

## **Doing Deals in Japan: An Analysis of Recent Trends and Developments for the U.S. Practitioner**

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Japanese deals are back. During the so-called “lost decade” of the 1990s when Japanese banks were saddled with non-performing loans and Japanese companies posted minimal earnings growth, it seemed as if the Japanese economy was left out of the globalization trend that was sweeping across the Western economies and much of the developing world. Perhaps lost in the shuffle of the tech boom, the fallout from Enron and Worldcom, the passage of Sarbanes-Oxley and the subsequent rules issued by securities regulators, the investigations of New York Attorney General Spitzer and the SEC into the recommendations of securities analysts and market timing abuses by certain mutual funds, on top of the grave concerns raised in a post September 11th world, there was little time left to discuss the critical changes which were taking place in world’s second largest economy. Although some companies and investors took another look at Japan somewhat earlier in the business cycle (and have consequently reaped the benefits

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of such investments), only recently have the numbers come back to generate renewed interest across the market.

The numbers have come back big. According to Thomson Financial, in 2005 the total number of Japanese deals was 2,552—second only to the U.S.—resulting in total deal volume exceeding \$167 billion—third in the world following the U.S. and U.K.<sup>2</sup> Japanese deals are up 109.2% in 2005 from their 2004 levels, while the U.S. and U.K. were at 33.3% and 15.6%, respectively. Granted, while Japanese deals may still account for a smaller percentage of the overall Japanese economy when measured against comparable figures in many Western economies, there is little doubt that the trends are up. Indeed, Thomson concluded that “Japan proved a hot market in 2005, far outpacing growth in the US, UK, and Australia.”<sup>3</sup>

The reasons for these developments are many, and include the decrease in cross-shareholdings between Japanese companies, an increase in shareholder activism as represented by notable market players, and simple business fundamentals that made doing a deal much more attractive than may have been the case only a few years earlier. In addition to these market developments, Japan has experienced tremendous changes to the legal profession itself, such as the establishment of a law school system modeled on

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<sup>2</sup> See Thomson Financial, *Mergers & Acquisition Review Fourth Quarter 2005*, at 3, [http://www.thomson.com/cms/assets/pdfs/financial/league\\_table/mergers\\_and\\_acquisitions/4Q2005/4Q05\\_MA\\_Financial\\_Advisory.pdf](http://www.thomson.com/cms/assets/pdfs/financial/league_table/mergers_and_acquisitions/4Q2005/4Q05_MA_Financial_Advisory.pdf) (last visited Mar. 7, 2006).

<sup>3</sup> *Id.* at 29.

the U.S. to train the next generation of Japanese attorneys (*bengoshi*),<sup>4</sup> as well as recent amendments to the Japanese Federation of Bar Association rules which now permit *bengoshi* and foreign attorneys to partner up to a certain extent.<sup>5</sup> Other notable developments in the M&A practice in Japan include:

- *An increase in the hostile or contested deal.* While still relatively small compared to the historic activity in the U.S., it is no longer the case that every deal in Japan must be a friendly one.
- *New defensive measures to combat the hostile bidder.* In the aftermath of the Livedoor hostile bid for Nippon Broadcasting System, Inc., Japanese boards have actively pursued a variety of defensive measures including the possible issuance of share purchase warrants (*shinkabu-yoyaku-ken*) which can operate in a manner similar to U.S.-style poison pills.<sup>6</sup>
- *More competition even in the mega-deals.* The business opportunities to do more deals has resulted in increased competition at all levels, which

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<sup>4</sup> See generally David A. Boling, *Legal Reform in Japan*, Asia Perspectives, Fall 2002, at 33-36.

<sup>5</sup> See Gaikoku Bengoshi ni yoru Horitsujimu no Toriatsukai ni kansuru Tokubetsusochi-ho [Special Measures Law concerning the Handling of Legal Business by Foreign Lawyers], Law No. 66 of 1986, art. 2, no. 15; art. 49-3, as amended in 2003.

<sup>6</sup> Although share purchase warrants are technically not shareholder rights plans or poison pills in the American sense of the term, in this article we have used such terms in cases when share purchase warrants are used as defensive measures since in the vernacular of practitioners in Japan there has not been, at least as of yet, any one label that has gained a strong and devout following. The ambiguity in commonly used phrases, however, should not blur the crucial differences in law between Japanese and U.S. “poison pills.”

has further highlighted the attractiveness of reaching an agreement with the target while adequately protecting such an agreement. For instance, the recent merger between UFJ Holdings and Mitsubishi Tokyo Financial Group for \$ 41 billion included the issuance of shares with certain veto rights as well as a fiduciary-out provision, both of which were firsts in major Japanese M&A deals.

- *Greater flexibility for cross-border transactions.* Amendments to the Corporation Law which permit the use of certain types of triangular mergers have recently been enacted. In addition, as a means of keeping the laws on the books up to speed with the dynamic changes in the market, the Japanese government has issued new guidelines on M&A defensive strategies.

All these changes may leave the U.S. legal practitioner somewhat perplexed as to where to start to learn how to get deals done in the new Japan. A widely shared opinion is that Japan is currently experiencing an increase in takeover activity that is comparable to the heyday of U.S. takeovers during the mid to late 1980s, a time which still largely provides the foundation for present American takeovers jurisprudence.<sup>7</sup> Still, while much

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<sup>7</sup> See, e.g., Curtis J. Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 Colum. L. Rev. 2171 (2005). For an interesting real-time account from the Japanese perspective of the events which took place in the United States during the 1980s, see NIHON KEIZAI SHIMBUN [Nihon Keizai Shimbun, Inc.], SEC NO SUGAO [The SEC's True Face] (Nihon Keizai Shimbun ed. 1989).

has changed in Japanese law and practice of late, the challenges of doing a cross-border deal with a Japanese company still remain.

This article examines the process which is currently being played out in Japan by: (i) analyzing the recent changes in Japanese law of relevance to M&A deals, (ii) discussing some recent contested deals in Japan that may shed some light on current market practices, and (iii) providing an overview of the key issues that a U.S. practitioner will likely face when working on a Japanese deal. While this analysis is by no means an exhaustive or comprehensive treatment of the subject matter, hopefully it will provide some insight into the changes that are taking place in Japan while also noting some of the future developments that may to some degree be anticipated.

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## **I. Recent Changes in Japanese Law**

A good starting point in better understanding the remarkable changes in the Japanese M&A markets is to review the recent amendments to Japanese law, certain policy initiatives by the functional regulators, and other guidelines issued by Japanese government agencies. When taken as a whole, these reforms are substantial and may well be the most ambitious and far reaching in a generation. While the specific measures in these reforms may not have a direct comparison to a particular event in the U.S. legal experience, one could reasonably characterize the reforms as representing a degree of change on the same level as the enactment of the Sarbanes-Oxley Act. Fortunately for the U.S. practitioner, however, the Japanese reforms have been drafted with purpose of facilitating more cross-border deals. Thus, at least in principle, the reforms should not increase the number of regulatory hurdles that a U.S. company must pass in order to enter the Japanese market.

### **A. Enactment of the New Corporation Law**

The most significant of these reforms was the enactment of a new Corporation Law (*kaisha-ho*) in June 2005. These reforms largely took effect in May 2006, except for certain provisions regarding possible cash-out and triangular mergers which are scheduled to take effect in May 2007. The Corporation Law is the primary source of Japanese corporate law and may be compared to the Delaware General Corporation Law, although there are notable differences that must always be considered prior to entering

into any transaction.<sup>8</sup> The vast majority of the changes to the Corporation Law involve the structuring and governance of Japanese entities, which by and large should not affect the legal compliance issues for a U.S. corporation. However, where a U.S. corporation does business with a Japanese entity or perhaps has an interest in a Japanese company as part of its international operations, the amendments to the Corporation Law will have a significant impact. Some of the more important changes include:

- *Revision of Japanese corporate structures.* The new Corporation Law adopts a number of important changes to the available corporate structures including: (i) the introduction of limited liability partnership companies (*godo-kaisha*) modeled after LLCs in the U.S.; (ii) abolishment of limited liability companies typically used by small businesses (*yugen-kaisha*); and (iii) expansion of the definition of parent-subsidary relationships from a straight majority of the vote test to include cases where the parent has control of the subsidiary.<sup>9</sup>
- *Streamlining of Japanese corporate governance rules.* The new Corporation Law also clarifies the applicable governance requirements of each of these entities. While the primary election for a joint stock

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<sup>8</sup> For instance, the Corporation Law does not permit cash-out mergers for 90% holders of voting shares in the absence of a merger agreement with the target company, as is commonly the case in Delaware. *See* Del. Gen. Corp. Law § 253.

<sup>9</sup> *See* Kaisha-ho [Corporate Law], Law No. 86 of 2005, art. 2, no. 3 [hereinafter Corporation Law].

company (*kabushiki kaisha*) of having a corporate auditor or committee system will remain in effect,<sup>10</sup> the new Corporation Law provides numerous changes to the applicable corporate governance rules including: (i) enhancing the qualification requirements of directors;<sup>11</sup> (ii) permitting the creation of an accounting counselor (*kaikei-sanyo*) in the articles of incorporation of a joint stock company;<sup>12</sup> (iii) allowing for board approval in writing by amending the articles of incorporation in contrast to the prior requirement of at least a telephone conference;<sup>13</sup> and (iv) requiring that a majority vote of shareholders will dismiss a director with or without cause in contrast to the prior supermajority vote requirement.<sup>14</sup>

- *Expansion of cash-out and triangular mergers.* The provisions to take effect in May 2007 will make cash-out and triangular mergers more available to foreign companies, which at present can engage in such transactions only when carried out under a special law that requires

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<sup>10</sup> See Corporation Law, art. 326, para. 2.

<sup>11</sup> See Corporation Law, art. 331, para. 1.

<sup>12</sup> See Corporation Law, art. 326, para. 2.

<sup>13</sup> See Corporation Law, art. 370.

<sup>14</sup> See Corporation Law, art. 341. The company may still elect to increase the voting requirement to a supermajority by amending its articles of incorporation. *See id.*

government consent.<sup>15</sup> The new structures will permit the surviving company in a statutory merger between two Japanese companies to use cash or stock of its non-Japanese parent company (or a combination) as the consideration given to the shareholders of the disappearing company.

- *New limited voting right pills.* In addition to the types of poison pills currently available under Japanese law, the new Corporation Law permits Japanese companies to issue a poison pill that can limit the voting rights of a hostile acquirer in contrast to the customary dilution of voting power in a flip-in/flip-out pill in the U.S.<sup>16</sup>

B. Amendments to the Securities and Exchange Law

Separate from the new requirements of the new Corporation Law, certain amendments to the Securities and Exchange Law<sup>17</sup> have gone into effect or are currently being considered by the Japan Financial Services Agency (“FSA”), which include the following:

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<sup>15</sup> See Corporation Law, art. 749, para. 1, no. 2.; Law on Special Measures for Industrial Revitalization, Law No. 131 of 1999, art. 12-9, para. 1.

<sup>16</sup> See Corporation Law, art. 108.

<sup>17</sup> The Securities and Exchange Law was originally modeled on the U.S. federal securities laws, although in operation there are substantial differences between the two systems of securities regulation. See generally Hiroshi Oda, JAPANESE LAW 268-271 (2d ed. 1999).

- *Definition of “market” trading in the tender offer rules* These amendments went into effect in July 2005, and were largely in response to Livedoor’s purchases of Nippon Broadcasting System, Inc. shares by means of an after hours, off-exchange trading system of Tokyo Stock Exchange, Inc. (the “Tokyo Stock Exchange”).<sup>18</sup> As a general matter, the Japanese tender offer rules under the Securities and Exchange Law apply when an acquirer obtains more than one third of voting rights in the target company.<sup>19</sup> Once the tender offer rules are triggered, the acquirer must either submit a tender offer to all shareholders or continue to obtain shares by market purchases. The particular issue with the Livedoor trades was whether the after hours, off-exchange trades were “market” purchases that complied with the tender offer rules. Since the law at that time was unclear on the issue, the amendments to the Securities and Exchange Law generally prohibited such trading in the absence of a tender offer that otherwise complied with the applicable rules and regulations.
- *Permitted withdrawal of tender offers.* Due to the increase in hostile activity in Japan, the FSA is currently revisiting the possible instances where a hostile acquirer may withdraw a tender offer. At present, the

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<sup>18</sup> See Shoken torihiki-ho [Securities and Exchange Law], Law No. 25 of 1948, art. 27-2, para. 1 [hereinafter Securities and Exchange Law].

<sup>19</sup> See Securities and Exchange Law, art. 27-2, para. 1.

tender offer rules do not explicitly provide that a tender offeror may withdraw a tender offer in response to certain defensive mechanisms, such as share purchase warrants and stock splits. Since there is the expectation that increasing numbers of Japanese companies will adopt defensive measures in various forms, the FSA is currently planning to explicitly provide that a tender offeror may withdraw a tender offer when the board of the target company refuses to cancel its defensive measures.<sup>20</sup>

- *Proposed changes to substantial shareholder reports.* The FSA plans to revise the rules for substantial shareholder reports under the Securities and Exchange Law, which are similar to Schedule 13D filings in the United States. Under the current rules, a shareholder and its group that holds more than 5% of the issued shares of a Japanese company must file the substantial shareholder report within five business days after crossing the 5% threshold, except for certain institutional investors which are permitted to file the reports in a longer period of time. The FSA plans to shorten this longer period for institutional investors, although it is not certain whether

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<sup>20</sup> See KINYUSHINGIKAI KINYUBUNKAKAI DAIICHIKAI [THE FIRST SECTION OF THE FINANCE DIVISION OF THE FINANCE COUNCIL], KOKAIKAITSUKESEIDOTO WORKING GROUP HOKOKU [THE REPORT THE WORKING GROUP CONCERNING THE TENDER OFFER AND OTHER RULES] 8 (December 16, 2005), [http://www.fsa.go.jp/singi/singi\\_kinyu/siryu/kinyu/dai1/tob/f-20051216-3..pdf](http://www.fsa.go.jp/singi/singi_kinyu/siryu/kinyu/dai1/tob/f-20051216-3..pdf) (last visited Mar. 7, 2006) [hereinafter THE TENDER OFFER REPORT]. Additionally, on July 22, 2005, a minister of the FSA orally suggested that the existing tender offer rules should be interpreted so that a tender offer can be withdrawn due to a stock split that would constitute a materially adverse effect with respect to the tender offer. See Transcript of FSA News Conference of July 22, 2005, <http://www.fsa.go.jp/gaiyou/gaiyouj/daijin2005b/20050722-1.html> (last visited Mar. 7, 2006).

this will eventually become law as there have been objections to such proposals.<sup>21</sup> Furthermore, the FSA has proposed that all substantial shareholder reports be filed electronically.<sup>22</sup> A widely shared opinion is that these proposed changes have been partly in response to the recent activities of certain institutional investors.

