carve-out by using a tax-free corporate split. Buyers should consider whether the target assets intended for the carve-out may be necessary for the management of the business after the acquisition (in some cases, a carve-out might actually be required by the competition laws of

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a relevant jurisdiction) and should negotiate the scope of the carve-out with the seller.

Deal structuring

Tax-free transactions

In the second deal-structuring phase, the available types of M&A transactions interplay from a tax perspective and determine whether the transaction can be tax-free. As shown in Table 1, under a taxable transaction (this is the general treatment under Japanese tax laws), assets and liabilities are transferred at fair market value (ie, the tax authority applies capital gains and losses) for tax purposes, unless the transaction is carried out between corporations within a relationship of wholly owned control. Under a tax-free transaction, assets and liabilities are transferred at net book value (ie, the tax authority defers settlement of gains and losses) for tax purposes. A tax-free transaction is only possible if the requirements set forth below are met.

Table 1: Tax consequences of taxable and tax-free transactions for target company and its shareholder

Tax status	Taxation of target company	Taxation of target company shareholder
Taxable	Gains or losses through M&A transactions should be included in the calculation of taxable income of the target company in the fiscal year during which the M&A deal was made.	• Capital gains through the transfer of shares are taxed. • Taxes on deemed dividend income are imposed.
Tax-free (if requirements are met)	Target's assets and liabilities are transferred to the buyer at their net book value.	• No tax is imposed on capital gain; no deemed dividend income is payable to shareholders.

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M&A transactions defined in Japanese civil laws

The interpretation of Japanese tax law by the tax authority is quite distinctive compared with other major jurisdictions. The Japanese tax authority has an unusual respect for the formality of the civil laws (ie, private laws) in looking at an M&A deal, rather than the substance of the deal. This means that M&A dealmakers need to approach the formal requirements for M&A transactions defined in the civil laws (as well as in the CTA, for tax purposes) very carefully, rather than relying on substantial compliance (ie, there is no reliance on the 'substance over form' doctrine, as might be the case in a US context).

There are four types of M&A transaction: share purchases, asset purchases, reorganisations under the Companies Act and corporate shareholder transactions. The four types of M&A transaction can be categorised from two points of view: what part of the target is transferred and what compensation is exchanged for it, as set out in Table 2.

Table 2: Types of M&A transaction

<table>
<tr><th colspan="2">Transaction type</th><th>What is transferred?</th><th>For what compensation?</th></tr>
<tr><td colspan="2">Share purchase</td><td>Shares</td><td>Cash</td></tr>
<tr><td colspan="2">Asset purchase</td><td>Business assets</td><td>Cash</td></tr>
<tr><td rowspan="5">Reorganisations</td><td>Merger</td><td rowspan="2">Business assets</td><td rowspan="5">Shares[3] and/or cash</td></tr>
<tr><td>Corporate split</td></tr>
<tr><td>Share exchange</td><td rowspan="3">Shares</td></tr>
<tr><td>Share transfer</td></tr>
<tr><td>Share delivery</td></tr>
<tr><td rowspan="3">Corporate shareholder transactions</td><td>Cash contribution</td><td>Cash</td><td rowspan="3">Shares</td></tr>
<tr><td>Contribution in kind</td><td rowspan="2">Business assets</td></tr>
<tr><td>Distribution in kind</td></tr>
</table>

3 For reorganisations, shares of a parent (or wholly owning listed company) of an acquiring company can be used as compensation. In this case, it would be triangular mergers, share exchanges, etc.

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Share purchases (including TOBs) and asset purchases are sales of a whole or a part of the shares or business assets of a target company, respectively, from one party to the other in exchange for cash. Tax treatments on share purchases and asset purchases are not specifically mentioned in the CTA, and so they are taxable. To qualify as a tax-free transaction in Japan, a hard rule before the 2017 tax amendment was that no compensation other than the shares of the buyer could be paid. Although this strict rule has been eased since the 2017 amendments, in principle, cash-only compensation still cannot be tax-free in M&A transactions in Japan.

Reorganisations and corporate shareholder transactions can be tax-free because a whole or a part of the compensation exchanged for the assets transferred are not cash but shares of the buyer.

Reorganisations are exhaustively stipulated in the Japan Companies Act and the same concepts are used in the CTA for taxation. There are five types:

- merger (*gappei*): a transaction in which an acquiring company comprehensively succeeds to all of the rights and obligations of a target company (or a newly established company comprehensively succeeds to all of the rights and obligations of two or more existing companies) in exchange for shares of the acquiring company and/or cash;
- corporate split (*kaisha-bunkatsu*): similar to a merger but the parties can choose the rights and obligations transferred, and whether wholly or partly;
- share-for-share exchange (*kabushiki-kokan*): a share-for-share transaction to establish a full controlling relationship between the parties;
- share transfer (*kabushiki-iten*): a variant of a share-for-share exchange by which a newly established corporation gains full controlling interest of one or more existing companies; and
- share delivery (*kabushiki-koufu*): a variant of a share-for-share exchange, newly introduced by the reformed Companies Act in force from 1 March 2021. After a share delivery transaction, the buyer becomes, not a 100 per cent shareholder of the target, but rather a shareholder exercising controlling power over the target. A 2021 tax amendment (effective from 1 April 2021) introduced special tax treatment on a share delivery. If 80 per cent or more of the compensation paid to a target company is in the form

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of the acquiring company's shares, the share delivery transaction can be tax-free even if up to 20 per cent of the compensation is cash.

Corporate shareholder transactions come in three kinds:

- cash contribution by a third-party shareholder in exchange for shares of the target company (*daisansha-wariate-zoshi*);
- contributions in kind in exchange for shares of the target company (*gembutsu-shusshi*); and
- distributions in kind from a subsidiary to a parent company (*gembutsu-bumpai*). Spin-offs are a kind of distribution in kind. When the 2017 tax amendments introduced tax-free treatment for spin-offs, there were substantially no spin-off cases in Japanese M&A. In 2019, however, Koshidaka Holdings, a Japanese listed company, announced the first major deal applying a tax-free spin-off.

Other than (generally) a no-cash compensation requirement, the following additional requirements need to be met in order to qualify as tax-free transactions under the CTA:

If a full controlling interest relationship (100 per cent capital ownership) exists between the buyer and target, there are no other requirements (other than the no-cash compensation requirement).

If there is a controlling interest relationship (more than 50 per cent but less than 100 per cent) between buyer and target, the requirements are continuation of the transferred business and 80 per cent or more of the officers and/or employees continuing to work for the transferred business.

In M&A transactions between companies without controlling interest relationships (ie, 50 per cent or less), the requirements (referred to as joint enterprise requirements) are:

- continuation of the transferred business;
- 80 per cent or more of the officers and/or employees continue to work for the transferred business;
- one of the main businesses of the target must have a relationship with one of the businesses of the acquirer;
- the relative business size of the related businesses specified in the previous requirement must be within a ratio of approximately 1:5 or at

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least one of the senior directors from each of the acquirer and target must become senior directors of the acquirer; and
- a shareholder of the target that held more than 50 per cent of the target's shares must continue to hold shares of the acquirer received in the deal.

By reviewing these requirements, foreign buyers who intend to enter the Japanese market without any subsidiaries or affiliates in Japan before the deal should be aware that they cannot fulfil the top two choices of requirements at the time of the M&A deal. As such, the last choice of requirements (ie, joint enterprise requirements) should be explored if they seek to complete tax-free M&A transactions. Otherwise, foreign buyers should carefully structure the M&A deal by combining several related transactions: first, making the necessary taxable transactions (eg, taxable share purchase, taxable reorganisations or cash contributions) to obtain controlling power, and then tax-free reorganisations or corporate shareholder transactions as the second (and third) transactional step, in order to optimise tax efficiency.

Squeeze-outs

The 2017 tax amendments introduced a significant change to the strict distinction between taxable and tax-free transactions, which affects the use of squeeze-outs. Before the 2017 amendments, cash compensation M&A transactions could never be tax-free. A transaction was taxable if an acquiring company paid cash compensation to minority shareholders who were against the reorganisation in order to gain a full controlling interest over an existing Japanese company after a share purchase, merger or share exchange (or share delivery after the recent tax reforms).

However, after the amendments, cash compensation is allowed for a tax-free squeeze-out if the acquiring company holds two-thirds or more of outstanding shares of the target company. If a buyer has a prospect of obtaining approval of two-thirds or more of the existing shareholders to the acquisitions at the beginning of transactions (and perhaps the rest of the existing shareholders

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might be against the acquisitions), merger, share exchange or share delivery can be tax-free with the use of squeeze-outs.

Taxable transactions: pros and cons of asset deals versus share deals

In most cases, the main acquisition transaction between independent parties is a taxable share purchase or asset purchase. To compare the tax impact of the two, Table 3 summarises the pros and cons of share purchases and asset purchases for buyers.

Table 3: Asset deals versus share deals

Deal type	Pros	Cons
Share purchase	• No need to renegotiate existing contracts. • Buyer has the possibility to use depreciation and net operating losses (NOL) after the deal. • Consumption tax is not levied and other transfer taxes are generally less imposed than in an asset deal.	• All legal and tax risks are preserved in the target company. • No goodwill of the target company is available for amortisation by the Buyer. • Reduced availability of debt push-down (See 'cross-border M&A' section below).
Asset purchase	• No inherited liabilities from target company limits the tax risks. • Buyer may step up and depreciate or amortise purchased assets (including intangible assets) for tax purposes (except for land). • Five-year equal rate amortisation of goodwill.	• Total tax cost may be increased (by two-level taxation on target company and its shareholder), which may result in raising deal prices. • Buyer may need to renegotiate existing contracts. • NOL after the deal remain with the seller. • Consumption tax is imposed. • Real estate registration tax and real estate acquisition tax are imposed only on asset purchase transactions.

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Consumption tax issues

Among the four types of M&A transactions (ie, share purchases, asset purchases, reorganisations or corporate shareholder transactions), only asset purchases are subject to consumption tax of (currently) 10 per cent of the consideration exchanged for taxable assets or services. The other three types of M&A deal are exempt from consumption tax. However, even in the other three types of M&A transactions, transaction fees associated with the deal such as brokerage fees, upfront fees or agent fees with regard to M&A deal financing can be subject to consumption tax.

There are some specifically exempted entities that may be of practical use in avoiding consumption tax issues in an M&A deal:

- a business with ¥10 million or less of taxable sales, in principle, for each of the past two years, and in the first six-month period of the year preceding the applicable tax period; and
- a business with a capital amount of ¥10 million or less, for two years after its establishment.

If a buyer chooses such a seller for an asset purchase, consumption tax can, in principle, be substantially exempted.

From 1 October 2023, a new, EU-style, qualified invoice system will be in force in Japan. Corporations paying consumption tax will only be allowed to recover consumption tax where a qualified invoice has been issued by a registered invoice issuer. Therefore, M&A dealmakers contemplating a deal near that time would be advised to register an acquiring company or target company as a taxable entity to engage in business in Japan.

Post-deal

In the third post-deal phase, the opportunities for risk and gain from a tax perspective are greatest for the buyer. The buyer's tax concerns mainly arise in post-merger integration and with the risks that can be avoided in connection with running afoul of Japanese tax authorities.

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Net operating losses

The net operating losses (NOL) of a corporation can be carried forward up to 10 fiscal years. For a large corporation, half of the taxable income can be deductible against NOL, while an SME can offset all taxable income against NOL. In some cases, using the NOL of a target company is limited to prevent tax abuse. Using NOL is at issue not only in the case of a share purchase but also in the case of a merger. With a share purchase, the target company still exists after an M&A transaction and can naturally use its own NOL. However, with a merger, the target company disappears immediately after the deal. Whether the acquiring company can use the NOL of the target company can be a significant tax issue. Especially for tax-free mergers in intragroup reorganisations (ie, more than 50 per cent controlling interest relationships between parties), the acquiring party needs to fulfil deemed joint enterprise requirements. See 'Tax-free transactions' above.

Special SME rules

Following the 2021 amendments, special measures to aid SMEs allow the buyer of an SME special taxation benefits on special reserve funds set aside to compensate for the specific risks of acquiring an SME that may only arise after an M&A transaction (off-balance-sheet liabilities, contingent liabilities, etc). The buyer of the SME must execute a share purchase (see 'Deal structuring' above), the acquisition price must be ¥1 billion or less, and the SME must have been approved for a managerial ability improvement plan. If all conditions are met, the special reserve funds for the specific risks of acquisition can be immediately deductible expenses for the fiscal year of the share purchase. If the specific risks of acquisition materialise during a five-year period, the buyer can use the special reserve funds. After a five-year lapse of time from the share purchase transactions without materialisation of the risks, five equal portions of reserve funds will be drawn down over the following five years.

Step-up tax basis of depreciable assets

Through asset purchases and taxable reorganisations, assets are transferred at fair market value. As between assets transferred by fair market value and

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book value, after a deal, the buyer can use more depreciation for assets transferred by fair market value (ie, the tax basis is stepped up) than for assets transferred at book value. If the buyer expects to gain taxable profits from an acquired business immediately after the deal, this step-up tax basis of depreciable assets is preferable. This means that taxable deals can be a practical option to minimise overall taxation of the buyer in an M&A deal.

Amortisation of goodwill

If the purchase price paid by the buyer to the seller is more than the fair market value of the net assets of a target company, the difference between the purchase price and the amount of net assets is recognised as goodwill. Under Japanese tax law, goodwill created through asset purchase or taxable reorganisations can be amortised (ie, can be used as expenses, deducted from gains) in equal portions over five years.

Tax investigations

Tax investigations against corporations doing business in Japan (including foreign companies) are undertaken periodically by the Japanese tax authorities.

Taxpayers need to keep documents relevant to M&A transactions and be ready for tax investigations for at least five fiscal years (ideally seven to 10 fiscal years) after the filing date of tax returns that include gains or losses from M&A transactions. If the tax authorities suspect tax fraud, they may conduct tax investigations as far back as seven fiscal years. In connection with tax investigations on the use of NOL, tax authorities can go back 10 fiscal years.

Tax authorities usually respect the formalities taken by taxpayers (ie, the parties to the transaction). That said, although it would be rare, tax-abusive transactions might be denied in accordance with the anti-tax abuse provisions of the CTA.

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The 2016 *Yahoo* case[4] provided some guidance on what the tax authority is thinking when going after corporations for tax avoidance related to corporate reorganisations. In that case, the court held that in judging whether there is abuse, the tax authority needs to consider whether a corporation's act or calculation to optimise taxation is unnatural, by using a procedure or method of reorganisation that is not normally expected, or by creating a form that deviates from the actual situation; and whether the acts or calculations are intended to reduce the tax burden by using reorganisations, and deviate from the original intent and purpose of the taxation on reorganisation provisions, taking into consideration the business purpose and other circumstances that provide reasonable grounds for such acts or calculations other than the mere reduction of tax burdens.

Specific issues arising from cross-border M&A involving Japanese companies

Parties to a cross-border M&A transaction into Japan should look at all phases of the investment as a whole. We examine the issues to take into account in cross-border M&A with Japanese corporations by phases, but all issues at all phases should be kept in sight when the deal begins.

Investment phase

Judicial double taxation and its relief

The central tax issue in cross-border M&A is the risk of international or judicial double taxation on the same income of both foreign buyers and the Japanese target companies, in each phase (ie, investment, repatriation and exit). Japanese domestic corporations, including Japanese subsidiaries of foreign corporations, are subject to Japanese corporate income tax for their worldwide income. A foreign company that has a permanent establishment (eg, a branch office, representative office, dependent agent, etc) in Japan is

4 *Yahoo Japan Corporation* case (Supreme Court, Decision of 29 February 2016, Minshu, Vol 70, No. 2, p242).

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subject to Japanese corporate income tax for the income obtained through that permanent establishment.

There is relief for this issue from domestic statutes, and also relief provided by tax treaties. In order to avoid double taxation unilaterally, the CTA adopts the Foreign Tax Credit and Dividend Received Deduction.[5] To avoid double taxation bilaterally, Japan has entered into 84 double-taxation avoidance treaties with about 151 countries and regions as of 1 March 2023. The double-taxation avoidance treaties to which Japan is a party are, in principle, based on the OECD Model Tax Convention. Under Japanese law, if there are conflicts between a treaty and domestic law, the treaty always prevails. For an example of the resolution of such conflicts, see 'Repatriation phase' below.