C. Notable Guidelines and Rules

In addition to the numerous changes to Japanese law, government ministries and other organizations have addressed the issues raised by the recent increase in hostile deals through the issuance of various guidelines and rules. While these guidelines and rules may not necessarily result in binding legal obligations for a company in a given case, they do provide important guidance as to how the legal and business communities in Japan are currently considering the issues associated with the increase in takeover activity.

- *The Corporate Value Report.* The Ministry of Economy, Trade and Industry (“METI”) established the Corporate Value Study Group, which was comprised by noted legal scholars and business representatives. The Group considered the applicable rules on hostile deals in other jurisdictions, including an analysis of the rules that apply in the U.S. and Europe. In May 2005, the Group issued its report on the recommended

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<sup>21</sup> See THE TENDER OFFER REPORT, at 12.

<sup>22</sup> See *id.*

rules for defensive measures in Japan (the “Corporate Value Report”), which discussed the Delaware experience with takeovers and the *Unocal* standard,<sup>23</sup> while also observing that additional changes would be needed to the rules in foreign jurisdictions to comport with Japanese practices.<sup>24</sup> In November 2005, the Group also provided a written opinion on how stock exchanges should treat rights plans, including the desired level of disclosure in such instances. The Group stated in its written opinion that shares with veto rights (so-called “golden shares”) should be allowed for public companies under certain conditions. For example, a company which issues golden shares should: (i) establish clear exercise conditions, (ii) provide that such shares can be cancelled at a shareholder or board meeting, and (iii) limit the effective period for such shares.<sup>25</sup>

- *The Defensive Measures Guidelines.* Based on the prior work contained in the Corporate Value Report, in May 2005 METI and the Ministry of Justice announced guidelines regarding the preferred uses of and advised

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<sup>23</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

<sup>24</sup> See KIGYOKACHI KENKYUKAI [Corporate Value Study Group], KIGYOKACHI HOKOKUSHO [Corporate Value Report] (2005) [hereinafter THE CORPORATE VALUE STUDY GROUP and THE CORPORATE VALUE REPORT, respectively], <http://www.meti.go.jp/press/20050527005/3-houkokusho-honntai-set.pdf> (last visited Mar. 7, 2006).

<sup>25</sup> See THE CORPORATE VALUE STUDY GROUP, KOSEINA BAISHUBOEISAKU NO ARIKATA NI KANSURU RONTENKOKAI [Disclosure of issues regarding fairness of defensive measures] 9 (2005), <http://www.meti.go.jp/press/20051110002/3-ronntennkoukai-set.pdf> (last visited Mar. 7, 2006).

limitations to rights plans (the “Defensive Measures Guidelines”).<sup>26</sup>

While the Defensive Measures Guidelines do not have the force of law, given their persuasive authority most Japanese companies follow their mandates when designing their rights plans.

- *Tokyo Stock Exchange Rules.* In March 2006, the Tokyo Stock Exchange made public its new rules on the permitted defensive measures of listed companies.<sup>27</sup> The new rules requires sufficient disclosure of defensive measures and prior consultation with the Tokyo Stock Exchange. The draft rules prohibited golden shares, which resulted in strong objections from the FSA and METI. Thus, the new rules permit golden shares “when the Tokyo Stock Exchange acknowledges that the defensive measure is not likely to infringe the benefits of shareholders and investors in light of the company’s business purposes, the purpose for issuing the golden shares, the content of the rights, the attributes of subscribers, and other

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<sup>26</sup> See KEIZAISANGYO-SHO [Ministry of Economy, Trade and Industry] & HOMU-SHO [Ministry of Justice], KIGYOKACHI KABUNUSI KYODO NO RIEKI NO KAKUHO MATAWA KOJO NO TAMENO BAISHUBOEISAKU NI KANSURU SHISHIN [Guideline regarding defensive measures to secure and increase corporate value and shareholders’ common benefits] (2005) [hereinafter THE DEFENSIVE MEASURES GUIDELINES], available at <http://www.meti.go.jp/press/20050527005/3-shishinn-honntai-set.pdf> (last visited Mar. 7, 2006).

<sup>27</sup> TOKYO STOCK EXCHANGE, BAISHUBOEISAKU NO DONYU NI KAKARU JOJOSEIDO NO SEIBITO NI TOMONAU KABUKENJOJOSHINSAKIJUNTO NO ICHIBUKAISEI NI TSUITE [Re: Partial Amendment of the Stock Listing Requirements, etc. accompanying the Adjustment, etc. of the Listing System regarding the Adoption of Defensive Measures] (Mar. 7, 2006), [http://www.tse.or.jp/guide/rule/taisho/060307\\_a1.pdf](http://www.tse.or.jp/guide/rule/taisho/060307_a1.pdf).

conditions of the golden shares.”<sup>28</sup> Note that as matter of policy the New York Stock Exchange prohibits the issuance of golden shares by listed companies.<sup>29</sup>

- *Pension Fund Association Guidelines.* In April 2005, the Pension Fund Association (*kigyo nenkin kikin rengokai*, formerly *kosei nenkin kikin rengokai*) announced guidelines regarding the exercise of voting rights in connection with proposed defensive measures (amended on April 10, 2006).<sup>30</sup> The Pension Fund Association represents the interests of pension fund participants at various Japanese companies, although it should be noted that there are significant differences between Japanese and U.S. pensions funds as a matter of practice.<sup>31</sup> As part of these guidelines, the Pension Fund Association noted that it generally approves of rights plans provided that (i) the company in question sufficiently explains how the rights plan will increase corporate value, (ii) the rights plan is approved at

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<sup>28</sup> *Id.* at 2.

<sup>29</sup> See NYSE Listed Company Manual § 308.00 (1999). However, one should note that while “golden shares” in the U.S. or Japan may have the common element of veto rights, they may operate quite differently in practice. For instance, as further discussed *infra*, the Class E Preferred Shares in the UFJ Holdings – Mitsubishi Tokyo Financial Group merger had deal protection elements when reading the specific text of the Basic Agreement of Recapitalization.

<sup>30</sup> KOSEI NENKIN KIKIN RENGOKAI [Pension Fund Association], KIGYOBASHUBOEISAKU NI KANSURU KABUNUSHI GIKETSUKEN KOSHI NO HANDANKIJUN [Decision Standard of Exercise of Voting Rights regarding Defensive Measures] (Apr. 10, 2006), [http://www.pfa.or.jp/top/jigyoku/pdf/gov\\_20050428.pdf](http://www.pfa.or.jp/top/jigyoku/pdf/gov_20050428.pdf) (last visited Apr. 11, 2006).

<sup>31</sup> For instance, Japanese pension funds are not as likely to be lead plaintiffs in securities class actions or derivative suits in a manner that has increasingly become the norm in the United States.

a shareholders meeting, (iii) the decision of the directors will not be arbitrary, and (iv) the rights plan is for a limited duration of time. The guidelines also object to golden shares and dead hand poison pills.

## II. Recent Contested Deals in Japan

In concert with the changes in Japanese law, we have seen an increase in the number of contested deals in Japan in recent years.<sup>32</sup> While people may reasonably disagree as to what this means for the Japanese M&A markets as a whole, what appears to be beyond doubt is that the contested deal can now be proposed whereas it may have been merely a *theoretical* proposal in the past. This past year provided the first clear signs that contested deals can happen with the some of the more notable examples being the UFJ Holdings – Mitsubishi Tokyo Financial Group merger and the Livedoor hostile bid for Nippon Broadcasting System, Inc. Given the primary importance of the facts in these new types of transactions, it is worth taking a moment to review the specifics of a few selected contested deals from 2005.

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<sup>32</sup> For this section we use the broader term “contested” deals rather than “hostile” deals since some of the transactions may not be properly defined as hostile. For instance, the UFJ Holdings – Mitsubishi Tokyo Financial Group merger involved an unsolicited third party bid but not a tender offer or proxy contest. However, for purposes of the definition of “contested” deals in this article, we do not intend to include those deals that are subject to a regular bidding process designed by the target company.

A. UFJ – MTFG Merger<sup>33</sup>

The events which ultimately led to the merger of UFJ Holdings, Inc. (“UFJ Holdings”) with Mitsubishi Tokyo Financial Group, Inc. (“MTFG”) actually began in the spring of 2004, when UFJ Holdings and its subsidiaries, UFJ Bank Limited (“UFJ Bank”) and UFJ Trust Bank Limited (“UFJ Trust Bank”), entered into a Basic Agreement with The Sumitomo Trust & Banking Co., Ltd. (“STB”).<sup>34</sup> Signed on May 21, 2004, the Basic Agreement provided, *inter alia*, STB with the right to further discuss the possible acquisition of UFJ Trust Bank for a two-year period, together with a no-shop clause. On July 14, 2004, however, the UFJ Group notified STB of the termination of their discussions under the Basic Agreement and began separate discussions with MTFG for the possible acquisition by MTFG of the UFJ Group’s entire business.<sup>35</sup>

On July 16, 2004, UFJ Holdings and MTFG signed a memorandum of understanding which provided for further discussions on a complete integration between their two banking groups. That same day STB filed a preliminary injunction at the Tokyo

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<sup>33</sup> During his secondment to Nishimura & Partners Mr. Hines participated in the firm’s representation of UFJ Holdings in connection with its merger discussions with MTFG. The Nishimura team was led by Masakazu Iwakura, a member partner of the firm, and the firm’s negotiation team included partners Takefumi Sato and Hirotada Inoshita, and associates Daisuke Matsubara, Yuki Oi and Hidetoshi Matsumura. However, all matters in this article are now of public record.

<sup>34</sup> A more detailed summary of the facts leading up to the vote at the UFJ and MTFG shareholders meetings is available in the registration statement filed by MTFG with the Commission. *See* Amendment No. 3 to Form F-4 of Kabushiki Kaisha Mitsubishi Tokyo Financial Group, May 18, 2005, at 63-68 (available on EDGAR at <<http://www.sec.gov/Archives/edgar/data/67088/000119312505110582/df4a.htm>>).

<sup>35</sup> The UFJ Group was comprised of UFJ Holdings, UFJ Bank, UFJ Trust Bank and UFJ Tsubasa Securities Co., Ltd.

District Court against UFJ Holdings, UFJ Bank and UFJ Trust Bank to prevent any further discussions with MTFG on a possible integration. STB prevailed at the Tokyo District Court on July 27, 2004,<sup>36</sup> however this ruling was later overturned on appeal before the Tokyo High Court on August 11, 2004.<sup>37</sup> The Supreme Court of Japan affirmed the Tokyo High Court's decision on August 30, 2004.<sup>38</sup>

On August 24, 2004, Sumitomo Mitsui Financial Group, Inc. ("SMFG") made an unsolicited proposal to UFJ Holdings for a one-for-one stock merger which represented about a 30% premium to UFJ Holdings shareholders based on the share prices of the two companies around that time. On September 10, 2004, MTFG, UFJ Holdings and UFJ Bank signed the Basic Agreement of Recapitalization which provided a 700 billion yen cash infusion from MTFG in consideration of certain Class E Preferred Shares of UFJ Bank. These preferred shares provided MTFG with veto rights upon certain triggering events as set forth in the Basic Agreement of Recapitalization.<sup>39</sup>

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<sup>36</sup> See *STB v. UFJ Holdings*, 1708 Shoji Homu 22 (Tokyo Dist. Ct., Aug. 4, 2004).

<sup>37</sup> See *UFJ Holdings v. STB*, 1708 Shoji Homu 23 (Tokyo High Ct., Aug. 11, 2004).

<sup>38</sup> See *STB v. UFJ Holdings*, 1708 Shoji Homu 23 (Sup. Ct., Aug. 30, 2004). The Supreme Court ruling finally adjudicated STB's claims for injunctive relief, however STB was still able to continue suit against UFJ Holdings, UFJ Bank and UFJ Trust Bank for monetary damages due to the alleged breach and termination of the Basic Agreement. On February 13, 2006, the Tokyo District Court denied STB's request for 100 billion yen in damages. STB appealed this ruling to the Tokyo High Court on February 24, 2006.

<sup>39</sup> An English summary of the Basic Agreement of Recapitalization is included the Form F-4 filing. See Amendment No. 3 to Form F-4 of Kabushiki Kaisha Mitsubishi Tokyo Financial Group, May 18, 2005, at 111-113 (available on EDGAR at <<http://www.sec.gov/Archives/edgar/data/67088/000119312505110582/df4a.htm>>), see also Masakazu Iwakura & Yuki Oi, *M&A Torihiki Keiyaku ni okeru Hibaishukaisha no Kabunushi no Riekihogo 3(i)* [Protection of the Interests of Target Company

On February 18, 2005, the UFJ Group and MTFG Group<sup>40</sup> signed an Integration Agreement which provided the merger ratios for the proposed integration in addition to the first fiduciary-out clause in the history of major Japanese M&A deals to the extent known through publicly available sources.<sup>41</sup> On February 25, 2005, SMFG withdrew its outstanding offer to UFJ Holdings for a proposed integration. On April 20, 2005, UFJ Holdings and MTFG signed the Merger Agreement.<sup>42</sup> The proposed integration as set forth in the Merger Agreement was approved at each of the shareholders meetings of UFJ Holdings and MTFG in June 2005, and the merger date was October 1, 2005 for most of the group entities with the remaining UFJ Bank and The Bank of Tokyo Mitsubishi having a merger date of January 1, 2006.

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Shareholders in M&A Agreements 3(i)], 1747 Shoji Homu 30, 35 (2005) (discussing how the Class E Preferred Shares had deal protection elements such as a break-up fee whereby UFJ had a call option to purchase such shares at a price higher than the issuance price).

<sup>40</sup> The MTFG Group included MTFG, The Bank of Tokyo-Mitsubishi Limited, The Mitsubishi Trust and Banking Corporation, and Mitsubishi Securities, Co., Ltd.

<sup>41</sup> An English translation of the Integration Agreement is included the Form F-4 filing. *See* Amendment No. 3 to Form F-4 of Kabushiki Kaisha Mitsubishi Tokyo Financial Group, May 18, 2005, at A-A-1 through A-A-21 (available on EDGAR at <<http://www.sec.gov/Archives/edgar/data/67088/000119312505110582/df4a.htm>>). The fiduciary-out clause is at Section 50 of the Integration Agreement, and provides language that is slightly different from a “superior proposal” formulation that would be considered customary in U.S. public company deals. *See id.* at A-A-14, A-A-15. In particular, the fiduciary-out is subject to the agreement of the parties by providing, “If, as the result of such discussion [on the Business Integration, New Terms (if any), and Third Party Proposal], MTFG and UFJ Holdings reach an agreement (such agreement shall not be refused or delayed without any reasonable cause; and the burden of proving in advance that there is no such reasonable cause is placed on the Proposal Receiving Party), they may, on the agreed terms and conditions, (a) modify the terms and conditions of the Mergers, (b) exempt the Proposal Receiving Party from its obligations under this Agreement..., or (c) terminate this Agreement.” *Id.* at A-A-15.

<sup>42</sup> An English translation of the Merger Agreement is included the Form F-4 filing. *See* Amendment No. 3 to Form F-4 of Kabushiki Kaisha Mitsubishi Tokyo Financial Group, May 18, 2005, at A-B-1 through A-B-6 (available on EDGAR at <<http://www.sec.gov/Archives/edgar/data/67088/000119312505110582/df4a.htm>>).

The UFJ – MTFG merger is important for numerous reasons, not least of which is that the combined entity MUFG is the largest Japanese financial institution and the largest bank in the world in terms of assets. Beyond the business ramifications, however, the merger is noteworthy from the M&A practitioner’s perspective in that it involved a number of firsts: the first bidding war among major Japanese banks in recent memory, the first time that shares with veto rights were used in a major Japanese M&A deal as a deal protection strategy, and as noted previously the first time a fiduciary-out clause was included in a major Japanese M&A deal to the extent publicly known. Although it is yet to be seen whether such new aspects to Japanese deals will become “market” or the exception to existing trends and customs,<sup>43</sup> the fact that all these firsts occurred within the scope of one transaction clearly suggests that Japanese M&A markets are much more dynamic and creative than may have been the case only a few years ago.

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<sup>43</sup> For instance, the discussion concerning the possible impact of the fiduciary-out clause in the UFJ-MTFG Integration Agreement continues. See Masakazu Iwakura & Yuki Oi, *M&A Torihiki Keiyaku ni okeru Hibaishukaisha no Kabunushi no Riekihogo 3(ii)* [Protection of the Interests of Target Company Shareholders in M&A Agreements 3(ii)], 1748 *Shoji Homu* 37, 40 (2005) (articulating that the necessity for discussions about the protection of target company shareholders’ benefits is increasing), see also, Robert G. DeLaMater, *Director Fiduciary Duties in the Context of M&A Transactions: Relevance of U.S. Experience in Japan*, paper submitted at Association of the Bar of the City of New York symposium, *M&A Transaction: Does the U.S. Style Work in Japan?*, Apr. 4, 2005, at 18 (“Under the present state of fiduciary duty jurisprudence in Japan, the bidder and its counsel should consider carefully and generally seek to resist any proposal by the target to include fiduciary out provisions in the acquisition agreement”). One indication that fiduciary outs may be on the rise is certain language contained in the Corporate Value Report and the Defensive Measures Guidelines which generally recommend that a target company consider possible competing proposals even when there is a white knight. See THE CORPORATE VALUE REPORT, at 85 (“In the event that a board already decided a sale of the company and is negotiating the sale with a third party, if a competing hostile acquirer emerges, the board is generally required to study a competing proposal of such acquirer. *A measure that completely takes away the opportunity to study such proposal is inappropriate without any special rationale not to study such proposal.*”) (emphasis added); THE DEFENSIVE MEASURES GUIDELINES, at 4-5.

## B. Livedoor – Fuji Television

While the UFJ – MTFG represented many firsts for Japanese M&A, the Livedoor – Fuji Television saga is noteworthy in a different manner in that it caught the public imagination and was a topic of discussion in many boardroom meetings since it possibly signaled the beginning of the true hostile bid. It would not be unreasonable to believe that executives at many public Japanese companies, witnessing the dramatic events in the Livedoor hostile bid unfold in the press, quickly revisited their existing defensive measures and contemplated possibly improving their defensive profile by issuing poison pills and the like. The facts of the Livedoor hostile bid are well known in Japan and may not require much repeating, and thus the essential facts are as follows.

In January 2005, Fuji Television Network, Inc. (“Fuji Television”), which held 12.4% of shares issued by Nippon Broadcasting System, Inc. (“NBS”), launched a tender offer for 100% of NBS shares at 5,950 yen per share. The tender offer represented approximately a 21% premium over the market price, and was launched partly because Fuji Television sought to rectify the situation where its de facto subsidiary, NBS, owned 22.51% of Fuji Television issued shares. The NBS board approved the Fuji Television tender offer. During the tender offer period, Livedoor, Inc. (“Livedoor”), an internet business company, acquired NBS issued shares through an after-hours, off-exchange trading system operated by the Tokyo Stock Exchange, which resulted in its holding 39.56% of NBS issued shares. This system is not a fully liquid market in that the buyer may purchase from specific sellers on an anonymous basis to a certain extent. Although

the Livedoor trades were legal at the time, many observers thought that such trading circumvented the tender offer rules which generally require an acquirer to make a tender offer or purchase shares in the market after passing the one third ownership threshold for target shares.

On February 28, 2005, the market price of NBS shares was 6,700 yen. In March 2005, Fuji Television purchased NBS issued shares as a result of its tender offer, which resulted in its holding 36.47% of NBS issued shares.

On February 23, 2005, NBS announced that it was issuing to Fuji Television certain share purchase warrants<sup>44</sup> exercisable at 5,950 yen per share. The effect of these share purchase warrants was that it would give Fuji Television majority control in NBS and dilute Livedoor's shareholding to less than 20%. Livedoor brought an action to enjoin the issuance of the warrants, and in March 2005 prevailed at both the Tokyo District Court and the Tokyo High Court.<sup>45</sup>

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<sup>44</sup> Share purchase warrants are securities under Japanese law and can be issued with or without consideration. *See* Corporation Law, art. 238, para. 1, no. 2. In accordance with the specific terms and conditions of such warrants, a holder can exercise and receive additional company shares. *See* Corporation Law, art. 236, para. 1. In this manner, share purchase warrants can serve a function similar to a shareholder rights plan in the United States.

<sup>45</sup> *See NBS v. Livedoor*, 1728 Shoji Homu 41 (Tokyo High Ct., Mar. 3, 23, 2005). Japanese courts have established a "primary purpose rule" whereby the issuance of equity securities can be enjoined if dilution of an acquirer's shareholding ratio predominates over other reasons for such issuance. *See* KENJIRO EGASHIRA, *KABUSIKI KAISHA-HO AND YUGENKAISHA-HO* 587 (3d ed. 2004). This rule can generally be applied in poison pill situations. However, in its ruling the Tokyo High Court enunciated certain exceptions to the primary purpose rule such as greenmailing, corporate raiding, issuing extraordinary dividends through assets sale and so forth. *See NBS v. Livedoor*, 1728 Shoji Homu 41, 46 (Tokyo High Ct., Mar. 3, 23, 2005). None of these exceptions were found to apply in the Livedoor case. *See id.* at 47-49.

By the end of March 2005, Livedoor's shareholdings in NBS issued shares exceeded 50%. In April 2005, Fuji Television, NBS and Livedoor agreed to a settlement which had three main points. First, NBS will become Fuji Television's wholly owned subsidiary, and Fuji Television and NBS agreed to pay 6,300 yen per share to NBS shareholders. This price was almost the same as or slightly higher than Livedoor's cost to acquire its NBS shares. The going private transaction closed on September 1, 2005. Second, Fuji Television agreed to subscribe to 12.75% of Livedoor issued shares, which fell just short of the 15% threshold under the applicable accounting rules that would trigger a partial consolidation of Livedoor. This share subscription closed in May 2005. Third, Fuji Television, NBS and Livedoor agreed to discuss possible business alliances.

The long term effects of the Livedoor hostile bid are still difficult to gauge in light of subsequent allegations of accounting fraud at Livedoor and certain of its affiliated entities. Whether Livedoor will indeed become "Japan's Enron", as many have initially observed, will be an issue to consider in the months and years ahead.<sup>46</sup> However, what can be observed with some degree of confidence at this point in time is that the Livedoor hostile bid dramatically increased the awareness of Japanese boards to the various legal issues that arise in hostile deals. Thus, if the Livedoor cases are something akin to the

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<sup>46</sup> At least in the United States, the more appropriate measure may be years since it is worth noting that the trials of top Enron executives were in full swing in 2006 while the bankruptcy was filed in 2001.

effect that *Unocal* or *Revlon*<sup>47</sup> had in the U.S. experience, the Livedoor cases substantially expanded the development of Japanese takeovers jurisprudence.

C. Yumeshin – Japan Engineering Consultants

Another important transaction for the issues it raised under Japanese law was the Yumeshin – Japanese Engineering Consultants deal. Although perhaps not as well known as the UFJ – MTFG merger or the Livedoor hostile bid, the interplay of the Japanese tender offer rules with permissible defensive measures in the Yumeshin transaction merits its own consideration and discussion. It all started in May 2005, when a financial adviser of Yumeshin Holdings Co. Ltd. (“Yumeshin”), a holding company for construction management and other related businesses, informed Japan Engineering Consultants Co., Ltd. (“JEC”), a construction consulting company, that Yumeshin sought to acquire additional JEC shares so that it would become a 51% owner. At that time, Yumeshin held 6.83% of JEC issued shares. On July 7, 2005, Yumeshin proposed a business alliance with JEC.

On July 8, 2005, JEC announced its general defense policy which provided that the company would exercise certain defensive measures if an acquirer began purchasing JEC shares prior to the completion of JEC’s review of the proposed acquisition as presented by such acquirer. JEC noted that such defensive measures were yet to be determined. In response, on July 11, 2005, Yumeshin announced a tender offer for

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<sup>47</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).

46.88% of JEC issued shares at the maximum, which would result in its holding 53.71% of JEC issued shares, at 550 yen per share. This tender offer priced JEC shares at about a 68% premium over the market price.

On July 18, 2005, JEC announced a stock split with one share being split into five shares that were to be distributed to shareholders of record as of August 8, 2005—prior to the end of Yumeshin’s tender offer period.<sup>48</sup> The stock split was scheduled to take place in October 2005—after Yumeshin’s tender offer period—thus the settlement date of the tender offer was necessarily delayed to account for the upcoming stock split. On July 20, 2005, however, Yumeshin launched a tender offer at 110 yen per share, which accounted for the one-for-five stock split. In addition, Yumeshin brought an action at the Tokyo District Court to temporarily enjoin the stock split. On July 29, 2005, the Tokyo District Court denied Yumeshin’s request for a temporary injunction.<sup>49</sup> On that same day, JEC

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<sup>48</sup> Under the current tender offer rules, a tender offeror is generally not allowed to reduce its tender offer price, and it is unclear whether it may reduce its tender offer price in the case of a stock split by the target. *See* Securities and Exchange Law, art. 27-6, para. 3. Thus, JEC could have announced the stock split *after* Yumeshin launched the tender offer so that it would be uncertain as to whether Yumeshin could reduce its tender offer price to account for the impending stock split. However, it appears that JEC announced the stock split *prior* to Yumeshin’s tender offer in order to avoid any possible confusion among JEC shareholders.

<sup>49</sup> *See Yumeshin v. JEC*, 1739 Shoji Homu 100 (Tokyo Dist. Ct., July 29, 2005). The Tokyo District Court noted that as general matter the board of directors of a target company may request additional information from a tender offeror and arrange for a discussion period in furtherance of the proper judgment of shareholders. *See id.* at 107. Furthermore, the court observed that a board of directors of a target company can take proportionate defensive measures when an acquirer does not respond to the target company’s reasonable requests. *See id.* at 108. Although the court suggested that JEC could have obtained the necessary information by responding to Yumeshin’s proposal for a possible business alliance, it held that JEC’s stock split was not unreasonable because JEC’s stock split did not make Yumeshin’s tender offer impossible although it pushed back the settlement date. *See id.* at 108-9.

announced that it planned to issue share purchase warrants to all of its shareholders upon shareholder approval at the upcoming annual general shareholders meeting in September 2005. Such warrants provided that they could not be exercised by a hostile acquirer who held in excess of 20% of JEC issued shares.

The next development was, as might be anticipated, the entry of a white squire. On August 8, 2005, Eight Consultants Co., Ltd. (“Eight Consultants”) announced a tender offer for 50.1% of JEC voting shares at the minimum at a price of 118 yen per share. Eight Consultants also made public a business alliance with JEC. The Eight Consultants tender offer was launched on August 9, 2005, and it was approved by the JEC board. During the month of August, Yumeshin was able to purchase only about 4% of JEC shares. In October 2005, Eight Consultants decreased the minimum number of JEC shares to be purchased in its tender offer to 20%, and ultimately purchased about 23% of JEC issued shares. Due to the entry of a white squire, JEC did not issue share purchase warrants at its annual general shareholders’ meeting in September 2005.