Choice of acquisition vehicle

When a foreign company plans to acquire a Japanese company, the buyer should consider a suitable acquisition vehicle for the deal. In choosing an acquisition vehicle, the foreign buyer should determine what entities the foreign buyer would like to offset the costs for acquisition against: if against the profit of a Japanese domestic corporation, the foreign buyer may prefer setting up a Japanese acquisition subsidiary, while if against its own profits, the foreign buyer may prefer to directly acquire the target or acquire through partnership, depending on the tax laws of the buyer's own jurisdiction.

Foreign buyer exception

When a foreign buyer intends to directly invest in a Japanese corporation, the four types of M&A transaction available are the same as the M&A transactions between Japanese domestic corporations, as described above: share purchases, asset purchases, reorganisations under the Companies Act and corporate shareholder transactions.

5 In the latter method, a maximum of 95 per cent of dividend income from a foreign subsidiary can be excluded from the taxable income of a domestic shareholder, unlike dividend income from a domestic subsidiary.

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However, a foreign buyer cannot be an entity for reorganisations under the Companies Act. For instance, a foreign company cannot merge directly with a Japanese domestic corporation. However, a domestic corporation can pay compensation in the form of a foreign parent company's shares (ie, a triangular merger).

Furthermore, in many cases, foreign buyers cannot avail themselves of tax benefits that Japanese domestic companies enjoy, as Japanese tax law has many exceptional rules against international tax avoidance. The contribution in kind from a foreign company to a Japanese domestic company is a good example. A foreign company can be taxed in Japan on the difference between the fair market value minus the book value of the assets transferred by a contribution in kind and such contributions can never be a tax-free transaction.

Debt push-down

Debt push-down is a way of effective M&A financing in Japan. In order to improve investment efficiency, debts for M&A financing are often pushed down from a foreign buyer to the target.

A recently terminated dispute over debt push-down as M&A financing involves Universal Music Japan GK, a Japanese subsidiary of the international group. Universal Music borrowed money from a foreign company within its group and when the Japanese subsidiary deducted the interest from its profits, the tax office disallowed it as tax avoidance under the CTA, and Universal Music filed a complaint. The Supreme Court rendered a judgment in favour of Universal Music on 21 April 2022.[6]

Transfer-pricing issues

Transfer-pricing is a cross-border tax issue in which companies doing business globally allocate profits and losses from one country in another. The practice can create huge tax liabilities and long-term tax disputes with the

6 *Universal Music* case (Supreme Court, Decision of 21 April 2022 (case No. 2020 (Gyou-Hi) 303)).

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tax authorities. IHI, a Japanese listed company, was subjected to ¥10 billion of additional corporate tax in connection with transactions with its Thailand subsidiaries by the tax authorities in 2018. The case is currently being disputed in the courts. Nihon Gaishi, another Japanese listed company, was fined ¥6.2 billion by the tax authorities in 2012 in connection with transactions with its Polish subsidiary. This case was also disputed at the Tax Tribunal and the court and, after 10 years from imposition of the tax, the Tokyo High Court ruled in favour of Nihon Gaishi in March 2022, and revoked taxation of ¥5.2 billion.

Japanese transfer-pricing regulations are largely in line with the OECD transfer-pricing guidelines. An M&A dealmaker should structure relevant joint R&D agreements and/or licensing agreements regarding (especially) the intangible assets of foreign parents and Japanese subsidiaries and should start to prepare transfer-pricing documents in accordance with Japanese transfer-pricing regulations in the very first investment phase.

Repatriation phase

Taxation on dividend income versus taxation on capital gains

In the repatriation phase, dividend income of a foreign parent company is usually subject to withholding tax, while capital gains of a foreign parent are usually not. However, there are some exceptions.

Withholding tax rates on dividend distributed from a Japanese subsidiary to a foreign parent company without a permanent establishment under the ITA is 20.42 per cent. However, a foreign company with a permanent establishment is required to file a tax return and the amount paid to the tax office as withholding tax can be recovered. If one of Japan's many double-taxation avoidance treaties applies, the withholding tax rate on dividend income paid by a Japanese company to a foreign shareholder with 25 per cent or more shares (or, in the Japan–US double-taxation avoidance treaty, only 10 per cent or more shares held) can be reduced up to 5 per cent.

On the other hand, if a foreign company without a permanent establishment transfers a small portion (ie, less than 5 per cent) of the outstanding shares in a Japanese subsidiary to the other entity, withholding tax from the share

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transfer is not usually imposed on its capital gains. However, there are some exceptions, described under 'Exit phase'.

Exit phase

In the exit phase of an investment in Japan, unique source income on capital gains in Japan can be a surprise to a foreign shareholder.

Usually, share purchase transactions between foreign companies (ie, not between Japanese domestic corporations) are not subject to Japanese tax, since the parties are not residents in Japan. However, two situations can cause issues under Japanese tax laws. First, if 5 per cent or more of the shares in a Japanese company are transferred from a foreign company holding a quarter of the Japanese company's shares for three years or more, the gains from the transfer are subject to corporate income tax, and the foreign company is required to file a tax return. Second, if a foreign company transfers shares of a Japanese domestic company, with 50 per cent or more of its assets in real estate in Japan, the foreign company's gains from the transfer are subject to corporate income tax, and the foreign company is required to file a tax return in Japan.

However, unless a Japanese double-taxation avoidance treaty specifically allows such special source income, foreign companies are not required to report the income in either of the above situations. Careful examination of the double-taxation avoidance treaties between Japan and the foreign countries where the foreign company is a resident is advisable.

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Labour and Employment Issues Relevant to 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.

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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.

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 employ-

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.

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.

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ment contracts to the buying 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 (called '*jogyo-joto*', which directly translates as a 'business transfer') is understood as an M&A transaction where an entire operating business unit, together with 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, which means that the employment contracts will be assigned to the buyer, 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

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type of asset deal with a comprehensive assumption of the seller's rights and obligations by the new company (in an incorporation-type company split) or the absorbing company (in an absorption-type company split).

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
Company split	Comprehensive transfer	Not required. However, the law requires the splitting company to notify the affected employees and explain in advance of the split.	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

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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 (this approach would naturally require the seller company to explain the process in advance).

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 (to be explained later).

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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 Rodosha Shokeiho, or the 'Workers Assumption Act').

The general flow of the legal process is as follows:

1. The splitting 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 splitting company does not challenge the objection, the employee will either stay with the former company or be transferred due to the split.

7 Act No. 103 of 31 May 2000.

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4 If the company challenges the objection, the matter needs to be resolved through a dispute resolution process (typically in court or mediation).
5 The Workers Assumption Act also requires the splitting company to discuss the transfer details with the employees before the notification. Also, it requires the splitting 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 out to the shareholders. 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.

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 trade union at the splitting company will be split in two, with the trade union consisting of the transferred employees being 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 new 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).

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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'. Generally speaking, 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 likely 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, because it is one of the factors named under article 10 of the LCA (ie, the extent of the disadvantage incurred by the employees). Therefore, it is advisable to introduce mitigation measures, such as a transition period and changes that benefit the affected employees (such as a pay rise), instead of having all changes be disadvantageous.

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. If 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 with a considerable accumulation of funds, and the

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merger or acquisition results in the company leaving the group, causing lesser funds to be available, which then causes diminished benefits, 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 deny 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 about whether these four criteria should be treated as 'strict' criteria (meaning all four conditions needs to be met) or merely considerations that the court will look into (the 'soft approach'), and courts have not been uniform in their ruling. In practice, the company should make sure that all four conditions are met, because there is no assurance that any particular court will take the soft approach.

Generally, a merger or acquisition should improve a company's economic or financial situation, 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 seek mutual separation instead of termination.

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

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An employer needs to enter 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 (ie, the Ministry of Health, Labour, and Welfare and its branch agencies) 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 just 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 fast-food chain store manager sued the franchise owner for unpaid overtime, the court determined that these store managers were non-managerial because they lacked discretion in their work and had 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 or more), 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.

9 Japan McDonald's case, Tokyo District Court judgment dated 28 January 2008.

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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 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 (to note, this rule applies to all creditors of the splitting company and not just employees).[10]

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.

10 Articles 759(4) and 761(4) of the Companies Act.

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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 has 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)[11] 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 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.

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

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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.

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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.

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Venture Capital Investment in Japan

Eric Marcks, Mangyo Kinoshita, Takahito Fujii, Akira Kawashiro and Pamela Cavallo[1]

Overview of the Japanese venture capital market

Size

Venture capital has been a hot topic in corporate Japan for the past couple of decades and its prominence in the capital markets and the popular imagination is expected to continue to grow. One piece of evidence of this phenomenon is that more and more Japanese university graduates seek to start their own business rather than join the government or large companies.

That said, the Japanese venture capital market remains smaller than one would expect. Japan has the third-largest economy in the world, but its venture capital market is comparable to a mid-size venture capital market in the United States, as measured by the amount of investment into Japanese start-ups. According to the CB Insights 'State of Venture 2022 Report', Japan's venture capital market is on par with that of Washington, DC and Denver, which

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is slightly smaller than the venture capital market of Seattle and significantly smaller than those of New York (one-seventh the size) and Silicon Valley (one-thirteenth the size).

Even within Asia, where Japan's economy is the second largest, it falls behind China and India in terms of venture capital market size. In 2022, China and India attracted 10 times and 4.7 times more venture capital funding, respectively, than Japan.[2] Of the 10 largest venture capital financing rounds in Asia in the fourth quarter of 2022, four were in China, two in India, one in each of South Korea, Singapore, Indonesia and the United Arab Emirates, and none was in Japan.[3] On the other hand, of the top 10 start-up investors in Asia by company count in the fourth quarter of 2022, five were from China, one was from each of Singapore, Indonesia and South Korea, and three were from Japan.[4] In terms of percentage of GDP invested in start-ups, Japan recently ranked 19th among the 38 Organisation for Economic Co-operation and Development countries according to Entrepreneurship at a Glance: 2018 Highlights.

The relatively smaller size of the venture capital market in Japan leads to smaller valuations and financing rounds. For example, the average size of financing rounds globally in 2022 was US$10.5 million for Series A, US$25 million for Series B, US$45 million for Series C, and US$100 million for Series D and later.[5] The investment trend survey by the Venture Enterprise Center found that Japan's corresponding figures were approximately US$730,000 for series seed and US$700,000 for early-stage investments.

Another data point is the number of unicorns (private companies with a market cap exceeding US$1 billion). At the end of 2022, there were 1,205 unicorns worldwide, with 258 reaching unicorn status in 2022. Japan currently has only six unicorns, as compared with 651 in the US, 172 in China, 15 in South Korea and 70 in India (see the complete list of unicorn companies in the 'State of Venture 2022 Report', CB Insights).

2 'State of Venture 2022 Report', CB Insights.
3 'State of Venture 2022 Report', CB Insights, 175.
4 'State of Venture 2022 Report', CB Insights, 178.
5 KPMG Venture Pulse Q4 2022, 9.

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Even so, venture capital financing is becoming increasingly important in Japan's financing market and the number of venture capital investors has been on the rise over the past few years, increasing 23 per cent from 658 firms in 2019 to 810 firms in 2022. As the number of investors increases and Japan's start-up ecosystem matures, the Japanese venture capital market is expected to continue to grow and become more active. The entrance of government-backed funds into the venture capital market in recent years also shows a growing awareness and emphasis on supporting and developing Japan's venture capital market.

Market participants

The range of VC investors in Japan is quite broad and diverse. The following types of investors are active in the domestic Japanese VC market:

- large, traditional Japanese VC funds affiliated with banks and financial institutions (Mizuho Capital, Mitsubishi UFJ Capital, SMBC Venture Capital, SBI Investment, Daiwa Corporate Investment, Nissay Capital, Shinsei Corporate Investment);
- VC funds financed by public money and focused on supporting domestic technology and industry (DBJ Capital, INCJ, REVIC, JIC-VGI);
- established domestic VC funds without financial institution affiliation (JAFCO, Global Brain, Globis Capital Partners, JAIC);
- newer VC funds without financial institution affiliation (MPower Partners, Mistletoe, Beyond Next Ventures, ANRI, East Ventures, WiL, Coral Capital (successor to 500 Startups Japan), Shizen Capital, Minerva Growth Partners);
- VC funds with ties to universities and research institutions (UTEC, Miyako Capital, OUVC);
- VC funds affiliated with overseas funds (DNX (related to Draper Nexus), Eight Roads, DCM);
- overseas investors (VC funds, including Softbank Vision Fund, Sequoia Capital and corporates/CVCs);
- overseas PE funds (Bain Capital);
- corporate investors (as direct investors or through dedicated CVC arms);
- angel investors; and

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- incubators (Samurai Incubate, Incubatefund, Dream Incubator), several of which are affiliated with universities (for example, the University of Tokyo Entrepreneurs Plaza, SFC-IV).

Because of the relatively small size of the VC market in Japan, the number of true VC lawyers (lawyers who devote the majority of their time to working with VC funds and startups) in Japan is limited. Most lawyers who hold themselves out as VC lawyers are primarily M&A lawyers who handle VC deals from time to time.

Japan has few firms such as Wilson Sonsini, Gunderson, and Fenwick & West that were started to serve emerging growth companies and remain largely focused on VC work. Many large, full-service Japanese firms, however, have VC teams with considerable experience.

International firms in Japan focus on M&A, capital markets, banking and finance, and project finance, and for the most part do not have the VC expertise in Tokyo that their network might have in California or in other VC hotspots, but some lawyers at international firms have developed specialisation in VC to support Japanese clients with their overseas VC activities.

Most startups in Japan are represented by domestic firms, which have expertise in all the practice areas necessary to serve growing companies while also generally offering lower rates and more startup-friendly fee structures than their international counterparts.

Startup lifecycle in Japan

The lifecycle of a typical startup in Japan will sound familiar to VC practitioners in many countries. The first financing round will usually be a founders' round, followed by outside investor rounds and, if all goes well, an eventual public listing or M&A exit. The first round of outside funding, usually from angel investors or early-stage VC funds, will often be in the form of convertible debt, followed by common stock and/or preferred stock financings in subsequent rounds.

One major difference between exits in Japan and the US is that entrepreneurs in Japan tend to view the IPO as the royal road to success. As a result, many founders in Japan aim for IPOs rather than M&A exits or remaining

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private, which may explain the small number of unicorns in Japan. Most startups that seek to list in Japan do so on Growth, the section of the Tokyo Stock Exchange focused on startups (market segments for startups such as Mothers and JASDAQ Growth were restructured into the Growth market segment in April 2022). Startups find Growth attractive because of its lenient listing requirements (there is no minimal market capitalisation requirement at the time of listing; on the 10th anniversary of listing and thereafter, companies must maintain a market capitalisation of a least ¥4 billion to demonstrate high growth potential. The average capitalisation size of companies listed on Mothers and JASDAQ Growth (both equivalent to the current Growth) between 2013 to 2019 was approximately ¥16,247 million at the time of listing.[6]

Technical aspects of financing rounds

Equity financings

Initial equity financings in Japan, especially those involving founders and other insiders, are often in the form of common stock issuances and convertible debt (see below). Later financing rounds or rounds with institutional investors are sometimes in the form of common stock issuances but most often in the form of preferred stock issuances.

Preferred stock issued by Japanese companies carry many of the same rights as in the US: liquidation preference upon actual and deemed liquidations, anti-dilution protections, dividend rights, pre-emptive rights, minority protections and board appointment rights.

Aside from these rights, preferred shareholders can also expect to receive contractual information and inspection rights. Unlike in the US, where rights of first refusal and co-sale rights typically benefit preferred holders only and burden key common holders only, in Japan, these rights benefit and burden preferred holders and common holders alike. Preferred holders in Japanese startups will not have registration rights.

6 www.gckk.co.jp/wp-content/uploads/2021/08/report0830.pdf.

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Convertible debt financings

As in the US, Japanese startups often use convertible debt in early financing rounds or as bridge financing. Convertible debt in Japan will typically have both a discount and a valuation cap.