The Yumeshin failed tender offer provides a good example of defensive measures that ultimately worked. While the Tokyo District Court did not give its definitive approval to JEC’s proposed stock split, in contrast to the Livedoor hostile bid the court did not choose to enjoin JEC’s defensive measures. Thus, the combination of the announcement of a general defense policy, a proposed stock split which delayed the hostile tender offer, the threat of an issuance of share purchase warrants, and the entry of a white squire ultimately worked to defeat the Yumeshin bid.

#### D. Other Notable Contested Deals

The list of recent contested deals could continue at length and provide a number of insights into current practices and strategies in Japanese M&A. However, in order to highlight the essential points and move on to an analysis of the key issues for the U.S. practitioner, we have narrowed the list down to two additional deals that many will likely recall from this past year.

##### (1) Rakuten – TBS

Another hostile bid which generated a great deal of coverage in Japan was the Rakuten, Inc. (“Rakuten”) bid for Tokyo Broadcasting System, Inc. (“TBS”). In October 2005, Rakuten, an internet business company, purchased 19.09% of TBS issued shares and proposed the integration of the two companies which would create a holding company under which both Rakuten and TBS would become subsidiaries.<sup>50</sup> However, Rakuten was not able to purchase additional TBS shares in part because TBS had already issued to Nikko Principal Investments Japan Inc. (“NPI”)<sup>51</sup> certain share purchase warrants that would be triggered upon the hostile acquisition of more than 20% of TBS

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<sup>50</sup> An added element to this transaction was that both parties owned professional Japanese baseball teams: Rakuten with its Rakuten Eagles of Sendai in northern Japan and TBS with its Yokohama Bay Stars.

<sup>51</sup> NPI is a subsidiary of Nikko Cordial Corporation, a financial services group.

issued shares.<sup>52</sup> The matter was ultimately resolved by Rakuten and TBS reaching a settlement at the end of November 2005. The terms of the settlement provided that: (i) Rakuten will withdraw its integration proposal; (ii) Rakuten and TBS will discuss possible business alliances until the end of March 2006 (later amended to June 2006); and (iii) until the end of March 2006 (later amended to June 2006), Rakuten's holdings of TBS shares shall be less than 10% and any holdings in excess of such threshold shall be placed into a trust account.

The Rakuten hostile bid is an example of share purchase warrants that operated in a manner that is familiar for the U.S. practitioner. Specifically, the warrants forced Rakuten to negotiate with management or roll the dice by going straight to the shareholders through a tender offer or proxy contest. This is in stark contrast to the Livedoor hostile bid, where for the reasons noted previously Livedoor was able to acquire shares without negotiating with management or launching a tender offer. A critical point for TBS was that its poison pill was already in place and was not contested by Rakuten in injunction proceedings before the Japanese courts. On this point, the cautionary tale of Fuji Television's prior difficulties was no doubt helpful to TBS in its advance preparation against a hostile bidder.

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<sup>52</sup> Once triggered, such share purchase warrants gave NPI a right to acquire approximately 21.2% of TBS issued shares at 90% of the average market price during the six months prior to the crossing of the 20% threshold by the hostile acquirer.

(2) M&A Consulting – Hanshin

M&A Consulting, Inc. (“M&A Consulting”), the well known fund led by Mr. Yoshiaki Murakami, has been involved in a number of contested deals in recent years.<sup>53</sup> One of the more recent deals for M&A Consulting, which also resulted in much Japanese press coverage, was the acquisition of shares in Hanshin Electric Railway Co., Ltd. (“Hanshin”).<sup>54</sup> In September 2005, M&A Consulting announced that an affiliated entity held approximately 27% of Hanshin shares on a fully diluted basis. There was no express consent of Hanshin. In January 2006 these shareholdings eventually increased to a high of 44.49%. Importantly, and in contrast to TBS, Hanshin did not have any share purchase warrants in place to deter this acquisition of shares. Although the discussions between M&A Consulting and Hanshin are continuing as of March 19, 2006, what is clear is that in the absence of duly issued share purchase warrants a target is considerably more vulnerable to the acquisition of its shares by a possible hostile bidder.

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<sup>53</sup> In January 2000, M&A Consulting launched a tender offer for shares of Shoei Co., Ltd. (“Shoei”), a real estate business company. However, certain major shareholders of Shoei, which together held more than 60% of Shoei shares, opposed the tender offer. In addition, Shoei announced a restructuring plan. The tender offer failed. In May 2002, M&A Consulting engaged in a proxy contest for control of Tokyo Style Co., Ltd., an apparel company. However, M&A Consulting eventually lost the proxy contest. In November 2005, M&A Consulting launched a competitive tender offer against a friendly tender offer by Nisshinbo Industries, Inc (“Nisshinbo”) for shares of New Japan Radio Co., Ltd. (“New Japan Radio”), a microwave-related product manufacturer. The highest tender offer price for M&A Consulting was 950 yen per share compared to a high of 880 yen per share for Nisshinbo. However, Japan Radio Co., Ltd., the parent company of New Japan Radio which held slightly under a majority of New Japan Radio shares, accepted Nisshinbo’s tender offer. Consequently, the M&A Consulting tender offer failed.

<sup>54</sup> This transaction also includes a famous Japanese professional baseball—the Hanshin Tigers. *See* note 50 *supra*.

### **III. Key Issues for the U.S. Practitioner**

Having now reviewed the recent changes in Japanese law and a few recent contested deals from this past year, the challenge for the U.S. practitioner is to boil down the complexity of Japanese M&A to a list of key issues that should be reviewed in any transaction which involves Japanese entities. In reaching such a concentrated analysis, however, the problem with any set of action items or the like is that it cannot replace a thorough analysis of the variety of legal issues in different jurisdictions that will necessarily arise in any cross-border deal. At the same time, in practice such lists are frequently helpful in organizing the various tasks and issues that must be considered. With these thoughts in mind, in this section we have set forth some of the main issues under Japanese law and U.S. securities laws that have often come into play in Japanese deals.

#### **A. Structuring the Transaction under Japanese Law**

Beginning with the fundamentals, there are seven basic transaction structures that are most often used in takeovers under the Corporation Law. Although these structures may be similar to certain transactions under the Delaware General Corporation Law that are familiar to U.S. practitioners, it is important to remember the obvious but essential point—these are not your usual DGCL transactions. In a given deal, therefore, the seven

structures below will likely require some measure of additional time and consideration prior to the final determination of an appropriate transaction structure.<sup>55</sup>

(1) Stock Purchase

A simple stock purchase of public company shares through the market is one option to obtain control of the target.<sup>56</sup> However, when the acquirer purchases a certain number of shares of a public company outside of the market, such purchases may be subject to the mandatory tender offer rules in Japan.<sup>57</sup>

(2) Issuance of New Shares

As a general matter under Japanese law, the board of the target public company can issue new shares to a third party or shareholders who seek to acquire the target public company, up to the authorized number of shares as set forth in such target's articles of incorporation.<sup>58</sup> However, if the subscription price for newly issued shares is deemed

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<sup>55</sup> As is often the case, tax and accounting issues, as well as possible rights and obligations under certain contracts that are reviewed as part of the due diligence process, will play a large role in determining the appropriate structure for a Japanese deal. These issues are beyond the intended scope of this article.

<sup>56</sup> See Corporation Law, art. 127.

<sup>57</sup> These issues are addressed in further detail in the discussion of the tender offer rules at Section III.B(1) *infra*.

<sup>58</sup> See Corporation Law, art. 199, para. 2, and art. 201, para. 1. Note, however, that the issuance of new shares is not subject to the mandatory tender offer rules. See Securities and Exchange Law, art. 27-2, para. 1; THE TENDER OFFER REPORT, at 4.

“especially favorable”<sup>59</sup> to the subscribing shareholders and all the outstanding shareholders are not entitled to subscribe for them, it will become necessary to obtain a supermajority vote of two-thirds or more of all voting rights (“Supermajority Vote”).<sup>60</sup> Under Japanese law and stock exchange regulations, there is no rule that is equivalent to the New York Stock Exchange rule that shareholder approval is required for the issuance of 20% or more of outstanding shares.<sup>61</sup>

### (3) Merger (*gappei*)

Japanese *gappei* are statutory mergers under the Corporation Law. Similar to a direct proposed merger in the U.S., *gappei* require a negotiated merger agreement between the acquirer and the target company which provides that the target company (the disappearing company) will merge into the acquirer (the surviving company).<sup>62</sup> In Japanese mergers, all assets and liabilities of the target company are transferred to the surviving company by operation of law, and target company shareholders receive shares

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<sup>59</sup> Although there are no bright line rules in the Japanese cases as to what is an “especially favorable” issuance, in practice the subscription price per share is often regarded as “especially favorable” if it is less than 90% of recent average market prices. See *Matsuka v. Miyairi Barubu Seisakujo* (Tokyo Dist. Ct., June 1, 2004), summarized in Yo Ota, *Miyairi Barubu no Shinkabuhakko Sashidome Moshitate Jiken Tokyo District Court Kettei* [Ruling of Tokyo District Court regarding Claim for Injunction of Issuance of New Shares of Miyairi Barubu], 1702 *Shoji Homu* 24, 24-25 (2004).

<sup>60</sup> More specifically, the supermajority requirement is two-thirds or more of the voting rights of shareholders who attend the shareholders meeting, unless the threshold is otherwise increased in the target’s articles of incorporation. See Corporation Law, art. 309, para. 2, no. 5.

<sup>61</sup> See NYSE Listed Company Manual § 312.03(c) (2004).

<sup>62</sup> See Corporation Law, chapter 5, subchapter 2.

of the surviving company as consideration.<sup>63</sup> However, under the new Corporation Law, target company shareholders may receive other forms of consideration such as cash and shares of other companies (i.e., consideration will no longer be limited to shares of the surviving company).<sup>64</sup> Japanese mergers are generally subject to a Supermajority Vote at the shareholders meeting of each of the disappearing and surviving companies.<sup>65</sup>

(4) Business Transfer (*jigyo joto*)

Business transfers are similar to asset sales in the United States. They also require a negotiated agreement between the target company and the acquirer, with such agreement providing that certain assets and liabilities will be transferred from the target company to the acquirer.<sup>66</sup> The transfer of contracts (including employment contracts) generally requires the consent of the other parties to such contracts under Japanese law. Furthermore, if the transferred assets and liabilities constitute “all or an important part” of the target company’s business, the business transfer in question generally requires a Supermajority Vote of the target company shareholders.<sup>67</sup> In addition, if the transferred

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<sup>63</sup> See Corporation Law, art. 749, para. 1, no. 2(i).

<sup>64</sup> For additional details on this point, please refer to the discussion on triangular mergers at Section III.C *infra*.

<sup>65</sup> See Corporation Law, art. 783, para. 1; art. 795, para. 1; and art. 309, para. 2, no. 12.

<sup>66</sup> See Corporation Law, art. 467.

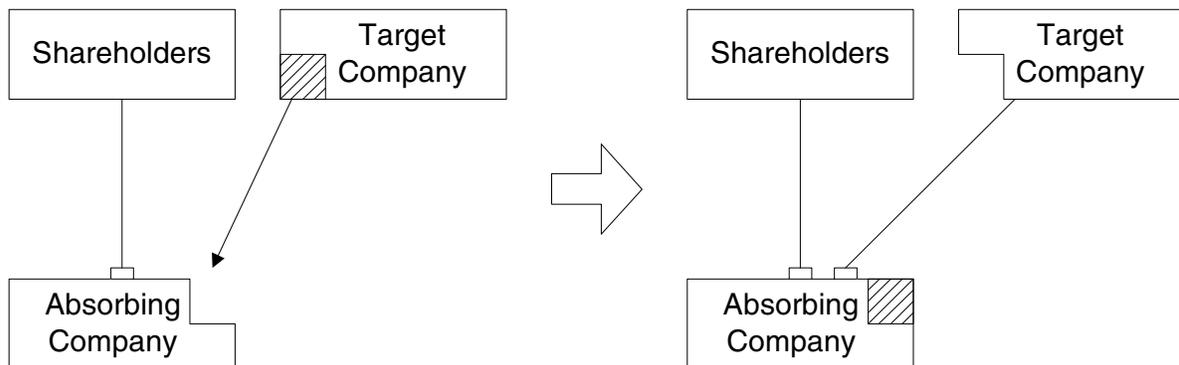
<sup>67</sup> See Corporation Law, art. 467, para. 1, no. 1 and 2, and art. 309, para. 2, no. 11. Under the new Corporation Law, if the book value of the transferred assets does not exceed 20% of the amount of all assets of the target company (with such amount calculated in accordance with an ordinance of the Ministry of Justice), the business transfer is not regarded as “important” unless as may otherwise be provided in the articles of incorporation of the target company.

assets and liabilities constitute all of the target company's business, the business transfer generally requires a Supermajority Vote of the acquirer shareholders.<sup>68</sup>

(5) Demerger (*bunkatsu*)

The demerger structure is in many ways similar to business transfers as discussed above. There are two kinds of demergers under the Corporation Law.

(i) Absorption Demerger (*kyushu bunkatsu*)



In an absorption demerger, by means of a negotiated agreement between the target company and the absorbing company (a) certain assets and liabilities of the target company are transferred to the absorbing company and (b) the target company receives absorbing company shares as consideration.<sup>69</sup> However, in the same manner as discussed previously with mergers, under the new Corporation Law in an absorption demerger the

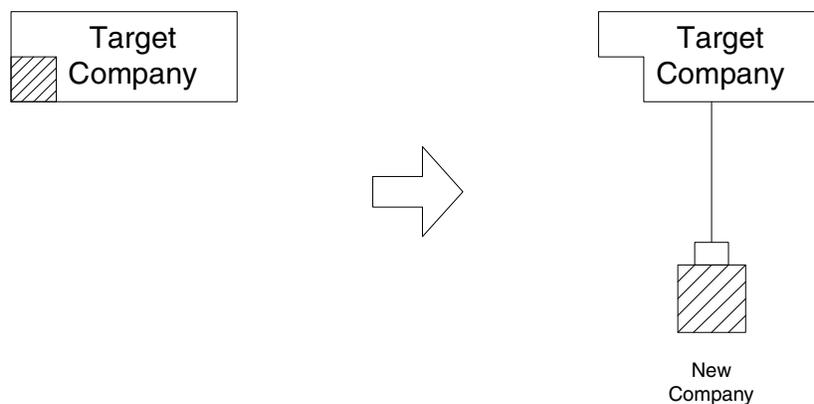
<sup>68</sup> See Corporation Law, art. 467, para. 1, no. 3, and art. 309, para. 2, no. 11.

<sup>69</sup> See Corporation Law, art. 758, no. 4(i).

target company may receive other forms of consideration such as cash and shares of other companies (i.e., consideration is no longer limited to shares of the absorbing company).<sup>70</sup>

Note, however, that the new Corporation Law does not permit such other forms of consideration in the second kind of demerger—the incorporation demerger.

(ii) Incorporation Demerger (*shinsetsu bunkatsu*)



In an incorporation demerger, by means of a *demerger plan* of the target company (a) the target company incorporates a new company by transferring certain of its assets and liabilities to such new company and (b) the target company receives new company shares as consideration.<sup>71</sup> In both an absorption and incorporation demerger, assets and liabilities are generally transferred by operation of law.<sup>72</sup> In contrast to business transfers, however, in both absorption and incorporation demergers the transfer of contracts

<sup>70</sup> See Corporation Law, art. 758, no. 4(ii)-(v).

<sup>71</sup> See Corporation Law, art. 763, no. 6.

<sup>72</sup> See Corporation Law, art. 759, para. 1; art. 764, para. 1.

(including employment contracts) generally *does not* require the consent of the other parties to such contracts.<sup>73</sup> However, both absorption and incorporation demergers involve certain additional disclosure requirements and mandatory procedures to protect creditors, which do not apply in the case of business transfers.<sup>74</sup>

A key benefit of both absorption and incorporation demergers is that any number of companies can jointly conduct the demerger.<sup>75</sup> This facet of demergers make them attractive structures in joint ventures where each party holds a certain number of subsidiaries, but may wish to effect a business transfer (i.e., an asset sale) rather than a stock sale of one or more of the subsidiaries to be contributed to the joint venture due to certain business, tax, accounting or other reasons. Demergers can also be useful structures in LBO transactions so that the target company can demerge certain assets and liabilities to a new company, which will then be acquired in a stock purchase by an acquisition vehicle. Such a structure may be particularly advantageous in circumstances where the parties seek to exclude contingent liabilities from the deal. Finally, it should be noted that demergers generally require a Supermajority Vote of (a) the target company

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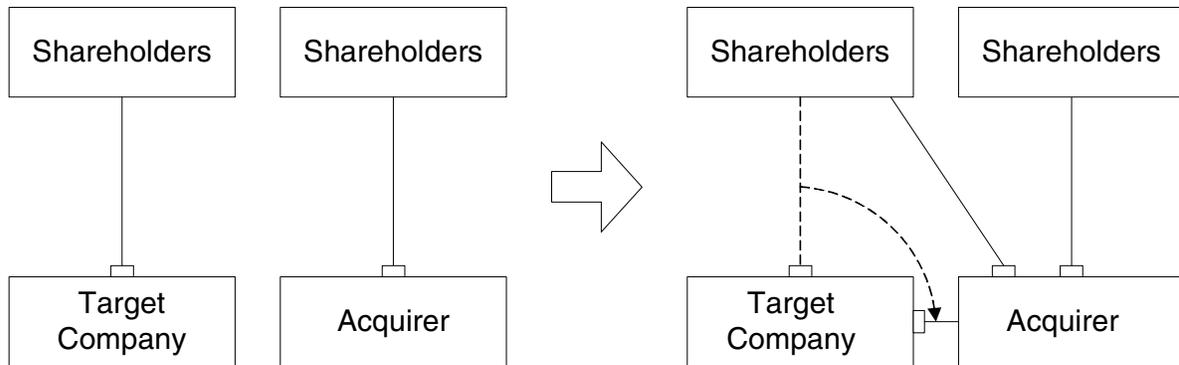
<sup>73</sup> See Corporation Law, art. 759, para. 1; art. 764, para. 1.

<sup>74</sup> See Corporation Law, art. 782; art. 791, art. 803; 811; art. 789, art. 810.

<sup>75</sup> See EGASHIRA, at 707; Corporation Law, art. 762, para. 1.

shareholders and absorbing company shareholders in an absorption demerger<sup>76</sup> or (b) the target company shareholders in an incorporation demerger.<sup>77</sup>

(6) Stock-for-Stock Exchange (*kabushiki kokan*)



An interesting structure under Japanese law that can often be used to “squeeze out” minority shareholders is the stock-for-stock exchange. In a *kabushiki kokan*, pursuant to a negotiated agreement between the target company and the acquirer (a) the acquirer acquires all of target company shares by operation of law and (b) target company shareholders receive acquirer shares as consideration.<sup>78</sup> Stock-for-stock exchanges generally require a Supermajority Vote of each of the target company and acquirer shareholders.<sup>79</sup> Accordingly, if one can obtain the approval of two-thirds or more of target shareholders (as well as of course the approval of the target board when signing the

<sup>76</sup> See Corporation Law, art. 783, para. 1; art. 795, para. 1; and art. 309, para. 2, no.12.

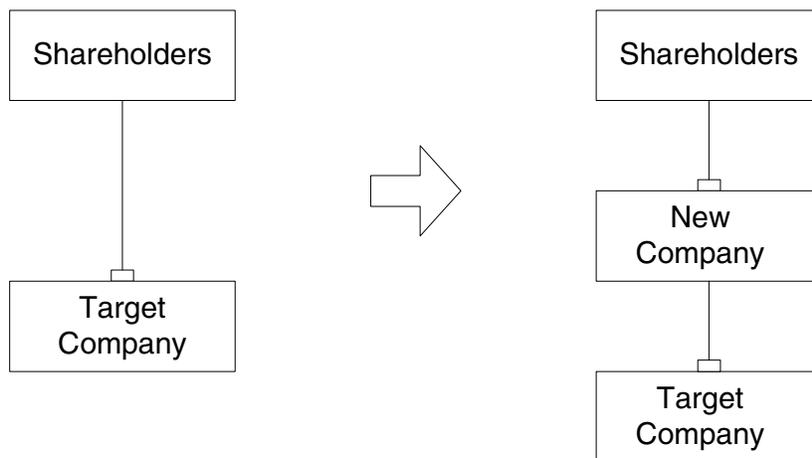
<sup>77</sup> See Corporation Law, art. 804, para. 1; and art. 309, para. 2, no.12.

<sup>78</sup> See Corporation Law, art. 769, para. 1.

<sup>79</sup> See Corporation Law, art. 783, para. 1; art. 795, para. 1; and art. 309, para. 2, no. 12.

stock-for-stock exchange agreement), the remaining one-third of target shareholders will have their target shares exchanged for acquirer shares which should decrease their voting power on a fully diluted basis. At the same time, however, the exchange of shares will effect the voting power of all the target company and acquirer shareholders because the total number of acquirer shares will necessarily increase as a result of the stock-for-stock exchange. The new Corporation Law rules on consideration apply in stock-for-stock exchange transactions, and thus target company shareholders may receive other forms of consideration such as cash and shares of other companies (i.e., consideration is not limited acquirer shares).<sup>80</sup> Such changes to Japanese law may facilitate more cash-out mergers of minority shareholders as is common in the United States.<sup>81</sup>

(7) Stock Transfer (*kabushiki iten*)



<sup>80</sup> See Corporation Law, art. 768, para. 1, no. 2(ii)-(v).

<sup>81</sup> See, e.g., Del. Gen. Corp. Law § 253.

Another structure which permits the consolidation of shares, but in a manner distinct from stock for-stock exchanges, is the stock transfer. A *kabushiki iten* requires a *stock transfer plan* of the target company, by means of which (a) a new company will be incorporated, (b) the new company will acquire all of target company shares by operation of law, and (c) target company shareholders will receive new company shares.<sup>82</sup> Stock transfers require a Supermajority Vote of the target company shareholders.<sup>83</sup> Moreover, any number of companies can jointly conduct a stock transfer.<sup>84</sup> In such joint stock transfers (*kyodo kabushiki iten*), several target companies can create a new joint holding company with each of the target companies becoming a wholly owned subsidiary thereof.<sup>85</sup> These transactions are particularly useful when parties agree to integrate their businesses, but would like to keep certain operations separate as a practical matter. Such a structure can also work to consolidate the shareholdings in a group of companies while also possibly improving the defensive profile of a company that is likely to be a target of a hostile bidder by correcting any distortions in such company's shareholding relationships with its affiliates since it will become a wholly owned subsidiary of a new holding company.

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<sup>82</sup> See Corporation Law, art. 772, para. 1; art. 774, para. 1; and art. 774, para. 2.

<sup>83</sup> See Corporation Law, art. 804, para. 1; and art. 309, para. 2, no. 12.

<sup>84</sup> See Corporation Law, art. 772.

<sup>85</sup> For example, on April 20, 2005, Seven-Eleven Co., Ltd., Ito-Yokado Co., Ltd., and Denny's Japan Co., Ltd. announced that they would conduct a joint stock transfer, which when closed on September 1, 2005 resulted in a \$12 billion transaction.

## B. Tender Offers and Proxy Contests

A common factor among all the basic transaction structures under the Corporation Law discussed above is that, with the notable exception of stock purchases, they all require some type of negotiated agreement or plan with management. If such negotiations do not result in such an agreement or plan or may be impractical as the case may be, Japanese law provides for tender offers in a manner that will be familiar to the U.S. practitioner. The Japanese takeover bid<sup>86</sup> rules (“TOB rules”) were modeled after the Williams Act and became part of the Securities and Exchange Law in 1971.<sup>87</sup> While it is still relatively rare in Japan for a hostile bidder to go directly to the shareholders by means of a TOB, such strategies have been more aggressively pursued in recent years by Japanese companies (e.g., Yumeshin) and certain shareholder activists (e.g., M&A Consulting). However, even in cases where an acquirer can reach an agreement with management, the TOB rules may still apply and thus should be an item that is included as part of the overall consideration of a possible transaction.

### (1) TOB Rules

Many acquisitions of Japanese public companies technically begin with a tender offer due to the mandatory TOB rules in Japan which apply irrespective of whether a

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<sup>86</sup> In the United States, we often refer to the “tender offer rules” under Regulations 14D and 14E of the Exchange Act. *See* 17 C.F.R. § 240.14d-1 *et seq.* Although Japanese securities law has historically referred to U.S. securities law when making new rules and regulations, in this case it appears that the English term “takeover bids” is the more favored expression amongst practitioners.

<sup>87</sup> *See generally* THE TENDER OFFER REPORT, at 1.

specific acquisition is friendly or hostile. As a general matter, an off-market acquisition of shares requires compliance with the TOB rules if (a) an acquirer group purchases more than five percent of the voting rights of the target company from more than ten sellers within a period of 60 days or (ii) an acquirer group purchases more than one third of the voting rights in the target company.<sup>88</sup>

Once the mandatory TOB rules are triggered, various disclosure and procedural requirements apply to the transaction in a manner similar to U.S. practice. For instance, under the TOB rules the tender offer period must be scheduled to last between 20 calendar days and 60 calendar days.<sup>89</sup> There is no requirement that the tender offeror must purchase all outstanding shares. Instead, the tender offeror usually sets the minimum and/or maximum number of shares it will purchase.<sup>90</sup> When the shares tendered fall below the stated minimum, the tender offeror will not purchase any shares. In cases where the shares tendered exceed the stated maximum, the tender offeror purchases shares on a pro-rata basis. Although the TOB rules permit the use of securities as consideration in tender offers, there have been relatively few instances of exchange

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<sup>88</sup> See Securities and Exchange Law, art. 27-2, para. 1. Note that the mandatory TOB rules do not apply to an issuance of new shares, mergers and stock-for-stock exchanges. See *id.*; THE TENDER OFFER REPORT, at 4; NISHIMURA & PARTNERS, M&A-HO TAIZEN [Corpus Juris M&A] 59-60 (2001).

<sup>89</sup> See Securities and Exchange Law, art. 27-2, para. 2. The FSA has recently considered whether to amend the rules from calendar days to business days, although no final action has yet taken place. See THE TENDER OFFER REPORT, at 7.

<sup>90</sup> See Securities and Exchange Law, art. 27-13, para. 4.

offers in Japan primarily due to the absence of tax rules which would permit tendering shareholders to defer their capital gains in exchange offers.<sup>91</sup>

After the launch of a tender offer, the tender offeror may withdraw the offer only for certain enumerated reasons as set forth in the TOB rules, such as an impending merger, the initiation of bankruptcy proceedings and so forth.<sup>92</sup> Additionally, under the current TOB rules a tender offeror may not reduce the maximum number of shares to be purchased or reduce its tender offer price. However, the FSA is considering possible amendments to the TOB rules which would permit a tender offeror to reduce its tender offer price in certain limited circumstances such as when the target company announces a stock split as occurred in the Yumeshin bid for JEC.<sup>93</sup>

Another important point to take away from the Yumeshin bid is that compliance with the applicable TOB rules is not always the end of the analysis. As you may recall,

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<sup>91</sup> In contrast to cash tender offers, the issuer of securities in an exchange offer in Japan may become subject to disclosure obligations under the Securities and Exchange Law, which are comparable to the registration statement requirements of the Securities Act and the continuing disclosure obligations of the Exchange Act. *See* Securities and Exchange Law, art. 27-4, para. 1. In the recent Amendment to the Securities and Exchange Law (which was enacted in December 2005, but will have an effective date prior to March 2009 as yet to be determined), non-Japanese companies may submit English-language documents together with Japanese summaries thereof to satisfy the applicable disclosure requirements in certain cases. *See* Supplementary Provisions of Securities and Exchange Law, Law No. 76 of 2005, art. 1; art. 2. These changes to Japanese securities laws are expected to ease the burden on non-Japanese companies that already have continuing disclosure obligations under Japanese law.