The Japanese equivalent of convertible notes is convertible bonds. Convertible bonds in Japan are structured to be coupled with warrants and, because they are regulated by statute, they are much more cumbersome to use than contract-based convertible notes. Among other things, the terms of the warrants attached to convertible bonds must be recorded with the relevant government authorities and their terms are publicly available.

An effort was made a few years ago to import a convertible investment document into Japan to simplify early-round financings. The convertible investment document that took root in Japan is the KISS, developed by 500 Startups, rather than the Safe, which was developed by Y Combinator. The main reason for the KISS' prevalence in Japan is that 500 Startups was active in Japan several years ago (it has since left Japan but its core team remains under the Coral Capital name). The Japanese equivalent of the KISS, the 'J-KISS' is subject to the same regulations as convertible bonds under Japanese law and is therefore much more complex than the KISS or Safe, but it is simpler to use than convertible bonds and has therefore become prevalent in Japan.

Contributions in kind

It is common for founders or business partners to contribute intellectual property to a company in exchange for stock, but this form of financing is difficult in Japan because Japanese law requires, as a general rule, that non-cash contributions be valued by a valuation firm or other qualified third party and presented to a court. The cost, time and unpredictability of the resulting valuation greatly complicate this form of financing in Japan.

Investor-favourable terms

Financing terms in Japan are generally more favourable to investors when compared with prevailing practices in the US. For example, participating

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preferred liquidation rights are far more prevalent in Japan than in the US. Similarly, later series of preferred stock often have liquidation preference over earlier series of preferred stock in Japan, whereas the standard approach in up rounds in the US is for all series of preferred stock to have *pari passu* liquidation rights.

Additionally, founders are usually asked to give the same representations and warranties as the issuer, albeit less and less.

Among the most investor-friendly terms commonly found in Japanese financing documents are redemption rights against the issuer or put options against the founders if the founders' representations and warranties are untrue, if a founder leaves the issuer, or if investors do not realise an exit at a pre-set valuation within a specified period after their investment. The frequency of these terms too is decreasing.

Another investor-friendly provision that we have seen with increasing frequency concerns valuation caps in J-KISSes: investors are insisting that the valuation cap be set at the valuation of the issuer at the time the J-KISS is issued. The valuation cap is designed to provide a ceiling on the price the noteholder is deemed to pay upon conversion and is set based on a hypothetical valuation that the investors and the issuer believe the issuer's valuation will reach at the time of conversion. The valuation cap for a convertible note was never meant to be equal to the issuer's valuation at the time of the note issuance, as this would defeat one of the purposes of the convertible note, which is to eliminate the need to set a valuation. And it would also give noteholders the protection against dilution afforded to equity holders while also giving them the benefit of creditor status, thereby allowing them to have their cake and eat it too. And yet this is precisely what more and more VCs in Japan are insisting on. Many issuers understand that this practice is a perversion of the way the J-KISS is supposed to work, but they generally accept it for two reasons. First, they have no choice, as more and more VC investors are insisting on this provision. Second, the alternative – having the investor instead subscribe to shares at the same valuation – is seen as less attractive to issuers compared to a J-KISS issuance, because in the former case, the issuer must deal with one more equity holder who will have certain management and shareholder rights.

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Documentation

Financing documents in Japan look similar to those used in VC financings in the US and many other parts of the world. The parties will first negotiate a term sheet. Based on the term sheet, the parties will then prepare a standard set of documents, which for a preferred equity financing will consist of a subscription agreement (equivalent to the stock purchase agreement in a US financing), a shareholders' agreement (equivalent to the investors' rights agreement, right of first refusal and co-sale agreement, and voting agreement in a US financing) and a charter document.

The charter document must be filed with the relevant authorities and must therefore be in Japanese, but the subscription agreement and shareholders' agreement may be in English. The charter document will reflect the terms of the preferred stock (dividend rights, liquidation preference, conversion, anti-dilution protections, etc) and the shareholders' agreement will reflect the contractual rights (deemed liquidation, pre-emptive rights, rights of first refusal and co-sale, drag-along rights, minority protections and information rights). As mentioned above, the shareholders' agreement will not have registration rights.

Unlike in the US, where the liquidation preference is set forth in the charter document and encompasses both liquidations and company sales, Japanese financing documents distinguish between liquidations and company sales (ie, deemed liquidations). Provisions regarding liquidations (where the issuer undertakes the action) are typically set forth exclusively in the charter document, whereas provisions regarding company sales (where the shareholders initiate the action) are usually set forth in either the shareholders' agreement or another agreement that is separate from the shareholders' agreement).

The documentation for convertible bonds and J-KISSes is considerably more complicated than the equivalent used in the US. This documentation may be in English, except that the part of the documentation that needs to be filed with the relevant authorities must be in Japanese.

There is a publicly available form of J-KISS that is widely used, but there are no publicly available templates for the other standard documents; consequently, the financing documents used in Japanese VC financings tend to be less uniform than in the US, where financing documents are based on or follow the

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publicly available NVCA forms. This is even more the case for English-language documents used for financings in Japan. The issuer will often prepare first drafts of financing documents, but it is not unusual for investors to prepare the first drafts, especially if they have forms that they are in the habit of using.

Secondary sales

Unlike in the US, the securities laws in Japan do not restrict the sale of unregistered securities and nearly all Japanese companies have provisions in their charter documents prohibiting shareholders, including preferred holders, from selling their shares without board approval. Board approval is in addition to the right of first refusal and co-sale procedures that shareholders must comply with to sell their shares. There is no active market for shares of privately held companies, and secondary sales of shares of startups in Japan are uncommon.

Stock options and restricted stock

As in the US and many other markets, Japanese startups frequently compensate their employees with stock options with vesting schedules similar to those found in the US. The rules regarding tax-qualified stock options in Japan are quite restrictive and complicated to implement and are premised on an IPO exit as opposed to an M&A exit; as a result, some early-stage startups, especially those that are considering an M&A exit as opposed to an IPO exit, opt for non-tax qualified stock option plans. Whether an issuer adopts a tax-qualified or non-tax qualified stock option plan, the administrative costs of maintaining a stock option plan in Japan will generally be higher than in the US.

In Japanese startups, there is no common practice or contractual arrangement equivalent to restricted stock in the US; however, founders often execute 'founders' agreements' under which they agree to subject their shares to a vesting schedule and a call right in favour of the other founders (but usually not the issuer) if they leave the issuer before call right on those shares has lapsed.

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Legal fees

Legal fees for VC deals in Japan are much lower than in the US, both on the issuer side and the investor side. This can be explained by the facts that hourly rates in Japan are generally lower than in other global financial centres, lawyers will often play a more limited role in a VC financing, parties tend not to extensively negotiate the documents, and there is less financing available in Japan than in other global VC markets (which means that companies have to limit their legal fees). Unlike in the US, the issuer will usually not pay the legal fees of a lead investor (though we have seen some new funds established by foreign VC investors try to impose this practice).

Most Japanese law firms do not take equity in their clients, in part because of concerns regarding conflicts of interest, but perhaps in larger part because it is not a common market practice and the challenges of introducing this practice to large and traditional firms would be complex.

Recent trends and developments

Hopeful signs for the Japanese VC market

Despite its relatively small size, the Japanese venture capital market is growing and market participants remain optimistic. According to the Japan Startup Funding Report published by INITIAL, the year 2022 saw the largest aggregate amount of venture capital investments in the past decade (approximately US$6.74 billion as compared to US$670 million in 2013). Despite a global slowdown in the venture capital market in 2022 that saw investments and deal flow fall by approximately 38 per cent and 28 per cent respectively, on a year-on-year basis the venture capital market in Japan has remained stable.[7] Indeed, the Japan Startup Funding Report found that venture capital investments in the country during the first half of 2022 exceeded half of the total investment amount for the full year of 2021, and the average investment per startup also increased on a year-on-year basis.

7 'State of Venture 2022 Report', CB Insights, 196.

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High-profile VC funds and PE funds turning their attention to Japan

Another sign of optimism is the fact that high-profile overseas venture capital funds are turning their attention to Japan. In 2021, SoftBank Vision Fund invested in Japanese startups for the first time and continued these investments in 2022. Despite its ties to Japan-based SoftBank, the Vision Fund had previously eschewed the Japanese market because few, if any, startups could accommodate the fund's minimum ticket size. The fact that the Vision Fund is beginning to deploy venture capital financing in the country is evidence of the market's maturity. In addition, overseas private equity funds and investment managers are increasing their investments in pre-IPO startups in Japan. The emergence of these new classes of investors is contributing to the enrichment and diversification of the country's venture capital market.

Strong CVC activity

The Japanese venture capital market has also benefited from buoyant corporate venture capital (CVC) activities. Japan has a huge number of companies with tremendous technological competence, but there exists the perception that they are no longer producing innovative products and the technologies of the future at the same clip as in the pre-2000s. Many companies have concluded that they can no longer rely solely on internal R&D to remain relevant on the global stage and that they must outsource innovation. These companies have turned to CVC as a means of achieving this objective. The global venture capital market in 2022 exhibited sluggishness and Japan was somewhat impacted by this trend. However, both domestic and outbound CVC activity has grown significantly in the past few years. For example, of the top CVCs by company count in the fourth quarter of 2022, five were from the United States, one was from each of South Korea and China, and four were from Japan.[8]

8 'State of Venture 2022 Report', CB Insights, 52.

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Japanese startups incorporate abroad to tap into larger foreign VC markets

As discussed above, the size of the VC market in Japan is small relative to the size of its economy. Nonetheless, there is a fair amount of public money in Japan available for startups, which makes it easier for startups to receive access to early-stage funding as compared to their counterparts outside of Japan.

One of the biggest challenges for startups in Japan is raising a sizeable amount of capital during the earlier rounds of financing. For example, in 2022, Series A and B rounds in the US raised on average US$11.6 million and US$30 million, respectively,[9] whereas Series A and B rounds in Japan raised only a fraction of these amounts during the same period. In light of this challenge, several years ago, a significant number of Japanese startups either converted into corporations under the laws of Delaware (or Singapore, the Cayman Islands, or other jurisdictions) when they concluded that they had reached their financing limits in Japan or they were initially organised as Delaware corporations to make it easier to raise capital in the US. Starting as a Delaware corporation also confers on companies the status of a US startup, which can be advantageous when raising capital or seeking business opportunities in Japan. These companies raised capital in the US and Japan through the Delaware parent company and conducted their research and operations through a Japanese subsidiary thereof. This trend is starting to reverse, however, as an increasing number of these companies are reincorporating in Japan, either because fundraising in the US was harder than anticipated or to seek a listing in Japan, where listing requirements are less stringent than in the US.

Foreign Exchange and Foreign Trade Act

In August 2019, amendments to the Foreign Exchange and Foreign Trade Act (FEFTA) imposed restrictions on investments made by foreign investors in Japanese companies active in restricted industries (notably, the information and communications technology industry). Foreign investments, even minority investments, in these restricted businesses require notification to

9 https://assets.kpmg/content/dam/kpmg/xx/pdf/2022/01/venture-pulse-q4-2021.pdf.

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the Japanese government. The Japanese government sought to ease the effect of these amendments by introducing, in May 2020, an exemption to the pre-closing notification if certain conditions are met. Use of this exemption, however, imposes certain constraints on foreign investors, including a prohibition in principle against appointing directors to the restricted business's board. The Japanese government has 30 days to review such notifications before a transaction can close; this period can be shortened to two weeks, and sometimes even less than one week, but it can also be extended to several months, depending on the circumstances. As with the CFIUS regime, which covers many minority investments in US startups, the FEFTA rules trigger pre-closing submissions in many foreign investments in Japanese startups, especially in the tech space.

Angel investment tax reduction

In an effort to boost investment in startups, the Japanese government has implemented a tax incentive programme (known as Angel zeisei) to individuals who invest in qualified early-stage companies. Individual investors may deduct 100 per cent of the investment amount, with a nominal deductible amount, up to a maximum of ¥8 million, from gross income, which can lead to reduction in tax of up to approximately 45 per cent of the invested amount for taxpayers in the top bracket. As a result, several VC funds that invest solely in such tax-qualified companies have recently emerged.

The Japanese VC market

Japan has many of the key ingredients for a flourishing VC ecosystem: a large, modern and technologically advanced economy, a sophisticated VC investment framework, an outstanding physical infrastructure, highly regarded research universities (although they are often not open to or adept at monetising scientific innovations), and competent professional advisers, among other factors.

People often blame Japan's conservative business culture and VC investors as the primary reason for the current state of Japan's VC market. They say that Japanese VC investors have the mindset of bankers rather than venture capitalists because many are former bankers. Additionally, many believe that

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Japanese businesspeople are too risk-averse to start their own business. There may have been some truth to these observations in the past, but the number of venture capitalists in Japan who have started their careers as entrepreneurs or VC investors (as opposed to bankers), the number of international VCs active in Japan, and the number of entrepreneurs in Japan have significantly increased in recent years. Gone are the days when a university graduate's dream job was joining a large company or a government ministry; more and more young professionals in Japan want to be entrepreneurs. These trends bode well for the growth and stability of the Japanese VC market, which should in turn give rise to many innovative start-ups in the years to come.

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11

Key Intellectual Property Issues in M&A Transactions

Takashi Hirose[1]

Introduction[2]

Japan is a scientific and technological nation, with one of the most important markets and the third largest GDP in the world. The number of annual patent prosecutions (including international patent applications) in Japan is about 289,000,[3] which is the third largest in the world. Japan is home to many global companies with highly technological and innovative skills and capabilities. Japan also has a suitable business and legal environment for companies; for instance, there is a very low crime rate, a highly educated workforce and

1 Takashi Hirose is an attorney at law (Japan and California) and a partner with Oh-Ebashi LPC & Partners (Tokyo office).

2 This chapter explains only some basic characteristics of the Japanese intellectual property system and some important issues in the M&A transaction context. It is not an exhaustive summary. In addition, this chapter purely reflects the personal opinions of the author, and does not represent the views of Oh-Ebashi LPC & Partners.

3 Japan Patent Office Annual Report, www.jpo.go.jp/resources/report/nenji/2022/document/index/0101.pdf.

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a reliable judicial system, especially regarding intellectual property-related cases. The Tokyo and Osaka District Courts have specialised divisions for intellectual property (IP) and Tokyo is also home to the Intellectual Property High Court. The average number of months needed for courts to resolve IP-related cases at the first instance is only around 12 to 15 months.[4]

IP and intellectual property rights (IPRs) are important assets that are key to Japanese companies' core value and the keys for the success of these companies in business. The important value of IPRs is the ability to exploit them economically. These include defensive abilities, for instance, preventing competitors from using a patented invention and making infringers pay damages. In addition, positive effects regarding external communication,[5] for instance, branding corporate products and services, are also included. Legal due diligence on IP is therefore a vital part of any preparation for an M&A transaction. One of the keys for the success of M&A transactions is to spot IPR issues properly and to take reasonable measures to deal with the issues. It is especially important for a buyer to ensure that key target company IP used before the M&A transaction will be continuously available to the buyer side (the target company or target business[6]).

4 Intellectual Property High Court, www.ip.courts.go.jp/vc-files/ip/2022/J_zenkokuchisai.pdf.

5 In June 2021, the amended Corporate Governance Code, a guideline made by Tokyo Stock Exchange and Financial Services Agency for listed companies, included items related to disclosure of IP investment strategy by listed companies. In addition, in response to the said amendment, in January 2022, the IP and Intangible Asset Governance Guideline was disclosed, in which the importance of disclosure of IP strategy with logical explanations and story lines is emphasised. Further, in March 2023, the IP and Intangible Asset Governance Guideline Ver.2.0 was disclosed.

6 In M&A transactions, in many cases the target is a company itself; however, in some cases the target is not a company itself but rather a part of the business of a company. In this chapter, 'target company' is used to also include cases where the target is part of the business of a company.