<sup>92</sup> *See* Securities and Exchange Law, art. 27-11, para. 1. As noted previously, the FSA has recently considered expanding the list of reasons for withdrawal of tender offers in response to an increase in the defensive measures used by Japanese companies. *See* THE TENDER OFFER REPORT, at 8-9.

<sup>93</sup> *See id.*, at 9.

in response to Yumeshin's business alliance proposal, JEC announced a general defensive policy which stated that defensive measures would be taken if an acquirer attempted to continue purchasing shares prior to JEC's review of any proposal submitted by such acquirer. When Yumeshin launched a tender offer for JEC shares, JEC subsequently announced an impending stock split which had the practical effect of delaying the settlement date of the tender offer. Although the legality of such a defensive tactic was upheld in the decision of the Tokyo District Court,<sup>94</sup> the precise balance between the interests of the target company and the tender offeror will likely remain a hot topic in Japanese M&A law with possible amendments to the TOB rules being an important development to monitor in the months and years ahead.

## (2) Proxy Contests

While proxy contests remain somewhat of a rare event in Japanese deals,<sup>95</sup> they do still occur and thus remain a possible option for the acquirer.<sup>96</sup> For instance, in certain

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<sup>94</sup> See *supra* note 49.

<sup>95</sup> Even in the United States, proxy contests are rare due to the effective results that can often be realized in a well planned tender offer. Additionally, the high profile, costs and risks associated with staging a proxy contest should not be underestimated. This said, the threat of an impending proxy contest has long been a possible strategy for the acquirer. The Delaware Supreme Court in *Unocal* observed this organic and multifaceted nature to M&A strategies when noting, "[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs...In [prior cases], the tender offer, while not an unknown device, was virtually unused with their coercive effects. Then, the favored attack of a raider was stock acquisition followed by a proxy contest. Various defensive tactics, which provided no benefit whatever to the raider, evolved. Thus, the use of corporate funds by management to counter a proxy battle was approved." *Unocal*, 493 A.2d at 957.

<sup>96</sup> See discussion of the M&A Consulting proxy contest for control of Tokyo Style Co., Ltd. in *supra* note 53.

cases the tender offeror may also wish to engage in or threaten a possible proxy contest as an ancillary strategy against the target company. Specifically, the tender offeror may consider a proxy contest when (a) its tender offer closes after the record date for shareholders who may attend the next shareholders meeting of the target company or (b) the tender offeror requires voting rights in excess of the stated maximum in its tender offer in order to obtain control of the target company (e.g., the tender offeror purchases a simple majority of target company shares through the tender offer, but needs a supermajority of voting rights at the upcoming shareholders meeting in order to defeat the incumbent board).

The Defensive Measures Guidelines briefly discuss these issues in noting that a tender offer combined with a proxy contest would enhance the efficacy of a proxy contest to cancel a rights plan.<sup>97</sup> In dealing with such issues, the Defensive Measures Guidelines recommend that a rights plan be redeemed by a vote at a single shareholders meeting.<sup>98</sup> Unlike the United States, in Japan shark repellants such as staggered boards are not as common a defensive strategy and thus Japanese companies should be able to follow this recommendation without much difficulty.<sup>99</sup> Accordingly, for a Japanese deal only one

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<sup>97</sup> See THE DEFENSIVE MEASURES GUIDELINES, at 15-16. Note that the Defensive Measures Guidelines prohibit dead hand poison pills. Specifically, the Defensive Measures Guidelines prohibit a rights plan that cannot be redeemed: (i) if one of the directors who was a director at the time of the adoption of such rights plan is replaced; (ii) unless a majority of directors at the time of adoption of such rights plan is replaced; or (iii) for a certain period of time even if a majority of the directors is replaced. See *id.* 16.

<sup>98</sup> See THE DEFENSIVE MEASURES GUIDELINES, at 9.

<sup>99</sup> See the discussion of staggered boards at Section III.D(2) *infra*.

proxy contest may be sufficient to replace incumbent directors whereas it may be necessary to have more than one proxy contest to take control of the board in the United States.

### C. Triangular Mergers

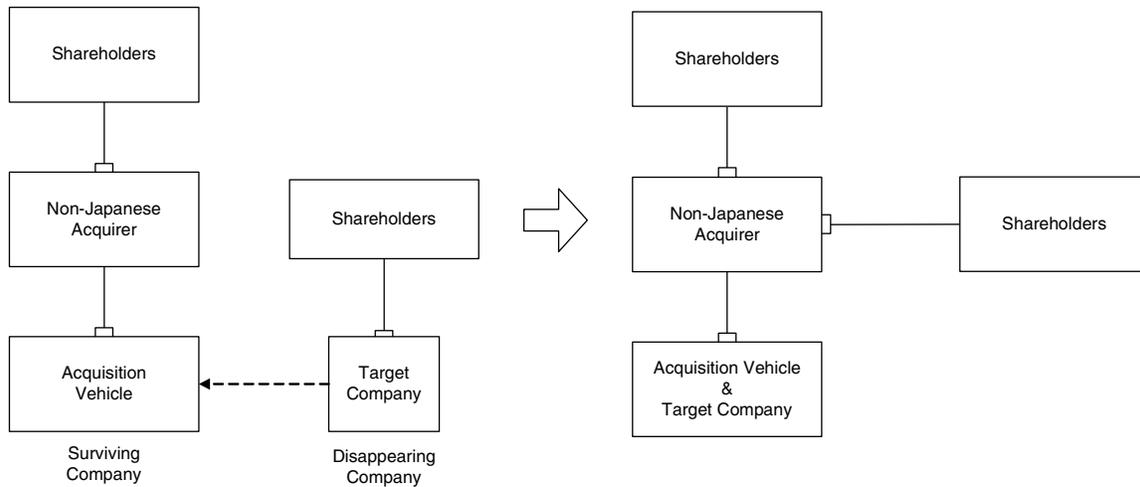
As noted previously, one of the significant changes to come out of the new Corporation Law are the provisions dealing with the expansion of cash-out and triangular mergers.<sup>100</sup> Specifically, these new provisions permit the acquirer as surviving company in a merger to distribute cash and/or shares of another company (e.g., a non-Japanese parent company of the acquirer) to the shareholders of the disappearing company.<sup>101</sup> The practical effect of these amendments to the Corporation Law is that for the first time non-Japanese entities may acquire all the shares of a Japanese public company through either a forward triangular merger or a de facto reverse triangular merger without government approval as required under Law on Special Measures for Industrial Revitalization. Provided below are descriptions of these two structures that one could expect to see once the provisions of the new Corporation Law take effect in May 2007.

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<sup>100</sup> For a more detailed analysis of the new rules relating to triangular mergers, see Takefumi Sato & Daisuke Matsubara, *Cash-out option means more M&A flexibility*, The IFLR Guide to Japan 2006, International Financial Law Review, Jan. 2006, at 21-25.

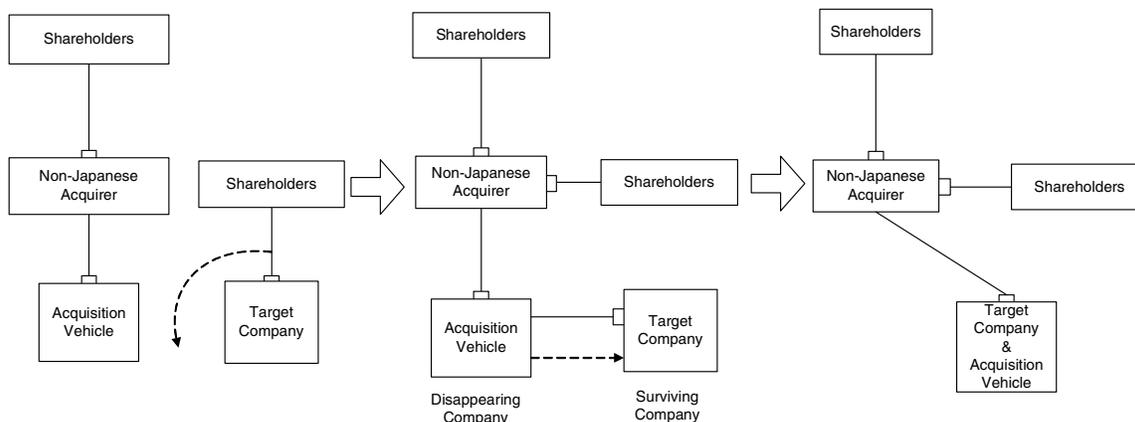
<sup>101</sup> See Corporation Law, art. 749, para. 1, no. 2; art. 768, para. 1, no. 2. Additionally, the surviving entity may also distribute other assets such as share purchase warrants and bonds. See Corporation Law, art. 749, para. 1, no. 2; art. 768, para. 1, no. 2

(1) Forward Triangular Merger



The Corporation Law does not permit mergers between Japanese companies and non-Japanese companies and the amendments to the new Corporation Law have not changed these provisions. Accordingly, in order to utilize the new rules permitting various forms of consideration in cross-border transactions, the non-Japanese acquirer must first either create or own a Japanese acquisition vehicle which will hold the cash and/or shares of the non-Japanese acquirer that will serve as the consideration for the transaction. A forward triangular merger results when the target company merges into the acquisition vehicle and the non-Japanese acquirer causes such acquisition vehicle to distribute cash and/or the shares to the target company shareholders.

(2) De Facto Reverse Triangular Merger



The de facto reverse triangular merger largely resembles a forward triangular with the significant structural difference being that, instead of a merger of the target company into the acquisition vehicle as is the case in a forward triangular merger, in a de facto reverse triangular merger the acquisition vehicle and target company conduct a stock-for-stock exchange whereby the acquisition vehicle acquires all of target company shares by operation of law.<sup>102</sup> Thus, the acquisition vehicle and target company will enter into a stock-for-stock exchange agreement which will provide that non-Japanese acquirer cash and/or stock will serve as the consideration for the acquisition of all target company shares. As noted previously, the stock-for-stock exchange will generally require a Supermajority Vote of each of the acquisition vehicle and target company shareholders. After the completion of the stock-for-stock exchange, the target company will become a

<sup>102</sup> See Corporation Law, art. 767; art. 768.

wholly owned subsidiary of the acquisition vehicle. In order to complete the de facto reverse triangular merger, the acquisition vehicle will then merge into the target company, which will result in the target company becoming a wholly owned subsidiary of the non-Japanese acquirer. The primary benefits of this structure is that, similar to a reverse triangular merger in the United States, it will enable (i) the target company to remain the surviving company, (ii) the non-Japanese acquirer to own all of the target company shares, and (iii) target company shareholders to receive cash and/or shares of the non-Japanese acquirer.

### (3) Effective Date of the Amendments

Although the triangular merger amendments to the Corporation Law were requested by certain Japanese business interests, the effective date for these amendments has been delayed until May 2007, which will be precisely one year after the other provisions of the new Corporate Law come into effect. However, these same triangular merger structures can be used prior to May 2007 in the event that the Law on Special Measures for Industrial Revitalization (the “Industrial Revitalization Law”) applies to the transaction. The Industrial Revitalization Law, a special purpose law that is expected to continue for a limited period of time, is a result of the legislative initiatives of METI which seek to enhance the productivity of certain Japanese industries.<sup>103</sup> In a transaction

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<sup>103</sup> An English summary of the recent amendment of the Industrial Revitalization Law, which includes the provisions on triangular mergers, is available at [http://www.meti.go.jp/policy/business\\_infra/downloadfiles/3-4.pdf](http://www.meti.go.jp/policy/business_infra/downloadfiles/3-4.pdf) (last visited Mar. 7, 2006).

subject to the Industrial Revitalization Law, the approval of a competent government minister is required as part of the application to be filed with the proper authorities. This approval is provided under certain enumerated conditions,<sup>104</sup> and in recent years there have been a number of MBO and LBO transactions which received the necessary approvals under the Industrial Revitalization Law.<sup>105</sup>

#### (4) Tax Treatment

One reason why it is anticipated that U.S. companies would prefer using a triangular merger structure when acquiring a Japanese company is their ability to access the U.S. capital markets in financing Japanese deals.<sup>106</sup> While the triangular merger amendments will permit stock deals in the manner described above, at the present time there are no tax laws which provide incentives to non-Japanese companies along the lines of the tax free reorganization rules for triangular mergers that currently apply in the

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<sup>104</sup> Among other requirements, a transaction must fall within one of the following categories in order to be approved: (i) a “self-restructuring plan”, (ii) a “business transfer and restart plan”, or (iii) a “co-restructuring plan.” Takefumi Sato & Daisuke Matsubara, *Cash-out option means more M&A flexibility*, at 23-24.

<sup>105</sup> For instance, The Carlyle Group acquired KITO Corporation, a manufacturer of material handling equipment, in 2003 through an LBO which was the first cash-out merger under the Industrial Revitalization Law. For a discussion of the various issues associated with going-private transactions under the Industrial Revitalization Law, see generally Hiroshi Uchima & Masaki Noda, *Going Private no Hoteki Shuho to Ryuiten* [Legal Structures and Issues of Going Private], 1675 *Shoji Homu* 81 (2003); Tatsuya Tanigawa & Mihoko Fukuzawa, *Sangyosaiseiho wo Riyoshita Going Private no Jitsumu* [Practice of Going Private under the Industrial Revitalization Law], 1676 *Shoji Homu* 22 (2003).

<sup>106</sup> The Corporate Value Study Report noted that the aggregate amount of market capital of corporations listed on the first division of the Tokyo Stock Exchange is approximately \$3.1 trillion (when assuming that one dollar is equal to 110 yen) as of August 2004, whereas the comparable figure for the New York Stock Exchange is \$12.3 trillion as of August 2004. See THE CORPORATE VALUE STUDY REPORT, at 15.

United States.<sup>107</sup> In order to harmonize the rules on triangular mergers in the United States and Japan and facilitate more cross-border transactions in the future it would be desirable if the necessary amendments to Japanese tax laws were considered in concert with the scheduled changes to take effect in May 2007. In the absence of such changes to Japanese tax law, the effective cost of capital in a Japanese triangular merger may be considerably higher than in a similar transaction that qualifies as a tax free reorganization in the United States. Such increased financing costs may ultimately be shouldered by the surviving business and become an issue for further negotiation between the parties as the case may be, and thus bringing more closely together the objectives of Japanese corporate and tax law is a goal worth pursuing.

#### (5) Appraisal Rights

The new Corporation Law has also amended the provisions relating to the appraisal rights of shareholders in, *inter alia*, a merger (for forward triangular mergers) or a stock-for-stock exchange (for de facto reverse triangular mergers). In particular, the amendments provide that the appraisal price must be a “fair price” which would include any synergies arising from the deal.<sup>108</sup> Under prior law, the appraisal price did not

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<sup>107</sup> For a discussion of the tax issues associated with transactions under the Industrial Revitalization Law, see Yo Ota & Tatsuya Tanigawa, *Japan’s New M&A Measures Open Door for Tax Benefits*, 30 Tax Notes International 887 (2003).

<sup>108</sup> See Corporation Law, art. 785, para. 1; art. 797, para. 1; art. 806, para. 1. See also Kenjiro Egashira, *Kaisha Hosei no Gendaika ni kansuru Yokoan (V)* [Commentary on Draft Outline of Modernization of Corporation Law System (V)], 1725 Shoji Homu 4, 9 (2005). Precisely how a court would determine the value of any perceived synergies remains an unresolved issue.

include any possible valuation effects of the merger or the stock-for-stock exchange on the relevant shares of the surviving company. In contrast to Delaware,<sup>109</sup> there is no market-out rule in Japan and thus appraisal rights are granted even if the stock used as consideration in the merger or stock-for-stock exchange is publicly traded. Thus, future developments in Japanese case law concerning the appropriate methods to calculate fair price in the appraisal context should be a matter that is monitored on a consistent basis.

#### D. Defensive Measures

In response to the increase in hostile deal activity in Japan, we have seen a marked increase in the defensive measures being considered by Japanese companies in order to forestall any would be corporate raiders. These actions by possible target companies began in earnest when the Livedoor hostile bid for NBS was on the front pages of Japanese newspapers. In this respect, as a consequence of Livedoor, many Japanese companies suddenly viewed themselves as more susceptible to takeovers. Since the precise extent to which Japanese companies can properly employ defensive measures is still an evolving area of law, we have outlined below some of the main points that can be observed at present.

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<sup>109</sup> See Del. Gen. Corp. Law §§ 262(b)(1), (2) (2005).

(1) Japanese Rights Plans

The most significant new defensive measure used by Japanese companies and the one that has justifiably received the most attention and scrutiny is the use of rights plans, typically through the issuance of share purchase warrants (*shinkabu-yoyaku-ken*).<sup>110</sup> The Defensive Measures Guidelines have provided the most recent guidance on the extent to which Japanese companies should be able to adopt rights plans, especially through the issuance of share purchase warrants, with the hope that such rules will prevail in practice although they do not have the force of law in a strict sense. As a result, some Japanese companies have adopted rights plans under the Defensive Measures Guidelines while others have not. The various legal issues concerning rights plans have been analyzed intensively since Livedoor case. What we have seen is what one might expect in these circumstances—much variety and flexibility across the market with companies adopting rights plans that are tailored to address the particular issues associated with their businesses. Although the specific terms and conditions of each of these rights plans may differ, as a legal matter the poison pills in Japan that are presently being used by target companies can be roughly categorized into four types, three of which involve the issuance of share purchase warrants.

- *Prior Warning Pills.* In this type of poison pill, as a general matter the target company issues a public warning by announcing that any potential

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<sup>110</sup> See note 6 *supra* regarding the use of the terms rights plans and poison pills in this article.

acquirers must (i) submit certain information in order for the target company to evaluate their acquisition proposal and (ii) refrain from purchasing target company shares until the evaluation of such acquisition proposal is reasonably completed. In the event that the acquirer fails to comply with such procedures or, in some cases, the target company believes that the acquisition will significantly decrease corporate value, then the target company will take certain defensive measures.<sup>111</sup> The general defensive policy announced by JEC in response to Yumeshin's proposed business alliance is an example of a prior warning pill. Prior warning pills are also sometimes used in conjunction with other types of defensive measures as part of a company's entire defensive profile.<sup>112</sup>

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<sup>111</sup> In some cases, a target company simply announces its evaluation of an acquisition proposal and only asks its shareholders to reject a tender offer (i.e., the target company does not take additional defensive measures), which remains the case as long as the acquirer complies with procedures required by the target company. See MATSUSHITA ELECTRIC INDUSTRIAL CO., LTD., MATSUSHITA ANNOUNCES PLANS TO MAXIMIZE SHAREHOLDER VALUE (Apr. 28, 2005), <http://panasonic.co.jp/corp/news/official.data/data.dir/en050428-8/en050428-8.html> (last visited Mar. 7, 2006).

<sup>112</sup> For example, Nippon Steel Corporation announced on March 29, 2006 that (i) it adopted a prior warning pill, (ii) Nippon Steel Corporation, Sumitomo Metal Industries, Ltd. and Kobe Steel, Ltd. signed a memorandum of understanding "which ensures the process for the three companies to cooperatively study the impacts on the strategic alliance and countermeasures in the event that an unsolicited offer is made to one of the three companies", and (iii) "the three companies have purchased the shares of each other." See NIPPON STEEL CORPORATION, PROGRESS IN TIE-UP MEASURES BY NIPPON STEEL, SUMITOMO METALS AND KOBE STEEL, AND AGREEMENT ON FURTHER ENHANCEMENT OF COOPERATION 1-2 (Mar. 29, 2006), <http://www0.nsc.co.jp/data/20060329120934.pdf> (last visited Mar. 30, 2006); NIPPON STEEL CORPORATION, NIPPON STEEL ANNOUNCES THE ADOPTION OF FAIR RULES FOR THE ACQUISITION OF SUBSTANTIAL SHAREHOLDINGS (TAKEOVER DEFENSE MEASURE) AND THE SHELF REGISTRATION OF STOCK ACQUISITION RIGHTS 1 (Mar. 29, 2006), <http://www0.nsc.co.jp/data/20060330115130.pdf> (last visited Mar. 30, 2006).

- *Trust Pills.* In the past year, a number of Japanese companies have issued so-called trust pills.<sup>113</sup> The key point for trust pills is the use of an intermediary, usually a trust, between the issuer and the shareholders. In trust pills, the target company usually issues the share purchase warrants to the trust without consideration and with an exercise price of nominal value. Depending on the specific terms of the trust pill, upon the occurrence of certain trigger events (e.g., crossing a percentage ownership threshold by a hostile bidder) the trust will distribute the share purchase warrants to target company shareholders. The hostile bidder, however, will not be able to exercise the warrants it receives, which results in the dilution effects of the poison pill.<sup>114</sup>
- *Conditional Issuance Pills.* Here, instead of issuing the share purchase warrants without delay, the target company may conditionally resolve to issue (or resolve to conditionally issue) the warrants without consideration at a nominal price to shareholders. This conditional resolution or issuance takes effect only upon the occurrence of certain triggering events as in the

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<sup>113</sup> For example, Wood One Co., Ltd., Seino Transportation Co., Ltd., and Pentax Corporation.

<sup>114</sup> Note that Japanese law does not permit Japanese companies to attach an option right to their shares. This is a critical point since share purchase warrants are not transferred upon a subsequent sale by shareholders of their underlying shares, while in the U.S. the rights “stick” to the shares in question. *See generally* Del. Gen. Corp. Law § 157(a). This unique aspect of share purchase warrants poses numerous issues under the Corporation Law and applicable U.S. securities laws as further discussed *infra*.

case with trust pills, with all shareholders except the hostile bidder given the right to exercise the warrants.

- *Limited Voting Right Pills.* This pill can be adopted under the new Corporation Law.<sup>115</sup> Limited voting right pills permit a company to convert its common shares to limited voting right shares by amending its articles of incorporation, and as part of such conversion the hostile acquirer will be excluded from voting such limited voting right shares in the future.

While some Japanese companies have adopted prior warning and/or trust pills, one should note that there were no cases where Japanese companies adopted conditional issuance or limited voting right pills in 2005. Furthermore, it is anticipated that at the upcoming annual shareholders meetings in June 2006 more Japanese companies will adopt poison pills, which may serve as a barometer on the development of market practices.<sup>116</sup> Thus, it appears that Japanese poison pills will continue to evolve in the near future and remain a matter of intense discussion among practitioners.

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<sup>115</sup> See Corporation Law, art. 322, para. 1, no. 1(ii); art. 108, para. 2, no. 3.

<sup>116</sup> For most Japanese companies, the fiscal year ends on March 31. As a result, the month of June is the most active month for shareholders meetings in Japan.

## (2) Other Notable Defensive Measures

In addition to share purchase warrants, there are other defensive measures that a Japanese company can take which will be familiar to the U.S. practitioner. At the same time, there are certain strategies that are common in the U.S. which are not frequently used in Japan, and thus provided below is a description of selected defensive measures that do and do not work in Japanese deals.

- *Dividend Increases.* Japanese target companies can use dividend increases as a defensive measure to counter the efforts of hostile acquirers. In cases where the target company can expect that an increase in dividends will result in a higher stock price, such a strategy may work in pushing the stock price above the hostile bidder's price in the context of a tender offer. This approach was successfully taken in two notable deals from a few years ago which involved Steel Partners, the U.S. investment fund.<sup>117</sup>

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<sup>117</sup> In December 2003, Steel Partners launched a hostile tender offer for shares of Sotoh Co., Ltd. ("Sotoh"), a texture dyeing company. Although a white knight launched a competing tender offer, Steel Partners' final price (1,550 yen per share) was higher than that of the white knight. In response to these developments, Sotoh announced that it would increase its dividend from 6.5 yen to 193.5 yen per share. The market price of Sotoh shares increased from 1,590 yen to 1,800 yen per share, and thereafter the Steel Partners tender offer failed. Around the same time in December 2003, Steel Partners launched a hostile tender offer for shares of Yushiro Chemical Industry Co., Ltd. ("Yushiro") at 1,150 yen per share. Yushiro announced that it would increase its dividend from 11 yen to 192 yen per share. The market price of Yushiro shares increased to about 1,600 – 1,900 yen from a previous 1,156 yen per share before the announcement. The result was the same: the Steel Partners tender offer failed.

- *Stock splits.* As demonstrated in the Yumeshin – JEC deal, stock splits can be effective defensive measures in tender offers by delaying the settlement date of the tender offer, which will make the tender offer less attractive to shareholders and the tender offeror. In the case of JEC’s stock split, this resulted in the delay of the tender offer settlement by 56 days. However, as a result of recent amendments to the Tokyo Stock Exchange rules, the maximum delay period has effectively become approximately 50 days.<sup>118</sup>
- *Staggered boards.* In contrast to U.S. practice, staggered boards are usually not an effective strategy in Japanese deals. This is because the maximum term of directors is two years under Japanese law, whereas in Delaware the directors can be separated into three classes with three-year terms.<sup>119</sup> Thus, a staggered board for a Japanese company can only delay the hostile acquirer for approximately one year. Additionally, the Defensive Measures Guidelines recommend that a company provide directors with one-year terms when the company in question has adopted a rights plan that lasts longer than one year so that shareholders can indirectly approve the rights plan annually when voting on the slate of

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<sup>118</sup> See Yo Ota, *Nihon Gijutsu Kaihatsu no Kabushiki Bunkatsu Sashitome Karishobun Meirei Moshitate Jiken* [Preliminary Injunction Case of Enjoinment of Stock Split of JEC], 1742 *Shoji Homu* 42, 44; 52 (2005).

<sup>119</sup> See Corporation Law, art. 332, para. 1; Del. Gen. Corp. Law § 141(d).

directors.<sup>120</sup> Furthermore, another reason for the ineffectiveness of staggered boards in Japan is that it is possible to dismiss directors at shareholders meetings without cause.<sup>121</sup>

- *Supermajority voting requirements.* In a manner similar to staggered boards, the use of supermajority voting requirements are not a commonly used defensive strategy in Japanese deals. Unlike in Delaware where the default rule is that a majority of outstanding shares can approve a merger although this threshold may be increased as provided in the certificate of incorporation,<sup>122</sup> Japanese law generally requires a Supermajority Vote for mergers or other significant corporate actions.<sup>123</sup> The new Corporation Law permits Japanese companies to *increase* this supermajority vote requirement by amending the articles of incorporation, but it is not possible to *decrease* the requirement to a majority of the outstanding shares as is the case in Delaware.<sup>124</sup> However, one area where the new

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<sup>120</sup> See THE DEFENSIVE MEASURES GUIDELINES, at 9; 12; 19.

<sup>121</sup> See Corporation Law, art. 339, para. 1; art. 339, para. 2 (indemnification may be available to a director who was dismissed without cause). In Delaware, the general rule is that any director may be removed with or without cause, although removal without cause may not be possible in certain cases when the corporation has elected to classify its board or have cumulative voting. See Del. Gen. Corp. Law §141(k).

<sup>122</sup> See Del Gen. Corp. Law §§ 102(b)(4), 251(c).

<sup>123</sup> See Corporation Law, art. 309, para. 2.

<sup>124</sup> See Corporation Law, art. 309, para. 2.

Corporation Law does provide for a simple majority vote is in the dismissal of directors with or without cause, which may be increased by amendment to the articles of incorporation.<sup>125</sup>

(3) Emerging Issues: Special Committee of Directors

As a corollary to the increase in defensive measures employed by Japanese companies, an issue that has received additional attention of late is the extent to which a special committee of directors should be formed in order to review and consider proposals from hostile bidders. In takeovers under Delaware law, special committees are often used when there is a question as to the independence of target company directors. This will often occur in going private transactions or when a controlling shareholder of the target is the acquirer. In such cases, the entire fairness test as enunciated by the Delaware courts will most likely apply to the transaction that is subject to judicial review.<sup>126</sup> The Delaware special committee process, therefore, is often used in furtherance of satisfying the requirements of the entire fairness test<sup>127</sup> since a well

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<sup>125</sup> See Corporation Law, art. 341.