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Collecting IP-related information of the target company before an M&A transaction in light of the characteristics of the Japanese IP system is therefore important. Examples of information to be collected include:[7,8]

- lists of important IPRs owned by the target company;[9]
- lists of IP licences granted to the target company[10] (not only from third parties but also from group companies of the target company), and licence agreements thereof;
- lists of IP licences the target company grants to third parties (including group companies of the target company), and licence agreements thereof;
- other IP-related agreements (including joint research and development agreements) other than licence agreements;
- IP-related agreements (including software licence agreements), materials on software used by the target company, how they are developed, third parties involved in the development or owning rights in the software (other than licensor, if any);
- material on the overview of the department that deals with and manages IP matters;
- internal rules of the target company to deal with or manage IP (including but not limited to internal rules on employee inventions), material on how the rules are implemented, etc; and

7 This is not an exhaustive list.

8 M&A transactions almost always require legal due diligence including IP due diligence. The buyer learns about the (potential) strong and weak points and related issues of the relevant IPRs. It is usual that the parties to the M&A transaction sign non-disclosure agreements (NDAs) regarding restrictions on the use of such confidential information. However, the protection given by the NDA is not perfect. If the M&A deal fails, the directors or employees of the potential buyer who are involved in the deal process still know the said points and issues. Carefully structuring the contents of NDAs, limiting the scope of persons who can receive the core confidential information and retaining a right to audit, etc are important, but this is still not perfect protection.

9 It is better to include information on any encumbrances including pledges and licences granted to third parties, etc.

10 It is better to include information on whether there is any non-performance of the obligations in the licence agreement by the target company that would lead to losing the licence granted.

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- material on IP-related disputes (including potential disputes) in which the target company or the IP used by the target company is involved (in addition, it is better to include information on any grounds for invalidation[11] of the important IP).

Intellectual property rights

Identification of IPRs

As stated, it is very important for a buyer to ensure that important IP of the target company used before the M&A transaction can be continuously available to the buyer after the transaction. Identification of the IPRs relevant for the intended M&A transaction, as well as analysis, description and appropriate listing thereof, are the important starting points of the deal process and essential for the success of the transaction. Thus the buyer must try to obtain from the seller comprehensive lists of important IPRs, including licences relevant to the M&A transaction. To check and supplement the lists, the buyer can check registered information at the Japan Patent Office (JPO) for patent, utility model, trademark and design rights (together, industrial property rights). However, there are certain limitations to this.[12] In addition, with regard to unregistered IPRs, such as copyrights, it is more difficult to check the comprehensiveness of the lists provided by the seller side based on public information. Therefore, in addition to appropriate efforts to collect information from the seller, it is important, for instance, to establish representation and warranty clauses stating that the target company legally and validly owns or is granted the IPRs

11 It is difficult to thoroughly find and evaluate issues regarding the grounds for invalidation of the important IP because of the limitation of time and other resources in legal due diligence. Thus, checking the grounds for invalidation thoroughly is often excluded from the scope of due diligence. Consequently, for instance, a proper arrangement of representation and warranties or a price adjustment clause, etc would be important.

12 Registers of industrial property rights include information on the name of the owner of an industrial property, whether assignment was made, whether an exclusive licence (*senyo jissiken* or *shiyoken*) is granted to a third party, and whether a registered pledge is established on an industrial property right. However, for instance, it should be noted that a non-exclusive licence is not registered (please note that some non-exclusive licences for trademarks would be registered. See footnote 38).

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that it uses or utilises to conduct its current business and that the said IPRs do not have any encumbrances that have an adverse effect on or inhibit the use of such IPRs.[13]

Points to note in schemes of M&A transactions

As stated under 'Licence', the schemes of M&A transactions mainly include share acquisition, comprehensive succession (eg, merger, company split) or a specific succession scheme (eg, business transfer). However, regardless of the schemes intended, identification of the relevant important IPRs is vital.

In a share acquisition, ownership of IPRs does not change directly, but checking the following points is important. First, the transaction may have an impact on licences granted to the target company since licence agreements often contain a change of control clause that might lead to termination of such licence agreements. Second, some of the relevant important IPRs may not be owned by the target company (but by a group company of the seller or third parties outside the group). In such cases, the buyer would need an arrangement to sell (transfer) the said IPRs to the buyer or to secure a licence (the latter option might be more feasible). Third, the seller may want to keep certain IPRs for continued use.[14]

13 There might be some cases where the compensation is denied or restricted if the buyer actually knows facts contrary to the contents of the representation and warranty clause or does not know such facts because of gross negligence (see Tokyo District Court Judgment 17 January 2006 (Heisei 18) Hanrei Jiho 1920 p136). In addition, it is important to include a clause that states the effects of the breach of the representation and warranty clauses, for instance, the buyer's right to seek indemnification, termination or price adjustment, etc. These would also apply to the other representation and warranty clauses explained in this chapter.

14 If the target company owns an IPR for which the seller or a group company has been granted a licence, there might be some cases where the seller wants to keep the licence.

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In a scheme using comprehensive succession, in principle, IPRs are automatically transferred without any individual succession procedures.[15] However, the same issues stated in the share acquisition part also apply.

In a scheme using a specific succession scheme, the assets, liabilities and agreements that the parties agree to transfer are transferred individually. The buyer must ensure that the necessary IPRs are properly identified and allocated.[16] In addition, the buyer has to make sure that the counterparties agree that the said agreements are transferred properly.[17] In addition, the second and third points addressed above also apply.

Registered IPRs

As stated, the buyer can find registered information regarding industrial property rights in the JPO IP register[18] (such as ownership of the right and change of the ownership, etc), including patent, utility model, trademark and design rights.[19,20] However, it should be noted that there are certain limitations on

15 Transfers of industrial property rights have to be registered at the JPO to be effective (Patent Act article 98(1)(i)). For the transfer of the IPRs to take effect under a comprehensive succession scheme (merger, company split), registration at the JPO is not required. Nonetheless, the fact of the succession has to be reported to the Director General of the JPO without delay (Patent Act article 98(2)).

16 Transfers of industrial property rights have to be registered at the JPO to make them take effect (Patent Act article 98(1)(i)).

17 Obtaining the consent as a condition precedent or as a covenant of the seller is a measure worth considering, depending on the importance of the agreements identified.

18 There is a way to request the register information online.

19 Patents are governed by the Patent Act. Utility models are governed by the Utility Model Act. Trademarks are governed by the Trademark Act. Designs are governed by the Design Act.

20 In addition, through the J-PlatPat system, it is possible to check the contents of gazettes for patents, utility models, trademarks and designs to see the scope and contents of the industrial property rights. It is also possible to check ownership, existence of exclusive licences and pledges. There is a time lag for a change of ownership to be reflected in the register, although since May 2019 the functions of J-PlatPat have improved. In addition, to see detailed information on exclusive licences and pledges, the relevant register information still has to be checked.

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the information registered at the JPO. For instance, with regard to licences, registrations of patents, utility models, trademarks and designs only contain information on exclusive licences (*senyo jissiken* or *shiyoken*).[21] Non-exclusive licences[22,23] are not registered at each register. In addition, though the registration of a pledge is required for it to take effect,[24] the pledge is not always properly registered.

Therefore it is important to collect information from the target company on whether proper registrations have been made and whether there are any encumbrances. Proper arrangements should be made for conditions precedent, covenants, and/or representation and warranty clauses to deal with registration and encumbrance issues (including, but not limited to, pledges[25] and licences) that may have an adverse effect on or inhibit the use of IPRs.

In addition to the core IPRs mentioned above, checking the company name as well as domain names is also important. Domain names are not considered traditional IPRs, but they can be significant in relation to branding, for instance; domain name registration can be checked using a Whois search. Company name registration is a requirement to establish a company; company name registrations can be checked online through the Registry Information

21 For instance, an exclusive licence (*senyo jissiken* or *shiyoken*) occurs on permission of the patentee; however, it does not take effect until it is registered at the JPO. On the other hand, registration is not required for a non-exclusive licence to take effect.

22 Before April 2012, non-exclusive licences for patent rights were registrable, though the registration was not a requirement for the non-exclusive licence to take effect but it was a requirement for duly asserting the right against third parties. On or after 1 April 2012, the system where a non-exclusive licensee can duly assert, without registration, its right against third parties was introduced (for patent, utility model and design rights). Please note that in order for a non-exclusive licensee of a trademark to assert its right against third parties, the non-exclusive licence for trademark has to be registered. See footnote 38.

23 A non-exclusive licence includes (as a contractual arrangement) monopolistic non-exclusive licence and non-monopolistic non-exclusive licence.

24 For instance, Patent Act article 98(1)(iii).

25 This is because, if a pledge is established on an important IPR and the obligor defaults on a debt, the said IPR can be taken by the pledgee.

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service. The scope of protection provided by a trademark right is different from that of a company name (in principle, the latter is limited).

Unregistered IPRs

Copyright

It is more difficult to identify and inventory important copyrights[26] that the target company actually owns or utilises. Under the principle of the creator doctrine, the copyright and moral right of an author vest automatically in the author who creates a work.[27] Unlike industrial property rights, no registration is required for copyrights and transferring copyrights. It is true that a registration system for copyrights is available (for instance, registration of transferring copyright and registration of establishment of a pledge are regarded as a requirement for a transferee (or a pledgee) to assert its rights against third parties[28]). However, the items within the scope of the registration systems are limited[29] and the registration system is not widely used. Thus, identifying the owner of copyrights, checking the change history for ownership and checking the existence of encumbrances are not easy.[30] In addition, if a work is created cooperatively by multiple people part of which belongs to an entity outside the

26 For computer programs and licensing issues see the 'Licence ' section and the 'Software and computer programs' section.

27 Important exceptions are work for hire and ownership of cinematographic works.

28 Copyright Act article 77(i)(ii).

29 For instance, registration of the true name (Copyright Act article 75); registration of the date of first publication, etc (Copyright Act article 76); registration of the date of creation of program work (Copyright Act article 76-2); registration of copyright (Copyright Act article 77); procedures for registration (article 78); exceptional provision for the registration of program works (article 78-2); registration of the right of publication (Copyright Act article 88).

30 On or after 1 October 2020, a non-exclusive licensee of copyright is able to assert his or her non-exclusive licence against a third party without any registration (Copyright Act article 63-2).

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target company, it makes issues more complicated.[31] Thus, efforts to carefully collect information from the target company or the seller are important.

Other IP

Trade secrets[32] and shared data with limited access under the Unfair Competition Prevention Act (UCPA) are also considered important.[33] They are not registered at a public office. In addition, there are lots of cases where the target companies do not develop lists thereof internally to manage them. Thus, efforts to carefully collect information from the target company or the seller are important.

Trade secrets

As one of the important requirements, a trade secret must be kept secret. Generally speaking, it is not easy to satisfy this requirement. It is not sufficient that the owner of the information in issue recognises that it is secret. Instead, it is required that employees or customers easily recognise the owner's intention to keep the information in issue confidential by clearly presenting such intention through an economically reasonable measure with respect to confidential compliance, depending on the specific situation. Thus, it is important to collect information on how trade secrets are managed in the target company.

31 A person who creates an original work need not to be a single person. Multiple people can express their individualities to create a single work. However, the author should be a person who makes an original expression only. Identifying the author is not necessarily easy. In addition, with regards to joint works, many restrictions are placed on each owner of the copyright for the joint work, for instance, transferring one's share, granting licences and exercising the copyright need the consent of the other joint owners.

32 The term 'trade secret' as used in the UCPA means technical or business information useful for business activities, such as manufacturing or marketing methods, that are kept secret and that are not publicly known.

33 Under the UCPA (ie, article 2 (i)(ii)(iii)), use of an indication of goods and the form of goods can also be protected under certain circumstances.

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Shared data with limited access

In 2019, in order to protect and use big data, an amendment to the UCPA was passed that makes shared data with limited access protected under the UCPA. The term 'shared data with limited access' as used in the UCPA (article 2(7)) means technical or business information that is accumulated in a reasonable amount by electronic or magnetic means as information provided to specific persons on a regular basis and that is managed (excluding information that is kept secret[34]). Since this system was introduced recently, there may be many cases where the target companies do not manage such data systematically or develop the relevant lists.

The buyer has to rely on the information for unregistered IPRs from the target company and it is important to consider, for instance, effectively establishing representation and warranty clauses in an M&A agreement.

Licence

Types of licence

Industrial property rights

With regard to industrial property rights, under the related laws, the types of licence are divided mainly into exclusive licence (*senyo jissiken*[35]) and non-exclusive licence (*tsujo jissiken*[36]). A non-exclusive licence is, as a contractual arrangement, divided mainly into monopolistic non-exclusive licence[37]

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34 Some scholars think that information kept secret should not be excluded from the information protected under the UCPA and that there might be some cases where the same information is protected as a trade secret and shared data with limited access (Ono & Matsumura (2020), Shin Fusei kyoso boushi ho gaisetsu 3rd edition volume 2, Seirin shoin 2020 pp11–13).

35 For a trademark licence, it is called '*senyo shiyoken*'.

36 For a trademark licence, it is called '*tsujo shiyoken*'.

37 The licensee is entitled to a contractual exclusive right to exploit the IP. In addition, a monopolistic non-exclusive licence is, as a contractual arrangement, divided into cases where the licensor itself is allowed to use the IP and cases where even the licensor itself is not allowed to do so. Thus, it is important to check whether the licensor itself is prohibited in its use of the IP in licence agreements.

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(*dokusenteki tsujo jissiken*) and non-monopolistic non-exclusive licence (*hi dokusenteki tsujo jissiken*).

Registration is required for an exclusive licence to take effect. Once an exclusive licence is established, for instance, even the patentee is not allowed to work the patented invention. Considering these points, exclusive licences are not widely used. In addition, an exclusive licensee (*senyo jissikenjya*) has the right to seek an injunction and damages, within the scope of the licence agreement, in its own name with respect to an infringement by an unauthorised third party.

For a non-exclusive licence to be established, registration is not required.[38] A non-monopolistic non-exclusive licensee does not have the right to seek an injunction or damages in its own name. A monopolistic non-exclusive licensees is considered to have the right to seek damages in its own name; however, whether it has the right to seek an injunction is not necessarily clear.[39]

Copyrights[40]

The Copyright Act provides only for non-exclusive licences.[41] Thus variations in the characteristics of licences are provided by contractual arrangements.

38 Before April 2012, non-exclusive licences for patent rights were registrable, though the registration was not a requirement for the non-exclusive licence to take effect but a requirement for duly asserting it against third parties. On or after 1 April 2012, the system where a non-exclusive licensee can duly assert, without registration, its right against third parties was introduced (for patent, utility model and design rights). On the other hand, with regards to trademark rights, a non-exclusive licence is still required to be registered to duly assert it against third parties.

39 See footnote 42.

40 The UCPA does not provide any type of licence regarding trade secrets. In addition, there is no registration system at a public office. The contents of trade secret license depend on a contractual arrangement between parties.

41 There is an exception. The owner of print rights has the exclusive right to reproduce the unaltered original work (Copyright Act article 80(1)).

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Whether a non-exclusive licensee has the right to seek an injunction, damages, or both can be considered the same as in an industrial property right licence.[42]

Issues related to the scheme of M&A transactions including change of control and similar issues

It is necessary to check whether there are any matters that have an adverse effect on the continuity of the use of the licensed IP.[43] One of the important points when checking licence agreements relating to the target company is to see whether the licences are properly succeeded (the licences granted are continuously available) through the M&A transaction. Whether and how the licences are properly succeeded depends on the type of scheme of the M&A transaction.

Buyer side's acquisition of shares issued by target company (share acquisition)[44]

In principle, theoretically, consents from licensors are not required to maintain licences. This is because the legal character of the target company does

42 There are several court cases that admit the possibility that monopolistic non-exclusive licensees are entitled to seek injunctions by using the subrogation right of oblige under the Civil Code article 423 (for patent rights, see Tokyo District Court 31 August 1965 (Syowa 40) Hanreitaimuzu 185 gou p209); for trademark rights, see Osaka High Court 10 July 2002 (heisei 14) (heisei 13 (ne) 23 gou); for copyright, see Tokyo District Court 31 January 2002 (Heisei 14) (hanrei jiho 1818 gou p165) and Tokyo District Court 29 September 2016 (Heisei 28).9.29 (Heisei 27 (wa) 482 gou)). However, among practitioners and scholars, there is still no common view regarding whether and under what conditions monopolistic non-exclusive licensees are entitled to seek an injunction. (Matsuda, S (2020), *Licence Keiyaku Ho* (*The Laws of Licence Agreements and Related Transactions*), Yuhaikaku.p74).

43 For instance, it is important to check whether there is any default of the obligation owed by a licensee (the target company) that could lead to losing the licence.

44 This includes purchasing issued shares of the target company. In addition, this can theoretically include, for instance, a share exchange scheme where a procedure for corporate reorganisation stipulated in the Company Act is used to obtain issued shares of the target company and make the target company a wholly owned subsidiary.

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not change even after the M&A transaction, so the licensee does not change. However, it is not unusual for licence agreements to include a clause that allows licensors to terminate their licence agreement when a substantial change occurs in the controlling power of the licensee, for instance, a substantial change to a licensee's shareholders or officers[45] (change of control (COC) clause). If a licence agreement that can be terminated based on a COC clause is essential to the target company, the purpose of the M&A transaction cannot be achieved without the licence. Then, for instance, one of the measures to be considered is to cause the seller to obtain the consent of the licensor as a condition precedent to closing the M&A transaction. If the licence agreement is important (but not essential) to the target company and certain negative effects are expected on the business of the target company, one of the measures to be considered is to have the seller owe the obligation to obtain the consent of the licensor in issue as a covenant.[46]

In relation to or similar to the said COC clause issue, the following are some circumstances where checking the continuous availability of licences is important:

1. If an important licence is granted by a group company of the target company or the seller, then it is necessary to check whether it is possible to make an arrangement[47] wherein the target company is granted the licence continuously.[48]
2. If the licensor of an important licence is a pure third party that is not a group company of the target company and the licence is granted to a group

45 This often includes the occurrence of corporate reorganisations under the Companies Act, including mergers and company splits, etc.

46 In addition, if the licence in issue is an important source of revenue and the licence is terminated because of the M&A transaction, the buyer could also consider using the arrangement to decrease the amount of consideration for the M&A transaction.

47 Transferring the IP licensed from the group company to the target is another measure worth considering. However, in general, a licensing arrangement might be more capable of being realised.

48 One of the important factors is whether there is any inconvenience caused by the fact that the IP regarding which the licence is granted is expected to be used by a company outside the group.

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company of the target company and the reason why the target company is entitled to use the IP related to the licence is because the target company is under the umbrella of the group company, it is necessary to check whether it is possible to make an arrangement wherein the target company is granted the licence continuously. Compared with (1), there is often more difficultly in achieving such arrangement.[49]

It is also useful to consider the measures outlined in the section discussing the COC clause issue.

Comprehensive succession scheme

The effect of a merger scheme and company split scheme is that, in principle, all or part of the assets, rights and obligations of the target company (or the target business) are comprehensively and automatically transferred. Thus, in principle, consents from the licensors are not required to transfer the licences. However, if a licence agreement includes a COC clause, it is useful to consider the measures stated above in the section on share acquisition.

With regards to patent licences, the Patent Act article 77(3) states 'an exclusive licence may be transferred only where the business involving the working of the relevant invention is also transferred' or 'where the transfer occurs as a result of general succession'. The Patent Act article 94(1) also states that 'a non-exclusive licence may be transferred only where the business involving the working of the relevant invention is also transferred' or 'where the transfer occurs as a result of general succession'.[50] It is considered that

49 Especially cases where the said group company is granted a licence based on a cross-licence arrangement or where the buyer is a major competitor of the licensor of the licence in issue.

50 Design Act article 27(4) and Utility Model Act article 18(3) state that Patent Act article 77(3) applies mutatis mutandis to exclusive licences. In addition, Design Act article 34(1) and Utility Model Act article 24(1) have the same rule as Patent Act article 94(1). However, the Trademark Act does not apply Patent Act article 77(3) to exclusive licences. In addition, Trademark Act article 31(3) does not have the exact same rule as Patent Act article 94(1). In other words, under the Trademark Act, in principle, a trademark licence may be transferred where the consent of the holder of a trademark right is obtained or

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the circumstances described in these two articles includes merger schemes and company split schemes. However, whether these articles are compulsory is not necessarily clear[51] and such issue is debated among scholars and practitioners. Thus, from the buyer's viewpoint, it is safer to consider taking the measures described in 'Buyer side's acquisition of shares' on the premise that these articles are not compulsory and could be displaced by a mutual agreement (ie, a COC clause could terminate the licence agreement even under a merger or company split scheme). In addition, considering the issues around checking the continuous availability of licences outlined in (1) and (2) above is also important.

Specific succession scheme

During a business transfer scheme, specific assets, liabilities and agreements, etc of the target company are identified and transferred individually. Thus, in principle, consent from the licensors is required to transfer the licences. However, a business transfer scheme is considered to meet the requirement of 'where the business involving the working of the relevant invention is also transferred' (Patent Act articles 77(3) and 94(1)).[52]

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where the transfer falls under general succession (for exclusive licence, see Trademark Act article 30(3), for non-exclusive licence, see Trademark Act article 31(3)). 'General succession' is basically considered to include merger schemes and company split schemes. In addition, the Copyright Act does not state the exception on transferring licences, such as 'where business . . . is transferred'. In principle, the consent from the licensor or general succession (this includes merger schemes and company split schemes) is required to transfer the licence for a copyrighted work.

51 Nakayama, N and Koizumi, N (Eds) (2017), *Shin Chukai Tokkyo Ho* Second edition volume 2, Seirinshoin. p1455.

52 The same rule applies to utility model and design. However, the rule does not apply to trademark or copyright. A trademark licence may be transferred only where the consent of the holder of such trademark right is obtained or where the transfer falls under general succession (Trademark Act article 30(3) and 31(3)). Business transfer does not constitute general succession. Further, in order to transfer a licence for a copyrighted work, the consent of the licensor or general succession is necessary too.

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Nonetheless, as stated above, from the buyer's viewpoint it is safer to consider taking measures on the premise that a COC clause could terminate the licence agreement even under a business transfer scheme.

Perfection of non-exclusive licence without registration

With regard to patents, utility models, designs and trademarks, for an exclusive licence to take effect, registration is required, which enables the exclusive licensee to duly assert its rights against a third party.

On the other hand, with regards to patents, utility models and designs, a non-exclusive licensee is able to duly assert its non-exclusive licence against third parties (including the new owner of an IPR) without registration. In addition, on or after 1 October 2020, without any registration, copyright licensees[53] are now able to duly assert rights against any third party who obtains copyrights from the owner.[54,55] However, a non-exclusive licensee of a trademark is required to register it to duly assert its rights against third parties.

53 In principle, the Copyright Act does not provide types of licences.

54 Copyright Act article 63-2. In addition, this amendment is applicable to licence agreements on copyright executed before 1 October 2020. However, the amendment is applicable only to a third party obtaining copyrights from the owner a copyright on or after 1 October 2020.

55 Under the Bankruptcy Act (*Hasanho*), if a licensor becomes insolvent (*hasan*), a bankruptcy trustee (*hasankanzainin*) appointed by the court can choose whether to cancel the licence agreement if the licensee does not meet the requirements for duly asserting its right against third parties (Bankruptcy Act articles 53(1) and 56(1)). On or after 1 October 2020 (because of the amendment to the Copyright Act on the perfection system), if the target company is a licensee of a copyright and the licensor become insolvent, the bankruptcy trustee cannot cancel the licence agreement just because proceedings for bankruptcy of the licensor have been initiated. The same rule has been applicable to non-exclusive licences for patent, utility model and design rights since the perfection system for non-exclusive licences was already introduced for them before the said amendment to the Copyright Act.

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When checking the existence of encumbrances on IPRs to be transferred by an M&A transaction, the buyer should consider the points outlined above.[56]

Software and computer programs

Software and computer programs sometimes act not only as an important life-line for the target company to continue its business but also as an important source of revenue. Hence understanding protection under Japanese law and the relevant issues is important for the success of the M&A transaction.

Like other IPRs, it is important to check, for instance, whether there is any issue of ownership of the rights to software and computer programs, as well as the continuity of the licence granted, infringement of third parties' rights and other encumbrances that would have an adverse effect on the use of such IPRs and to consider measures including proper establishment of representations and warranties.[57]

56 In cases when an asset transfer scheme is used and the buyer obtains an IPR with an encumbrance of a non-exclusive licence to a third party (ie, the target company is the original licensor), which can be duly asserted against the new owner (ie, the buyer) with regards to whether and to what extent the licence agreement itself between the original licensor (the target company) and the licensee (the said third party) is succeeded by the new owner (the buyer), scholars have yet to reach a consensus. (Nakayama, N and Koizumi, N (Eds) (2017) op cit p1607) Thus, a new agreement between the original licensor, the licensee and the buyer on whether and how the licence agreement is transferred is necessary to avoid legal problems. This issue also arises when, after an M&A transaction, the buyer becomes the owner of the target company, which is a non-exclusive licensee who can duly assert its rights against third parties, and after that the relevant IPR is transferred from the original licensor to a new owner of the IPR, it is better for the buyer to seek a new agreement between the original licensor, the new owner and the target company to avoid the said legal problem.

57 If the software in issue is an essential asset of the target company (for instance, the software is one of the most important sources of revenue by giving licenses to third companies) and a serious issue on the ownership of the software is found, to make resolving the issue a condition precedent or a covenant before the closing would be an important measure to consider.

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Protection under the Copyright Act, Patent Act and UCPA

Computer programs[58] can be protected under the Copyright Act if the expression of such computer program has originality, though the protection does not extend to the programming language, coding conventions or algorithms.

In addition, under certain conditions, inventions related to computer software[59] can be protected by the Patent Act. An invention protected under the Patent Act should be a 'creation of a technical idea utilising the laws of nature'.[60,61] Under the Examination Guidelines for Patent and Utility Model (the Examination Guidelines[62]), inventions utilising computer software in the following examples are considered to meet this requirement:[63]

1. those concretely performing control of an apparatus or processing with respect to control; or
2. those concretely performing information-processing based on the technical properties such as physical, chemical, biological or electrical properties of an object.

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58 The definition of computer program is an expression of a combination of instructions to cause a computer to function in order to be able to obtain a certain result (Copyright Act article 2(1)(x)-2).

59 Computer software means a program related to the operation of a computer or any other information that is to be processed by a computer equivalent to a program (the Examination Guidelines, Part III Chapter 1, Eligibility for Patent and Industrial Applicability 2.2 Note).

60 The Patent Act does not protect mathematical formulae, mental activities of humans, arbitrary arrangements or computer programming languages.

61 To be patented, an applicant has to meet other requirements such as novelty and inventive step, etc.

62 The Examination Guidelines Part III Chapter 1, 2.2(1).

63 In addition, the Examination Guidelines (Part III Chapter 1, 2.2(1)) also state: 'computer software for causing a computer to execute a procedure of a method, which is a "creation of a technical idea utilising the laws of nature" and thus constitutes a statutory "invention", or a computer or system for executing such a procedure is normally a creation of a technical idea utilising the laws of nature as a whole, and thus, it constitutes a statutory "invention".'

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In addition, it is considered that those utilising computer software meet this requirement if 'information processing by the software is concretely realised by using hardware resources'[64] (even in those cases not constituting (1) or (2)).

Not only the boundary of whether computer programs are protected under the Copyright Act, but also the boundary of whether they are protected under the Patent Act is not necessarily clear. In addition, the Copyright Act protects only the expressions of computer programs. Thus, if the software in issue uses source code with different expressions from the original work, it does not constitute an infringement of copyright. On the other hand, even if the expression of source code is not the same as the original work, the right of a patented invention can be asserted if the software in issue achieves the same function and characteristic of the patented invention.

Further, there might be some cases where software provided as 'software as a service' can be protected under the UCPA, since users would not be able to access the object codes of the software and the codes might meet requirements to be protected as trade secrets.

Other points to note for computer programs

If a computer program used by the target company is provided by a third party through a licence, checking the contents of the licence agreement is important to ensure the continuous availability to the target company (see section on change of control issues).

If the computer program that is used was developed by a third-party vendor cosigned by the target company, it is also important to check the agreement

64 The Examination Guidelines, Part III Chapter 1, 2.2(2).

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for software development to find any restriction on the use of the software and other issues.[65,66,67]

In addition, there might be some cases where the developed computer program uses open source software. In this case it is important to check the terms and conditions of the relevant open source software licence to see whether there is any restriction on the developed software, such as an obligation to disclose improved source code, etc. Considering these points, collecting information on software licence agreements, agreements on software development and material on the development history is important.

Antitrust law perspective

A detailed explanation from an antitrust perspective in the context of IP is not within the scope of this chapter.[68]

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65 For instance, it is important to check whether the related rights are transferred from the vendor to the target company, whether the source code and the related materials are provided to the target company to maintain and improve the software, whether there are any remaining rights that the vendor has, whether there is any encumbrance on the use of the software, whether adapted or extended versions were made, who own the rights of these, whether there is any restriction on improving the software, etc.

66 In addition, with regard to assignment of the rights of software from, for instance, a vendor, to the target company, checking whether the relevant agreement states that the rights stipulated in Copyright Act articles 27 (translation rights, adaptation rights, etc) and 28 (rights of the original author in connection with the exploitation of a derivative work) are clearly transferred is important. This is because Copyright Act article 61(2) states that these rights are not supposed to be transferred if a contract for the transfer makes no particular reference to the rights set forth in articles 27 and 28. In addition, it is important to check whether the non-assertion of moral right of the author (eg, vendor) is included in the said relevant agreement as well since it is considered that the moral right cannot be transferred under Japanese law.

67 Further, it is important to check whether an escrow system is used for the computer program in case the licensor becomes bankrupt.

68 For more information see, eg, *The Intellectual Property and Antitrust Review: Japan* (Shigetomi, Furusho, Hirose), https://thelawreviews.co.uk/title/the-intellectual-property-and-antitrust-review/japan.

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In Japan, the Anti-Monopoly Act (AMA) sets forth the relationship between antitrust and IP law. Specifically, article 21 of the AMA sets forth that: 'The provisions of this Act shall not apply to such acts recognisable as the exercise of rights under the Copyright Act, Patent Act, Utility Model Act, Design Act, or Trademark Act.' Based on this provision, the Japan Fair Trade Commission (JFTC) has published Guidelines for the Use of Intellectual Property under the Antimonopoly Act to deal with various issues involving such relationship, including licence-related issues, etc. The JFTC has also issued Guidelines on Standardisation and Patent Pool Arrangements on antitrust issues in relation to standardisation.

In addition, the JFTC has also issued Guidelines to the Application of the Antimonopoly Act Concerning Review of Business Combination (Guidelines for Review of Business Combination) to provide general guidance for M&A transactions from the viewpoint of the effect of restraint on competition. In principle, this does not set out different analytical methods to evaluate the effect of business combinations just because the business combination in issue is related to IP. However, considering, for example, the importance of potential competitiveness derived from data or IPRs, in December 2019, some parts of the Guidelines for Review of Business Combination were amended in relation to evaluating whether restraining competition in a particular field of trade occurs or not by a business combination of parties with important IPRs or data.[69]

Ownership issues in relation to IPRs

Group company issues

See sections on 'Points to note of schemes of M&A transactions' and 'Issues related to the scheme of M&A transactions including change of control and similar issues', as well as 'Buyer side's acquisition of shares issued by target company (share acquisition)'.

69 Examples are Note 5, Note 12 and Note 18 of the Guidelines for Review of Business Combination.

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Joint ownership of IPRs

Patent, utility model, design and trademark rights

Joint ownership of an industrial property right creates several encumbrances. For instance, where a patent right is jointly owned (except for general succession) a joint owner shall obtain the consent of all the other joint owners in order to assign its own share of the ownership. In addition, to establish a right of pledge on its own share of the ownership, the said consent is also required (Patent Act article 73(1)). Further, a joint owner shall obtain the consent of all the other joint owners in order to grant a licence to third parties (Patent Act article 73(3)). Thus, if the buyer identifies the joint ownership of a patent right and specific succession scheme is used as an M&A scheme, the consents of all other joint owners are required to obtain the relevant share. In addition, if the buyer identifies the joint ownership of important relevant patent right, the buyer has to keep in mind the said encumbrances with regard to utilising the patent rights.[70] On the other hand, unless otherwise agreed, each joint owner may work the patented invention without the consent of the other joint owners (Patent Act article 73(2)).[71]

It should be noted that the Patent Act article 73 shall apply mutatis mutandis to utility model rights, trademark rights and design rights.[72]

70 Joint ownership creates many encumbrances to use of the relevant IP; thus, if the relevant jointly owned IP is considered essential or important to the buyer, having the seller owe an obligation to acquire the other share of ownership is one of the measures that should be considered. In addition, having the seller owe the obligation to receive consent from the other joint owners to use the relevant IP independently is also a measure that should be considered. Further, if no jointly owned IP is identified, it is better to consider establishing a representation and warranty clause to warrant, for instance, the relevant important IPRs are solely owned by the target company.

71 Further, if a jointly owned patent is infringed, a joint owner is entitled to request injunctive relief and compensation without the consent of the other joint owners.

72 Utility Model Act article 26, Design Act article 36, Trademark Act article 35.

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Copyright

In principle, to assign its own share of the ownership of a jointly owned copyright, to establish a right of pledge on it and to grant a licence, the consent of all the other joint owners is required (Copyright Act article 65(1)(2)). Unlike industrial property rights, for a joint owner to exercise the copyright, the said consent is also required.[73,74] However, the other joint owners may not, without justifiable grounds, refuse the said consent (Copyright Act article 65(3)).

Joint research and development agreement

Checking joint research and development agreements (joint R&D agreements) is also important. Joint R&D agreements usually stipulate important clauses dealing with newly obtained IPRs such as, for instance, who owns the newly obtained IPRs, how the IPRs may be exercised, whether any restriction on the use of the IPRs exists, how the parties deal with improvement of the IP, who should maintain the IPRs, and whether there is any restriction on research on the deliverables.

One of the important points to check is whether the target company properly receives (or is vested properly with) the important IPRs from its employees or the other parties participating in the joint R&D. Theoretically, it is ideal to include the employees and the third parties working on joint R&D in an M&A agreement as parties. However, in general, this is not practical.[75]

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73 For instance, when a joint owner itself creates copies of the original work for business purposes, in principle consent is required.

74 On the other hand, as with patent rights, if a copyright is infringed, a joint owner is allowed to request injunctive relief and compensation without the consent of the other co-owners (Copyright Act article 117(1)).

75 In particular, it is difficult to collect information on the internal arrangements and rules of the other party to the joint R&D agreement. With regard to copyrights, the Copyright Act has a work for hire system in which an employer can obtain the copyright of its employee without any established internal rule. This means that transferring copyright from the employees of one party to the R&D agreement to the other party is less problematic.

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Thus, after collecting the relevant information and checking these issues, it is beneficial to consider, for example, establishing representation and warranty clauses in an M&A transaction agreement to ensure, for instance, that all important IPRs obtained through joint R&D are properly transferred to (or vested in) the target company.[76]

Employee inventions (Patent Act) and work for hire (Copyright Act)

Employee inventions (Patent Act)

With regard to inventions, the inventor must be a natural person and in principle the person who originally made the invention has the right to obtain a patent. However, with regard to employee inventions,[77] if an employer makes certain arrangements, such as preparing internal rules for employee inventions before an invention is made,[78] the employer is entitled to be vested with the right from the beginning or receive the right to obtain a patent. On the other hand, the employer has to provide 'reasonable benefit' to the employee. This is called the employee invention system.

Thus, it is important for the buyer to check whether the target company has internal rules for employee inventions with the proper content and arrangement. In addition, it is also important to check whether the reasonable benefit has been given to the relevant employee properly. If the reasonable benefit is not paid, there is a risk that the employee will claim compensation from the

76 In addition, if the IRPs made by the joint R&D is an essential asset of the target company (for instance, it is an important source of revenue or competitiveness) and a serious issue on the ownership (or availability) of the IPRs is found, to make resolving the issue, a condition precedent or a covenant before the closing would be an important measure to consider.

77 The employee invention must meet the following three conditions: (1) an invention made by an employee, (2) an invention whose nature falls within the scope of the business of the employer and (3) an invention achieved by the employee's acts as part of present or past duty of the employee owed to the employer.

78 The internal rule has to state, for instance, that the right to obtain a patent on an employee invention is vested, from the moment the invention is completed, in the employer.

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target company. In order to ascertain such risk, it is important to collect information on the contents and operation of the related internal rules, whether there is any dispute between the target and an employee, whether there is any patent right that produces a large amount in licence fees, whether there is any patent right that is used in the target company's products with a large sales volume, whether there is any patent right used in cross-licensing widely used by competitors, etc.

In addition, it is beneficial to include representation and warranty clauses in an M&A transaction agreement stating, for instance, that employee inventions are properly vested in or transferred to the target company and reasonable benefits have been properly provided.[79]

Work for hire (Copyright Act)

With regard to copyright, in principle the person who creates a work obtains the copyright and moral rights of the work (ie, the principle of the creator doctrine). However, with regard to a work for hire,[80] an employer is automatically vested with the copyright and moral rights of the work from the beginning. In addition, unlike the employee invention system, internal rules for the employer to obtain a work for hire are not required. Further, the employer does not have to provide reasonable benefit to an employee.

79 In addition, if the buyer finds an unpaid reasonable benefit issue during legal due diligence, it might be beneficial to consider having the seller (or the target company) bear the obligation to clear up the unpaid benefit or (if it is difficult to estimate the total amount of the unpaid benefit in order for the amount of consideration for the M&A transaction to reflect the said unpaid benefit) having a special indemnification clause in the transaction agreement.

80 Requirements for establishing an original work for hire are as follows: (1) the original work is made during the course of employment, (2) the original work is made at the initiative of the employer, (3) the original work is made by the employee of the employer, (4) the original work is made public in the name of the employer, and (5) It is not stipulated otherwise in a contract, in employment rules or elsewhere at the time the work is made. With regard to computer programs, (4) is not required.

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IP-related legal disputes

Cases where a target company is sued based on alleged infringement of a third party's IPRs

It is very important to evaluate legal risks where a target company is (or can be) sued by a third party based on infringement of the IPRs of a third party. An example is the situation where a third party sues a target company, demanding that it suspends sales of products with a large sales volume, claiming a large amount of compensation, or both.

However, during legal due diligence, in general it is not practicable to comprehensively collect and evaluate information on potential legal disputes of this kind. What a buyer mainly can do is to collect information on cases where a target company has already been sued by a third party based on the IPRs of such third party or cases where a target company has actually received a warning letter regarding potential infringement.[81]

Cases where a target company sues a third party infringing IPRs of the target company

As above, it is not practicable to comprehensively collect the relevant information with respect to whether a target company can sue a third party infringing its IPRs. What is practically possible is to collect information on cases where the target company has already sued a third party and potential disputes regarding which the target company has actually considered, for instance, whether to send a warning letter.

In general, the risk derived from cases where a target company is sued based on alleged infringement of a third party's IPRs is more serious than those described here. Nonetheless, the risks should not be underestimated. For

81 It is true that it is not impossible to check, for instance, industrial property rights of third parties that have been registered at the JPO to see whether, for instance, products of the target company infringe them. However, considering the limitation of time for due diligence, the resources available and the potential large numbers of competitors and their IPRs to be checked, etc, it would not be practicable to thoroughly implement such actions.

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instance, consider the circumstance where the target company has been able to achieve a competitive position in a market because of the ownership of a patent right of a certain patented invention and the target company sues a competitor based on an infringement of the patent right. If the target company loses the case because of, for example, invalidity of the patent, the negative impact on the target company will be substantial.

Administrative disputes at the JPO and litigation to cancel a trial decision

Checking, for instance, material on opposition to the grant of patents, trials for patent invalidation at the JPO and litigation rescinding the trial decision is important, especially if they are related to the important relevant patents that are a source of competitiveness in a market. This is because they provide important information on the validity of the said patent.

Representations and warranties

It is, in general, difficult to collect information on the validity of the relevant IPRs and the target company's non-infringement of third parties' IPRs and evaluate the risks thereof. It is important for the buyer to consider, for instance, establishing adequate representations and warranties to cover the risks derived from such matters,[82] which is often a topic of dispute between

82 In addition, if the buyer discovers litigation where there is high possibility that the target company will lose, the following are examples of measures to consider, depending on the magnitude of the adverse effects arising from the result of the litigation on the target company's business: (1) abandoning the transaction (for instance, if an injunction were to be granted against sales of the target company's products that have a large sales volume or if the patent for a major medical medicine were found to be invalid), (2) decreasing the amount of consideration for the M&A transaction in advance (if it is possible to evaluate the total amount of damage caused to its business), (3) including a condition precedent regarding settlement of the litigation, and (4) including a special indemnity clause.

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the seller and buyer since even the seller has difficulty in comprehensively evaluating such risks.

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Warranties, Indemnities and Insurance in M&A

Nobuo Nakata and **Takanari Sekiguchi**[1]

Japanese practice in share sale and purchase agreements – historical background and recent trends

In Japan traditionally mutual trust and credibility were most important for companies to maintain and expand business relationships with longstanding trading counterparties in the closed market. Once such mutual trust and credibility had failed through an inappropriate act by a company, the company would be disqualified and expelled from the market. Because of this tradition, even M&A transactions in Japan were conducted based on mutual trust and credibility rather than relying on legal contracts. At that time, the vast majority of sale and purchase agreements (SPAs) were very short and simple with insufficient protection for purchasers. However, for the past 20 to 30 years, Japanese companies have completed M&A transactions in the United States and Europe and learned Western-style M&A practice, including the importance of legal

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contracts. In addition, the Japanese market is now much more open than previously to new joiners such as emerging Japanese companies and international companies. As a result, in many cases the counterparties in domestic M&A transactions in Japan are these new market joiners rather than long-standing traditional Japanese companies. For such M&A transactions, relying on legal contracts is natural and appropriate, and the SPAs have now become much longer and more detailed, with adequate protections for purchasers.

Nowadays, the style and content of SPAs for M&A transactions in Japan are quite similar to those in the US and Europe – and they are becoming more similar year by year.

Warranties for Japanese M&A

Overview

Formerly most Japanese M&A transactions were conducted on an 'as is, where is' basis, and broad lists of warranties in Japanese SPAs were rare, because at that time target companies in most M&A transactions were already very well known to the purchasers in the small and closed market. However, it is now quite common that thorough due diligence is conducted during the M&A process and a broader list of warranties is provided in the SPA. It is now the general understanding and belief in the Japanese market that, at least for listed companies, to secure appropriate and sufficient legal protection, including warranties in SPAs to hedge the risks associated with M&A transactions, is an obligation of the purchaser's management in light of the directors' duty of care.

List of warranties

Following international standard practice, warranties in Japanese SPAs basically consist of:

- those in relation to the seller (such as title to the shares, capacity to enter into the SPA, authorisation given through all required corporate procedures, completion of all necessary filings and reports to the government, if any, and valid and binding effect of the SPA); and

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- those in relation to the target company (such as those regarding legal incorporation and existence, shares and other equities, financial statements, real and movable property, intellectual property, office lease and plant lease, bank borrowings, corporate bonds and notes, business agreements and activities, data protection, environmental issues, unfair competition, compliance with laws, officers and employees, outsourcing, labour union, pensions and benefits, IT systems, disputes and government proceedings and contingent liabilities, etc).

All exceptions to those warranties should be precisely listed and described in sufficient detail in the disclosure schedule to be attached to the SPA.

Indemnities for breach of warranty

Limitations

At present it is quite common in Japan to provide in the SPA:

- the cap on the maximum total liabilities of the seller for indemnity for breach of warranty;
- threshold or deductibles for the seller's indemnity obligations to trigger;
- de minimis to be counted for the threshold or deductibles; and
- the time limit to raise a claim for indemnity based on breach of warranty.

These provisions depend on discussion and negotiation between the seller and the purchaser, but there is a market standard depending on the size of the transaction and the nature of the target company business (eg, if the target company is a heavy industry manufacturer, more environmental risk anticipated, and if it is an IT/technology company, IP infringement risk might be serious). Under the current Japanese market standard, the cap is somewhere between 10 and 40 per cent of the purchase price (the larger the purchase price, the lower the percentage of the purchase price for the cap) and the typical time limit in the Japanese market is 10 years from the closing date for the fundamental warranties, seven years from the closing date for the tax and environmental warranties and one to three years from the closing date for other general warranties. The market standard and actual risk found through due diligence will influence the negotiation between the seller and the purchaser.

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Special indemnities

The facts that are in breach of warranties found during due diligence and known to the purchaser, and eventually specified by the seller in the disclosure schedule to be attached to the SPA, need to be specifically covered by special indemnities in the SPA, although if the amount of such special indemnity can be identified or agreed on or before the signing of the SPA, such issues will be treated as debt-like items and the amount identified and agreed will be simply deducted from the purchase price, rather than being covered by the special indemnity clause. As to special indemnities, the application of all the limitations for indemnities for breach of warranty, including the cap, threshold or deductible, de minimis and the time limit should be expressly excluded from the SPA (in line with international standard practice).

Sandbagging clause

In Japan the validity of a 'sandbagging' clause, namely, the provision in the SPA that even if the purchaser knew the breach of warranty on or before the signing of the SPA, the purchaser would still be entitled to claim indemnity against the seller for the breach of warranty, has not been tested by court precedents. On the other hand, there are some court precedents that confirmed the validity of an anti-sandbagging clause, namely, the provision in the SPA that if the purchaser knew the breach of warranty on or before the signing of the SPA, the purchaser would no longer be entitled to claim indemnity against the seller. In addition, where neither sandbagging nor anti-sandbagging clauses are provided in the SPA and the SPA is silent in this respect, there is a court precedent in Japan that the purchaser will not be allowed to claim indemnity against the seller as far as the purchaser knew, or should have known for gross negligence, the breach of warranty on or before the signing of the SPA. It is therefore advisable, when a purchaser knows the breach of warranty, that the purchaser should provide a special indemnity clause to cover this issue in the SPA, rather than simply relying on the sandbagging clause in the SPA, even if the sandbagging clause is successfully included in the SPA. Note, however, that in Japan such court precedents in the lower courts will not legally bind subsequent cases.

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Necessity to expressly exclude the application of Japanese statutory law clauses

In order to achieve the same consequences as under international standard practice, with a breach of warranty the purchaser can seek indemnity against the seller only as provided and limited in the SPA, and the sale and purchase of the shares will not be avoided, rescinded, terminated or otherwise overturned. It is very important, especially on the seller side, that the application of the following Japanese statutory law clauses will be expressly excluded from the SPA:

- termination for breach of agreement;
- statutory liability for sale of defective goods;
- misunderstanding; and
- fraud.

Security measure for indemnity payment

Internationally, the escrow arrangement with a bank or notary public (depending on the country) as an escrow agent has been the most typical measure to secure future payment of the possible indemnity obligation of the seller for breach of warranty. However, in Japan escrow has not been commonly used, partly because of the general prohibition of deposit service under the Act Regulating the Receipt of Contributions, Receipt of Deposits and Interest Rates (Law No. 195 of 1954, as amended). Under this legal restriction, only trust banks, commercial banks and lawyers can be escrow agents, but few provide escrow service and it is not easy to find an appropriate escrow agent in Japan for M&A transactions.

Instead of escrow, instalment payments of the purchase price have been used for security, but in this case the seller may have concerns about the credit risk of the purchaser and the time, costs and difficulties of enforcing the purchaser to pay the outstanding purchase price. Warranty and indemnity (W&I) insurance, which has become more commonly used recently for Japanese domestic M&A transactions, should be the perfect solution.

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Recent changes in W&I insurance in Japan

Past practice

While there are no public statistics, according to one of the leading insurance brokers in Japan, a W&I insurance policy appears to be purchased in around 10 per cent of Japanese outbound M&A transactions (ie, where a Japanese company acquires a foreign company). Japanese companies tend to take out a W&I insurance policy in auction deals in which a prospective bidder is required to take a W&I insurance policy. This arrangement is called 'stapled insurance' or 'sell–buy flip'.

For Japanese outbound M&A transactions Japanese insurance regulations prohibit a foreign insurer from directly providing Japanese companies with an insurance policy. In practice, in these cases, a 'fronting' arrangement is used, where a Japanese insurer provides W&I insurance on behalf of a foreign insurer, but transfers almost all risks to the foreign insurer by entering into a reinsurance contract.

On the other hand, W&I insurance has not been popular in Japanese domestic M&A transactions (ie, where a Japanese company acquires a target company in Japan). For domestic deals, an SPA and a due diligence report (DDR) are prepared, all in Japanese. However, Japanese insurers used to be reluctant to provide W&I insurance by using their own exposure and, accordingly, often arranged reinsurance in order to transfer almost all insurance risks to foreign reinsurance companies. This meant a foreign reinsurer doing underwriting on behalf of a Japanese insurer, with underwriting procedures implemented in English. This required a Japanese acquirer to prepare English translations of the SPA and DDR. Also, underwriting calls have to be made in English. As a result of this inefficiency, Japanese companies have seldom taken out a W&I insurance policy in a domestic deal.

Recent trends since 2020

Since 2020, some Japanese insurers, such as Tokio Marine & Nichido Fire Insurance Co Ltd (Tokio Marine), Sompo Japan Insurance Inc (Sompo Japan), Mitsui Sumitomo Insurance Company Limited (Mitsui) and Aioi Nissay Dowa Insurance Co Ltd (Aioi), have started providing W&I insurance for Japanese

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domestic M&A transactions using their own exposure. This enables underwriting procedures, including reviewing an SPA and DDR and making underwriting calls, to all be implemented in Japanese from start to finish. This change makes W&I insurance more appealing to parties to M&A transactions in Japan. Private equity (PE) funds especially have become interested in W&I insurance and begun purchasing W&I insurance policies.

In addition to those insurers, AIG General Insurance Co Ltd (AIG) used to provide underwriting work in Japanese from time to time, and while it is not clear when such Japanese underwriting work might be available, this practice is seemingly still continuing.

Characteristics of W&I insurance in Japan

Non-US type

W&I insurance in Japan can be categorised as non-US type, typically prevalent in Europe and Australia. In particular, as with an underwriting call, questionnaires are shared with the insured in advance of the call. With an insurance policy, a cover spreadsheet is prepared, which clarifies which warranties in an SPA shall be covered, partially covered or excluded by the insurance policy.

Japanese practice is non-US type, as in US-type representations and warranties insurance, questionnaires are not usually shared in advance (if not requested) and no cover spreadsheet is prepared.

Unique characteristics

There are several unique features in Japanese practice. First, the minimum insurance premium that W&I insurers generally expect to charge is around ¥10 million. The minimum premium needs to be set so that an insurer can make sufficient profit to keep its business, considering various costs such as underwriting work. Therefore international insurance companies, regardless of whether US type or non-US type, are unlikely to target small M&A transactions.

However, this is not necessarily applicable in Japan. Japanese insurers target not only medium-sized or large M&A transactions, but also target small M&A

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transactions that international insurers have declined to accept because the expected premium is likely to be less than the assumed minimum premium level (ie, ¥10 million).

Japan has a significant issues with an aging society and a low birth rate, and many family businesses are currently struggling to find a successor. This has created a large demand for company succession M&A transactions, where another Japanese company, typically a bigger company, acquires and succeeds the family business. Owing to this demand, Japanese insurers are interested in these M&A transactions; since the purchase price or enterprise value tends to be small, it is expected that insurance premiums will become less than ¥10 million, taking into account a kind of volume discount strategy.

With regard to this point, Aioi takes a quite different approach, using sell-side W&I insurance, targeting a small M&A transaction where its purchase price or enterprise value is less than ¥200 million. Aioi simplifies underwriting processes by offering very limited pre-fixed warranties that contain:

- title to the shares;
- material agreements;
- employees;
- litigation;
- financial statements; and
- tax.

We have researched 31 recent court cases (where judgment was given up to December 2019), which are publicly available and deal with a claim for damages based on breach of warranty. The result is as follows:

Proportion of breach of warranty judgments by type

Breach type	Percentage	Breach type	Percentage
Financial statements	44 per cent	Tax	7 per cent
Material agreements	14 per cent	Litigation	7 per cent
Compliance with laws	12 per cent	Fundamentals	5 per cent
Employment	9 per cent	Operations	2 per cent

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Aioi's pre-fixed warranties are in line with the above data.

Aioi does not require a vendor DDR from a seller for underwriting work, and this helps Aioi save costs and time. Although the minimum premium is not clearly published, Aioi indicates the possibility that the premium may be ¥2 million where the purchase price or enterprise value is ¥200 million. Mitsui also provides a sell-side W&I insurance policy that targets small M&A transactions, and its minimum premium is ¥3 million based on public information.

Buy-side W&I insurance

Although there are no statistics owing to insufficient precedents, W&I insurance premiums will be 2 to 3.5 per cent of the limit of liability in an insurance policy, retention will be around 1 per cent of the purchase price (or enterprise value), which is typically used in an international practice, or the limit of liability, and in the same way, de minimis will be around 0.1 per cent of the purchase price (or enterprise value) or the limit of liability. A policy period for general warranties is often set at three years after the completion date, and the periods for fundamental and tax warranties tend to be seven years after the completion date.

Sell-side W&I insurance

Sell-side W&I insurance has not usually been used to date in Japan. However, as with the pre-fixed type of sell-side W&I insurance provided by Aioi, Aioi indicates that the premium could be lower than their buy-side policies.

Exclusion

Exclusions are in line with international practice, and typically include knowledge, disclosure, price adjustment, forward-looking statement, asbestos, pollution and product liability.

Among them, as with disclosure, there are two ways to exclude what is disclosed by the seller to the buyer in international practice. US-type W&I insurance excludes what was disclosed in the disclosure schedule. On the other hand, the non-US type excludes what was disclosed during the due diligence, regardless

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of whether such information is specified in the disclosure schedule. This difference is linked to the SPA provisions. A disclosure schedule often constitutes a US-type SPA. This is sometimes not so with a non-US-type SPA, which tends to permit broader seller liability exemption. Even if an item is not referred to in the disclosure schedule, the seller may be exempted where such item is disclosed in the due diligence process, including disclosure via virtual data room (VDR). A Japanese SPA often does not refer to either type of exemption mechanism. Accordingly, there is no strong logical link when deciding which disclosure mechanism to select in relation to the insurance policy. However, as in non-US-type W&I insurance, Japanese insurers currently tend to exclude what was disclosed during the due diligence regardless of whether such information is specified in the disclosure schedule.

Underwriting process

Buy-side W&I insurance

There are three major insurance brokers in Japan: Marsh Japan Inc, Aon Japan Ltd and Willis Japan Services KK. When they are retained, they start preparing a non-binding indication (NBI). Insurers are usually required to provide their NBIs to an insurance broker within three business days. Then the broker prepares an NBI report for its client. An NBI report elaborates on each insurer's NBI, including coverage and other key comparative metrics such as expected breadth of coverage position, premium, retention and de minimis.

Then the insured decides which insurer it will work with and requests to start underwriting work. Underwriting fees are paid as agreed between the insurer and the insured (in an expense agreement or service agreement). Some Japanese insurers make it clear that they do not charge underwriting fees depending on the purchase price or enterprise value of the target company. Counter-intuitively, underwriting fees tend to be exempted in small M&A transactions in Japan. For example, Tokio Marine stated that if the purchase price or enterprise value is less than ¥5 billion the underwriting fees will not be charged. This demonstrates the tendency of insurers in Japan trying to adjust traditional W&I insurance to the small M&A market.

Once underwriting has been initiated, the processes are almost the same as in typical non-US-type W&I insurance. It takes two to three weeks to complete the

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whole underwriting process and reach final agreement on an insurance policy between the insurer and the insured. First, the insured gives the insurer's underwriting team, in addition to an SPA, access to VDR and DDR on condition that the insurer submits non-reliance letter to the advisers. The underwriting team sends the questionnaires, which constitute general and specific questions, to the insured after reviewing the VDR and DDR. The insured completes the questionnaires and has an interview (underwriting call) with its advisers (ie, lawyers and accountants engaged in due diligence of a target company). Then the insurer prepares a policy draft, including a cover spreadsheet. A cover spreadsheet is attached to the policy, distinguishing clause by clause which warranties in the SPA are covered, partially covered or excluded.

According to one insurance broker, many M&A lawyers are not yet familiar with W&I insurance, and owing to this lack of experience insurance coverage has sometimes been less than it should. Therefore it is crucial to retain lawyers experienced in this area.

Sell-side W&I insurance

Sell-side W&I insurance has not been popular to date, so there are no typical procedural precedents. Aioi is expected to establish its own practices. As mentioned, Aioi provides concise sell-side W&I insurance, where it does not require a vendor DDR for an SPA seller for underwriting work. Although it is not clear exactly what practices Aioi will create, it may request VDR or some scope of documents for its underwriting work. Some kind of questionnaire or underwriting call to the seller may be also implemented.

Stapled insurance

The rise of stapled insurance

The amount of stapled insurance has been increasing globally, where a seller, often a PE fund in an auction process, requires a buyer to purchase a buy-side policy to limit a seller's exposure by providing alternative recourse. There are two types of stapled insurance: hard staple and soft staple.

One of the biggest differences between hard and soft staple is who is supposed to select an insurer. In a hard staple, the seller selects an insurer based on

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an NBI report an insurance broker prepares. The insurer then undertakes pre-underwriting work, including reviewing vendor DDR and VDR. After that, an initial policy draft is provided to the seller. The seller shares this policy with a prospective bidder, together with a draft SPA. Then the bidder negotiates with the insurer with such a policy and makes a confirmatory underwriting process, using the bidder's DDR and updated VDR. A hard staple requires that the prospective bidder takes W&I insurance to make an M&A transaction.

In a soft staple, a seller obtains an NBI report from an insurance broker and shares it with a prospective bidder, who will select which insurer to purchase insurance from. A soft staple allows the bidder to decide whether to take insurance and from which insurer to purchase it. Sharing the draft SPA with a prospective bidder is the same as with a hard staple.

As Willis Towers Watson points out, a hard staple is usually a 'take it or leave it' approach.[2] This means that 'the seller warranty package is only available if a buy-side W&I insurance policy is purchased'. On the other hand, 'a soft staple permits the buyer to decide ultimately whether to contract insurance or assume residual transaction risk and usually limited seller resource'.

Non-recourse

Non-recourse is often used together with stapled insurance. Non-recourse means that the only recourse for a buyer is a W&I insurance policy, unless there is seller fraud or wilful misconduct. If the seller requires a non-recourse arrangement as a mandatory condition, then a prospective bidder has no choice but to purchase W&I insurance so as to make a deal with the seller. Therefore, if a non-recourse arrangement is required, the buyer generally chooses to purchase a buy-side W&I insurance policy even if it is a soft staple, which does not force a buyer to take it out.

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2 'Use of Transactional Risk Insurance and "W&I Stapling" is on the rise despite a slowdown in the global M&A markets', https://willistowerswatsonupdate.es/riesgos-corporativos-y-directivos/transactional-risk-insurance-wi-stapling/.

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Current practice in Japan

In Japan, stapled insurance has not been prevalent. However, PE funds have started using stapled insurance, including hard staple. It is expected that such stapled insurance arrangements will increase and this will make W&I insurance more popular in Japan.

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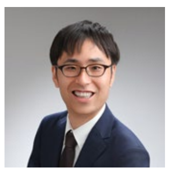

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Dispute Resolution in Japan

Tsuyoshi Suzuki, Shin Setoyama and Naoki Aso[1]

Introduction to the dispute resolution framework in the context of M&A

Litigation

Overview

Japan is a civil law country influenced by Western legal models. Litigation is the most common legal dispute resolution method in the field of M&A in Japan, particularly in cases where all the related parties are domestic parties (Japanese individuals or companies), while various forms of alternative dispute resolution (ADR), including arbitration, have gradually become more popular in recent years.

The official language of court proceedings is Japanese. Briefs must be written in Japanese and the party who submits evidence written in a foreign language must submit a Japanese translation. Thus, in complex commercial cases that

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have international aspects, costs for translation for briefs and evidence could constitute a substantial portion of the overall cost for the litigation.

Judges

Judges are appointed by the Supreme Court for 10-year terms and selected from graduates of the Legal Research and Training Institute. Judges serve as associate judges for the first 10 years of their career, and from the sixth year they are allowed to manage a case alone. The 10-year term is usually continuously renewed until mandatory retirement.

Structure of courts and allocation of cases

The Japanese court structure consists, in principle, of three tiers of civil courts: district courts, high courts and the Supreme Court. Summary courts have jurisdiction over cases where the amount in dispute does not exceed ¥1.4 million and over civil conciliations (regardless of the amount in dispute).

Civil cases are usually commenced at the district court as the court of first instance. The district court located at the place where the defendant resides or has its registered main office has specific jurisdiction over the case. Cases are administered by a single judge or a panel of three judges, depending on their nature and complexity. Parties who are not satisfied with the judgment rendered at the district court may file an appeal to the regional high court.

Some large district courts have special divisions or divisions that concentrate on matters including commercial claims. While certain categories of statutory disputes related to the Companies Act (such as nullification of the resolution of the shareholders' meeting and shareholders' derivative actions) are restricted to the commercial divisions of the district courts, typical commercial disputes such as cases where interpretation of the M&A agreement is at issue are reviewed by normal civil divisions of the district court.

Case management meetings and evidentiary hearings

The court may hold oral hearings or preparatory meetings in order to identify the factual and legal issues and the evidence required. In Japan, oral hearings

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or preparatory meetings are non-consecutive and usually held about once a month. In cases where the parties live far away from the court, the court may hold preparatory meetings via telephone conference.

Various meetings and discussions on the use of IT for court proceedings were held by the courts, Ministry of Justice and Bar Association in 2019 and 2020. A new case management conference through Microsoft's Teams software started in February 2020 at the IP High Court and certain district courts and in December 2020 all district courts implemented this conference system.

Evidence and disclosure

The jury system does not exist in civil cases and professional judges examine the substance and credibility of evidence. Therefore the rules of evidence are not complex and in general any evidence is admissible. The court has discretion to determine the necessity of the review of evidence submitted by the parties including hearing of witnesses. Judges tend to put less value on the testimony of a witness than on documentary evidence. Therefore, although it depends on the nature of a case, the court is relatively strict about allowing a large number of witnesses for examination at the hearing.

Under Japanese law, in principle, parties have a responsibility to present evidence to prove their case. Holders of documents have an obligation to disclose documents in certain categories under the Code of Civil Procedure, such as documents the retaining party has cited in its brief and documents that were created with regard to the legal relationship between the parties. Further, the holders of the documents have a general catch-all obligation to disclose documents that do not fall under the categories of the listed exceptions, such as:

- documents that are created solely for the purpose of the holder's internal use;
- confidential information held by professionals (such as attorneys and doctors); and
- public officials' documents, the disclosure of which would cause harm to the public.

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The court may assist a party in collecting evidence by ordering the disclosure of documents either by another party to the proceedings or a third party. However, when making a request for disclosure, in principle the requesting party has to specify the indication, the purport, the holder, the facts to be proven and the cause of the obligation of disclosure of the document.

If it would be extremely difficult to disclose the documents, the requesting party is alternatively allowed to present only 'matters by which the holder of the document can identify the document pertaining to the petition'.

Arbitration

Overview

In recent years, Japanese companies have gradually become familiar with international arbitration and the number of international arbitrations in which Japanese corporations are involved has increased. Not only the Japan Commercial Arbitration Association, which is the most frequently used arbitration institution for commercial arbitrations in Japan, but also the International Chamber of Commerce, the London Court of International Arbitration, the American Arbitration Association–International Centre for Dispute Resolution Foundation, the Singapore International Arbitration Centre and other arbitration institutions are also used by Japanese companies. This trend is also true in the field of M&A in Japan, especially in cases where all the related parties are international or have international aspects.

Certain categories of M&A-related disputes must be resolved by court proceedings in Japan, particularly if such disputes are related to an acquired company or joint-venture company established under Japanese law. For example, dissolution of a joint-venture company established under the Companies Act must be undertaken at court in Japan. On the other hand, many disputes between the parties to a shareholders' agreement or alliance agreement can be resolved through arbitration proceedings.

Generally speaking, arbitration is an extremely reliable dispute resolution platform in Japan. Japan is a pro-arbitration country and a recent High Court decision confirmed an extremely cautious attitude towards the setting aside of

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arbitral awards.[2] The Arbitration Act was enacted in August 2003 and came into force in March 2004. The Arbitration Act is applicable to arbitral proceedings whose place of arbitration is in Japan. The Arbitration Act generally adopts the UNCITRAL Model Law (prior to its 2006 amendment) with some deviations. Currently, the Legislative Council of the Ministry of Justice is conducting discussions on potential revision of the Arbitration Act to harmonise it with the 2006 amendment of the UNCITRAL Model Law and other issues concerning arbitration and mediation, particularly from a global perspective.

Arbitration has a number of advantages compared with litigation. However, litigation is often more cost-effective; the parties must incur fees for arbitrators and the work of party counsel is often more extensive compared with typical litigation. On the other hand, different from litigation, the parties may agree on the language used in the arbitration proceedings. If the parties agree that English shall be used in the arbitration proceedings and appoint arbitrator(s) who understand English, the parties may submit English documents as evidence without attaching a translation, which could significantly reduce the costs of the dispute.

Arbitrators

One of the advantages of arbitration is that the parties may appoint arbitrators taking into account their professional background and personality. In court proceedings, the court appoints the judges; and it is not uncommon for judges to be removed from long-running cases in the midst of proceedings owing to mandatory reassignment. Arbitrator candidates are not restricted to lawyers admitted in Japan or Japanese citizens.

2 Decision of the Tokyo High Court dated 1 August 2018, The Financial and Business Law Precedents, No. 1551, p13.

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Confidentiality

Arbitration proceedings are basically kept confidential. In litigation, dates for oral argument are open to the public and anyone may observe court documents unless the parties obtain a protective order.

Framework of arbitration

The parties to an arbitration are not allowed to file an appeal to request a review of the arbitral award. Alternatively, the parties are entitled to file a petition for setting aside the arbitral award to the court. The grounds for setting aside an arbitral award are set forth in the Arbitration Act, and are substantially the same as those set out in the UNCITRAL Model Law.

Under the Arbitration Act, the grounds for setting aside an award are basically limited to procedural defects of the arbitration proceeding (ie, the arbitration agreement was not valid; the party was not given the chance to appear before the tribunal; or that the composition of the arbitral tribunal or the arbitral proceedings were not in accordance with the provisions of the law). In other words, a defect in the arbitral award with respect to the merits of the case does not constitute grounds for setting aside the arbitral award unless it amounts to a violation of public policy in Japan. Incorrect application of substantive law or disregard of applicable law itself is not sufficient for setting aside the arbitral award. Further, the court has discretion not to set aside the arbitral award even if it had grounds for setting it aside. In this regard, the standard of the judicial review on the merits of a case is deferential to the arbitral award.

Enforceability

A party may file a petition for enforcement of the arbitral award to the court. A copy of the arbitral award, which must be identical to the arbitral award, and a Japanese translation of the arbitral award must be submitted in conjunction with the petition for enforcement. The standard for review and grounds for recognition and enforcement are substantially the same as those contained in the UNCITRAL Model Law.

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Japan is a signatory to the 1958 New York Convention subject to the reciprocity reservation. In addition, Japan is also a signatory to the Geneva Convention on the Execution of Foreign Arbitral Awards. Further, Japan has bilateral treaties with multiple countries. These treaties guarantee the enforcement in Japan of arbitral awards made in other treaty countries.

Recent topics

With the cooperation of the Japanese government and private sectors, in February 2018, the Japan International Dispute Resolution Centre (JIDRC) was established. Subsequently, in May 2018, the Japan International Dispute Resolution Centre (Osaka) (JIDRC-Osaka) opened as the first set of facilities specialised for international arbitration hearings or other types of ADR in Japan. JIDRC-Tokyo started its operation as one of the most suitable facilities for a hearing of international arbitration or other types of ADR in March 2020. Virtual/online hearings are also available at the two centres.

Overview of typical M&A disputes in Japan

Disputes before an M&A transaction

Injunction to enjoin issuance of new shares

Issuance of new shares is one form of M&A transaction, which comes into effect on the specified payment date (if the payment date is specified) or the date of the subscriber's actual payment (if the period for the payment is specified).

If new shares are issued at a low price, the value of each share held by the existing shareholders will be diluted. Further, if a large number of shares are newly issued, the shareholding ratio of the existing shareholders will be diluted, and existing shareholders could lose control of the company. Therefore, the Companies Act grants existing shareholders the right to enjoin such issuance of new shares before the effective date in cases where the new shares are to be issued in violation of laws and regulations or the articles of incorporation or the new shares are to be issued in a significantly unfair manner.

While the existing shareholders have other means to dispute the validity of the issuance of new shares after completion of the subscription of newly issued

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shares in limited circumstances, such as filing of an action to seek invalidation of the issuance of new shares, the practical burden to obtain such after-the-fact relief is higher than injunctive relief in advance of completion of the issuance of new shares.

More detailed explanation of the two grounds for injunctive relief to enjoin the issuance of new shares before the effective date is as follows.

Ground 1: violation of laws and regulations or the articles of incorporation

Existing shareholders may seek injunctive relief to enjoin issuance of new shares on the ground that the new shares are to be issued in violation of laws and regulations or the articles of incorporation (article 210, item 1 of the Companies Act).

Under the Companies Act, a public company (which means a company of which shares are freely assigned without the company's first refusal right) may issue new shares via resolution of the board of the directors' meeting while the resolution of the shareholders' meeting is required for a non-public company (a company of which management has first refusal right for the assignment of shares). However, if the subscription price to be paid for the newly issued shares is 'notably advantageous' to the subscribers, the Companies Act requires even a public company to obtain the resolution of the shareholders' meeting in order to give the existing shareholders a right to take a certain control over the dilution of their shares.

Thus a common category of dispute occurs when a public company plans to issue new shares without obtaining the resolution of the shareholders' meeting, and then existing shareholders file an injunction to enjoin such issuance of new shares alleging that the planned subscription price is 'notably advantageous' to the new subscribers and that the company's issuance of new shares via mere resolution of the board of directors' meeting (without the resolution of the shareholders' meeting) is in violation of the Companies Act.

A 'notably advantageous' price is interpreted as a notably low amount compared with a fair amount. If a company is listed on a stock market, generally speaking, the market price on the date closest to the effective date of the issuance of new

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shares is the fair amount. In cases where the non-public company of which the value of a share is difficult to calculate or where the market price of the listed company is sky-rocketing, the fair amount is strenuously argued by the parties. In addition, whether the subscription price is 'notably' low usually becomes another issue.

Ground 2: significantly unfair manner

Existing shareholders may seek injunctive relief to enjoin issuance of new shares on the ground that the new shares are to be issued in a significantly unfair manner (article 210, item 2 of the Companies Act).

Issuance of shares in a significantly unfair manner means that the issuance of shares is used for inappropriate purpose. More specifically, 'inappropriate purpose' means that share subscription is primarily used for the purpose of transition of the controlling power of the company in cases where the control of the company is disputed, rather than other purposes (eg, to meet the company's financial needs or to strengthen alliance relationship with partner companies). The standard for determining the existence of inappropriate purpose is commonly called the Primary-Purpose Rule.

Disputes related to termination of negotiation of an M&A agreement

In addition to the above, another typical dispute before the execution of the M&A agreement is a claim for compensation arising from termination of negotiation of the M&A agreement.

Introduction

Generally, the principle of 'private autonomy', or more specifically the principle of 'freedom of contract', governs the negotiation of an M&A agreement because M&A transactions are agreements between private entities. Thus under the principle of freedom of contract:

1. parties are free to enter into a contract based on their own free will; and
2. the agreed contract based on their respective free will should be respected and binding.

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Reflecting aspect (1) above of the principle of freedom of contract, each party must take responsibility for collecting and analysing the information necessary to make a final decision on whether to enter into an M&A agreement. Therefore, if the negotiation is terminated before the execution of the M&A agreement, in principle each party should bear incurred costs and each party is not liable to the other party for compensation of any loss.

Culpa in contrahendo

As explained, the parties may decide whether to enter into a contract based on their free will and the parties are bound by the contract if they actually enter into it. Conversely, the parties are not contractually liable to the other party until they enter into a contract. Thus, in principle, no rights and obligations arise between the parties at the stage of contractual negotiations.

However, even before the execution of the final agreement, there are occasions where a party's expenditure in reliance on the other party's actions or expressions during contractual negotiation should be legally protected. Therefore, Japanese law recognises the theory of culpa in contrahendo, which means that the party that negligently invokes the other party's reliance on the execution of the contract should be liable to the other party's incurred loss in expectation for the contract.

Culpa in contrahendo is a general principle that applies to all areas of law and is also applicable to contractual negotiation of an M&A agreement. Therefore, in cases where the negotiation for the M&A agreement is terminated, the party may be liable for compensation for damage incurred by the other party if the party unilaterally terminated the contractual negotiation, or acted in bad faith as if it would enter into the final agreement and the other party took actions in reliance on such attitude (eg, making expenditure or terminating existing agreements in expectation of the final agreement). Generally speaking, the awarded damages are limited to reliance damages only and the courts rarely accept damages for lost profit.

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Obligation to negotiate

During the course of negotiation of an M&A agreement, the parties sometimes execute a memorandum of understanding (MoU), which contains the parties' obligation to negotiate with the other party exclusively or to negotiate in good faith. When the parties cannot reach final agreement, sometimes the validity and meaning of these clauses are disputed.

Sumitomo Trust v UFJ Holdings, et al is a leading case on this issue. In this case, Sumitomo Trust and UFJ Holdings (both companies are financial institutions) had executed an MoU in which the parties owed an obligation to negotiate in good faith for future collaboration and an obligation not to negotiate with other parties. UFJ Holdings, however, unilaterally notified Sumitomo Trust that it would withdraw and terminate the negotiation under the MoU and disclosed to the public that it would offer Mitsubishi-Tokyo Financial Group the opportunity to integrate the business of both groups. Sumitomo Trust filed a preliminary injunction to seek a court order to enjoin UFJ Holdings to negotiate on business integration with Mitsubishi-Tokyo Financial Group. While the Supreme Court dismissed Sumitomo Trust's petition because it could not find the necessity to award the injunctive relief, it held that UFJ Holdings breached its obligation and that the detriment suffered by Sumitomo Trust could be addressed by compensation for damage.[3]

After the Supreme Court's decision on the preliminary injunction, Sumitomo Trust filed a lawsuit on the merits against UFJ Holdings seeking compensation for damage. The Tokyo District Court found that the parties' obligation to negotiate in good faith for future collaboration and obligation not to negotiate with the other parties set forth in the MoU was not a mere gentleman's agreement and UFJ Holdings should be liable for the breach of these obligations.[4] The Tokyo District Court then held that the damages to be awarded to Sumitomo Trust should be limited to reliance damages, and the court dismissed Sumitomo Trust's claim because it only sought expectation damages and refused to establish reliance damages. After Sumitomo Trust filed an appeal to the Tokyo

3 Decision of the Supreme Court dated 30 August 2004 Minshu, Vol 58, No. 6, p1763.

4 Decision of Tokyo District Court dated 13 February 2006, Hanrei Jiho, No. 1928, p3.

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High Court, this case was settled whereby UFJ Holdings (and others) promised to pay a certain amount (¥2.5 billion) to Sumitomo Trust.

Summary

The principle of freedom of contract governs negotiations on M&A agreements. In principle, the parties are free to decide whether to execute the final agreement and they are not contractually liable until execution of the final agreement. However, in some cases, unilateral termination of negotiations or bad-faith conduct may result in legal responsibility to compensate the other party's reliance damage.

Disputes after an M&A transaction

Invalidation of merger

Limitation of the period of filing and standing

Under Japanese law, in general, invalidity of a legal action can be asserted by anyone, at any time and without using court procedures, as long as there is a defect in the legal action that would make the action null and void.

However, in the case of a merger, this general principle is modified, because after a reorganisation of a company (including a merger) takes place, various new legal relationships have been built among various related parties based on such corporate action, so that maintaining this general principle may be detrimental to the stability of many related parties.

The Companies Act provides a special court procedure for invalidating a merger. The claim of invalidation of merger must be made through this statutory court procedure within six months from an effective date of the merger and may not be settled outside the court. Moreover, standing is limited to related

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parties such as shareholders, directors, auditors and creditors of merged and merging companies.

Grounds of invalidity

The Companies Act does not provide for an exhaustive list of grounds of invalidity. The following are examples of defects that were found to be grounds for invalidation under court precedents:

Violation of procedures in the Companies Act – a merger must take place in accordance with specific procedures under the Companies Act. However, after a merger comes into effect, the grounds for invalidation are limited to significant procedural defects (eg, absence of resolution of shareholders' meeting or lack of the mandatory clause in the merger agreement).

Defective intention for merger – in principle, under Japanese civil law, if there is a mistake in a party's manifestation of intention, an agreement based on such manifestation of intention is considered null and void. Whether this principle is applicable to a merger is debated. There is a precedent that affirmed this issue while the scope and value of this case precedent are arguable. The decision of the Nagoya District Court of 21 November 2007 accepted a claim of invalidity of merger based on a mistake. The court held that, considering the specific circumstances of the case, the Companies Act – which sets forth a bar on claims of invalidity for the subscription of shares after the registration of the formation of the company – shall not be analogically applicable to the merger in order to protect shareholders and creditors of the merging and merged companies.

Other grounds – there are some other grounds for invalidation, including violation of regulations of the Antimonopoly Act (eg, failing to wait for the clearance period for the gun-jumping regulation).

Effect of court's decision of invalidation

The court's decision of invalidity comes into effect not only concerning the party of the court's decision but also to any third parties as well. On the other hand, it does not have a retroactive effect and it only invalidates the effect of the merger prospectively. After the merger invalidation comes into effect, the

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merged and merging companies revive, and existing rights and obligations transferred to the merged company are returned to the original company (ie, transfer of the rights and obligations). New debts a company incurred after the merger but before the invalidation of the merger comes into effect, will incur joint and several liability for the merged and merging companies, and new assets acquired by the company during the period become jointly owned assets for the merged and merging companies.

Compensation for damage related to M&A disputes

M&A disputes can be resolved by compensation for damage. This type of dispute can be settled not only through litigation in court but also through an arbitration or out-of-court settlement. The followings are some types of cases which are commonly disputed relating to M&A.

Breach of duty to explain

As mentioned, the principle of freedom of contract is generally applicable to M&A transactions. Reflecting this principle, each party must take responsibility for collecting and analysing the information necessary to make its decision to enter into an M&A transaction.

In many case precedents where the court dismissed the plaintiff's claim of the defendant's breach of the alleged duty to explain certain aspects of the M&A transaction, the courts referred to the finding that the parties have equal bargaining power (especially in M&A disputes between listed companies). Indeed, many M&A transactions are made between companies with equal bargaining power. However, depending on the type of transaction and nature of the parties, such principle should not be directly applied. A typical example is a transaction between a business entity and consumer. In such case, a duty to explain may be imposed on one party.

In cases where one party is a large and sophisticated company while the counterparty is a small company that is not familiar with M&A transactions, there is a possibility that the duty to explain is imposed on the sophisticated party. Further, in cases where a party has information that would significantly affect the other party's decision, the party may owe an obligation to explain such

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information. In its decision dated 27 November 2012, the Supreme Court found that, in the specific circumstances of the case, an arranger of a syndicate loan owed the duty under the doctrine of good faith to explain certain information to potential participants of the syndicate loan who were not contractual parties with the arranger of the loan.[5]

Representations and warranties

Influenced by M&A practice outside Japan, representations and warranties clauses and indemnification clauses are commonly used in M&A agreements in Japan. As the number of agreements with such clauses increases, the number of disputes in relation to such clauses has also increased.

The Decision of Tokyo District Court of 17 January 2006 is a case relating to representations and warranties.[6] The court held that the seller breached the representations and warranties clause. The court further ruled that, had the buyer been grossly negligent for not being aware of the facts represented and warranted by the seller, the buyer could not have claimed compensation from the viewpoint of equity, regardless of the fact that there was no written clause to limit the buyer's rights in this situation. In this case, the court found that the buyer was not grossly negligent. The courts may interpret contractual clauses in a way that is not written in the contact to restrict a contractual party's claim, even though the principle of freedom of contract is fundamental in transactions between private parties, including M&A transactions.

5 Decision of the Supreme Court of Justice dated 27 November 2012, Shumin, No. 242, p1.

6 Decision of Tokyo District Court dated 17 January 2006, Hanrei-Times No. 1230, p206.

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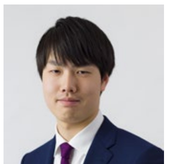

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