<sup>126</sup> “The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.” *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994), quoting, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). See also Del. Gen. Corp. Law § 144(a)(3).

<sup>127</sup> See *id.*

planned and executed special committee process can shift the burden of proof to plaintiff shareholders in future litigation proceedings.<sup>128</sup>

Special committees in Japan share many of the aspects that one usually finds in a special committee that operates under Delaware law, with the interest of maintaining independence in the decision-making process playing a fundamental role.<sup>129</sup> However, one key difference between current practices in Japan and Delaware is that under present Japanese law there are no clear prudential standards for reviewing the decisions of target boards. A consequence of the continuing development of Japanese law is that the special committee process is evolving in parallel with the consideration of new defensive measures.

At the present time, special committees are most often used when a Japanese company adopts a rights plan. A customary example is when, as part of the announcement of a rights plan, a Japanese company will require that activation and cancellation of the rights plan be determined by the board of directors that “assigns maximum value to the recommendations” of a special committee.<sup>130</sup> In contrast to the

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<sup>128</sup> “Particular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm’s length.” *Id.* 638 A.2d at 1120-1121.

<sup>129</sup> See THE CORPORATE VALUE REPORT, at 91-94.

<sup>130</sup> LION CORPORATION, NOTICE CONCERNING THE ISSUANCE OF SUBSCRIPTION RIGHTS IN PREPARATION FOR THE INTRODUCTION OF A TRUST-TYPE RIGHTS PLAN, at 7 (Feb. 6, 2006), <http://www.lion.co.jp/en/press/html/2006009f.htm>; SEINO TRANSPORTATION Co., LTD., ISSUANCE OF STOCK ACQUISITION RIGHTS FOR A TRUST-TYPE RIGHTS PLAN 10 (May 17, 2005), <http://www.seino.co.jp/seino/e/news/pdf/17may2005-01.pdf> (last visited Mar. 7, 2006).

customary practice in the United States, in Japan the members of the special committee are not only directors of the target company, but may also include independent statutory auditors or outside advisors such as legal counsel.<sup>131</sup> The concerns related to maintaining the necessary independence of the special committee process are present in Japan as is the case in the U.S. experience,<sup>132</sup> and such issues have resonated with investors and led some to vote against rights plans where the special committee was not considered sufficiently independent from management.<sup>133</sup>

Given this evolving nature of special committees in Japanese deals, we will likely see additional changes in the manner in which special committees are constituted and operated in the coming years.

#### E. U.S. Federal Securities Laws

In addition to Japanese law considerations, practitioners should keep in mind the possible implications of U.S. securities laws when doing Japanese deals. In particular,

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<sup>131</sup> See LION CORPORATION, *id.* at 7; SEINO TRANSPORTATION CO., LTD., *id.* at 9.

<sup>132</sup> Defining “independence” is a well known issue for U.S. practitioners in complying with the new corporate governance rules and regulations that came into effect after the enactment of the Sarbanes-Oxley Act. See 17 C.F.R. 240.10A-3; NYSE Listed Company Manual § 303A.02; NASD Manual Rules 4200(a)(15), 4350(c).

<sup>133</sup> For example, it is reported that the Pension Fund Association voted against rights plans proposed by two companies at their respective shareholders meetings in 2005 because of their dissatisfaction with the independence of special committee members in one case and the authority given to the special committee in making decisions for the corporation in the other. See The Yomiuri Shimbun, *Poison Pill Donyu Hantai no Case* [Cases of Objecting to the Introduction of Poison Pills], Morning Edition of July 7, 2005, at 9, available at <http://www.yomiuri.co.jp/atmoney/mnews/20050707mh05.htm> (last visited Mar. 7, 2006).

given the globalization of both institutional and individual investment, securities of Japanese issuers that have never been listed on an exchange outside of Japan are frequently beneficially owned by persons resident in the U.S. Thus, a deal with a Japanese issuer may trigger various requirements under U.S. securities laws. This section provides guidance for structuring M&A transactions in compliance with U.S. securities laws, reviews the consequences for violating such laws, and also examines the potential impact of U.S. securities laws on Japanese rights plans.

(1) Application of U.S. Securities Laws to Japanese Business Combinations and Tender Offers

The Securities Act of 1933 (the “Securities Act”) regulates offers and sales of securities in the U.S. Pursuant to Section 5 of the Securities Act, issuers must file a registration statement in respect of securities offered and sold in the U.S. or comply with an exemption from the registration requirement.<sup>134</sup> “Offer” and “sale” include proposals to U.S. security holders requiring a vote on whether to accept new or different securities in exchange for their existing securities.<sup>135</sup> The three typical Japanese business combination structures (*gappei* or mergers, *kabushiki kokan* or stock-for-stock exchanges, and *kabushiki iten* or stock transfers) generally require approval by the shareholders who will receive new or different securities as a result of the transaction and

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<sup>134</sup> See 15 U.S.C. § 77e (1997).

<sup>135</sup> See § 77b(a)(3).

are therefore subject to the Securities Act when U.S. holders are asked to vote on the transaction.<sup>136</sup>

Section 14(d) of the Securities Exchange Act of 1934<sup>137</sup> (the “Exchange Act”) and the rules promulgated thereunder provide detailed disclosure, procedural and filing requirements regarding tender offers for securities registered under the Exchange Act. Section 14(e) of the Exchange Act<sup>138</sup> and the rules promulgated thereunder create procedural rules for all tender offers made in the U.S. Moreover, Section 13(e) of the Exchange Act<sup>139</sup> and the rules promulgated thereunder set forth additional rules applicable to all issuer tender offers and going private transactions conducted in the U.S. Any tender offer made with respect to shares held by U.S. persons or shares registered with the SEC must therefore comply with these requirements, as applicable, unless it falls within an exemption from the Exchange Act tender offer requirements.

An entity seeking to acquire the shares of a foreign private issuer<sup>140</sup> through a business combination or tender offer can nonetheless avoid the requirements of the

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<sup>136</sup> See Sections III.A.3, 6 & 7, *supra*, for a discussion of *gappei*, *kabushiki kokan* and *kabushiki iten*. In the case of a cash-out merger or cash-out stock for stock exchange, the offeror does not make an offer or sale of securities to the target company shareholders, and the Securities Act is therefore not applicable. However, note that the Corporation Law does not permit cash-out mergers in the manner provided under Delaware law. See *supra* note 8.

<sup>137</sup> 15 U.S.C. § 78n(d) (1997).

<sup>138</sup> § 78n(e).

<sup>139</sup> § 78m(e).

<sup>140</sup> A foreign private issuer is any issuer not organized under the laws of the U.S., provided that more than 50 percent of its outstanding voting securities are not owned by U.S. residents and: (i) less than

Securities Act and Exchange Act by excluding U.S. holders from the transaction or, in the case of a tender offer where part of the consideration is securities (*i.e.*, an exchange offer), offering U.S. holders only the cash proceeds of shares pursuant to a so-called vendor placement.<sup>141</sup> As discussed below, these alternatives are frequently impractical or prohibited under Japanese laws. Therefore, the Cross Border Rules which are exceptions to the general requirements of the Securities Act and Exchange Act,<sup>142</sup> are the primary means by which U.S. shareholders can be included in Japanese tender offers and business combinations.<sup>143</sup>

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half of the executive officers or directors of the issuer are U.S. citizens or residents; (ii) more than 50 percent of the assets of the issuer are not located in the U.S.; or (iii) the U.S. is not the issuer's primary place of business. *See* 17 C.F.R. § 230.405 (2004).

<sup>141</sup> In the context of a business combination or tender offer in which securities make up part of the consideration, Japanese issuers could also issue shares to U.S. holders pursuant to a private placement under Section 4(2) of the Securities Act or register the shares to be issued to U.S. holders with the SEC. However, a private placement is often impractical because the issuer is required to know in advance that all U.S. persons who receive the offer are qualified under the Securities Act to participate in a private placement. Registering shares with the SEC is also frequently impractical because of the time and expense involved and the triggering of ongoing Securities Act reporting requirements. For a comprehensive analysis of the application of U.S. securities laws to non-U.S. transactions, *see* Stephen D. Bohrer, *The Application of U.S. Securities Laws to Overseas Business Transactions*, 11 STAN. J.L. BUS. & FIN. 126 (2005).

<sup>142</sup> *See Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings*, Securities Act Release No. 7759, Exchange Act Release No. 42054, 60 Fed. Reg. 61,382 (Oct. 26, 1999) (hereinafter, the "Cross Border Release").

<sup>143</sup> "[T]he Commission is adopting exemptive rules that are intended to encourage issuers and bidders to extend tender and exchange offers . . . and business combinations to the U.S. security holders of foreign private issuers." *Id.* at 61,382.

(i) Exclusion of U.S. shareholders

Offerors can avoid SEC jurisdiction over a business combination or tender offer by excluding U.S. holders from the offer or sale.<sup>144</sup> Offerors' ability to take this approach depends on whether, under the laws of their own jurisdictions, some shareholders may be excluded from the offer and whether the offeror can win approval for the transaction without the votes of U.S. shareholders. This approach would also require that the transaction be structured and documented in a way that made it clear that no offer was being made in the U.S.<sup>145</sup>

The exclusion of U.S. holders is not likely to be permitted in Japanese business combinations because the Corporation Law requires that all shareholders of a class be treated equally.<sup>146</sup> This rule is most likely interpreted to require that shareholders of a

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<sup>144</sup> See *id.* at 61,383 (discussing the possibility that notwithstanding the adoption of the Cross Border Rules, some non-U.S. issuers will continue to exclude U.S. holders from participation in business combinations).

<sup>145</sup> The Securities Act definitions of "offer to sell," "offer for sale," and "offer" include "every attempt or offer to dispose of, or solicitation of an offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." § 77b(a)(3). "Tender Offer" is not specifically defined in the Exchange Act or rules promulgated thereunder. However, tender offers are generally characterized by eight factors: "(i) an active and widespread solicitation of public shareholders is made for shares of an issuer; (ii) the solicitation is made for a substantial percentage of the issuer's stock; (iii) the offer to purchase is made at a premium above the prevailing market price; (iv) the terms of the offer are firm rather than negotiable; (v) the offer is contingent on the tender of a fixed minimum number of shares and is often subject to a ceiling of a fixed maximum number of shares to be purchased; (vi) the offer is open for only a limited period of time; (vii) offerees are subject to pressure to sell their stock; and (viii) public announcements of an acquisition program precede or accompany the accumulation of stock." MEREDITH M. BROWN, ET AL., TAKEOVERS: A STRATEGIC GUIDE TO MERGERS AND ACQUISITIONS § 4-2.A. (2d ed. 2004).

<sup>146</sup> Corporation Law, art. 109, para. 1 ("A stock company must treat shareholders equally in accordance with content and the number of shares owned by them").

class be offered identical consideration in a business combination or tender offer, and not just consideration of equal value.

In the context of an exchange offer, to ensure that no offer is made in the U.S., documents concerning the transaction should not be disseminated in or otherwise sent to the U.S and offerors should obtain undertakings from nominees not to send any such documents into the U.S. Moreover, offerors should not accept tenders from U.S. persons and require all tendering shareholders to certify that they did not receive any documents in the U.S. Japanese registration statements announcing a cash tender offer often contain a legend indicating that the acquirer does not intend to make the offer in the U.S.<sup>147</sup> However, as indicated in Section III.B.1. above, exchange offers are rare in Japan due to unfavorable tax treatment.

(ii) Vendor Placements

The SEC has taken the position that if a foreign issuer offers and issues to U.S. residents securities as consideration in a tender offer that are immediately resold outside the United States for the account of the U.S. residents, there is no offer or sale made to

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<sup>147</sup> The following is a typical legend: “Shareholders residing overseas need to offer their shares through their standing agents in Japan. This tender offer does not intend to, directly or indirectly, be made in or towards the United States, and is not carried by use of the mails in the United States or in any other interstate commerce in the United States or international commerce nor by use of any facilities of a national securities exchange in the United States.” For an analysis of the legality of such legends under the Securities and Exchange Law, see Tatsuya Tanigawa & Mihoko Fukuzawa, *Sangyosaiseiho wo Riyoshita Going Private no Jitsumu* [Practice of Going Private under the Industrial Revitalization Law], at 27.

the U.S. residents for purposes of the Securities Act.<sup>148</sup> In such transactions, this “vendor placement” technique works as follows: (i) U.S. holders of target company securities receive the same offer as was made to all target shareholders; (ii) a U.S. holder’s acceptance of the offer is deemed an agreement to have the acquiring company’s shares that would otherwise be issued to such U.S. holder be issued instead to a trustee located outside the United States; (iii) upon receiving shares from the acquiring company, the trustee promptly resells them outside the United States; and (iv) following such resale, the trustee remits the cash proceeds, less expenses, to the U.S. holder.<sup>149</sup> However, the SEC has permitted this approach in only limited circumstances, and has not codified the process, but rather signaled that it will evaluate the availability of vendor placements on a case by case basis.<sup>150</sup>

Vendor placements are typically not a useful means to avoid U.S. jurisdiction in Japanese exchange offers because under Japanese law shareholders cannot be forced to accept different forms of consideration in a given transaction.<sup>151</sup> Accordingly, where a

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<sup>148</sup> See, e.g., *Singapore Telecommunications Ltd.*, SEC No-Action Letter, 2001 WL 533462 (May 15, 2001); *TABCORP Holdings Limited*, SEC No-Action Letter, 1999 WL 766087 (August 27, 1999); *Durban Roodepoort Deep, Limited*, SEC No-Action Letter, 1999 WL 1578786 (February 23, 1999); *AMP Limited*, SEC No-Action Letter, 1998 WL 870709 (September 17, 1998); Cross Border Release, at 61,386.

<sup>149</sup> See *id.*

<sup>150</sup> See Cross Border Release, at Note 38.

<sup>151</sup> See Securities and Exchange Law, art. 27-2, para. 3.

target company's shares are owned by U.S. and Japanese shareholders, the acquirer is not permitted to offer cash to U.S. shareholders and stock to Japanese shareholders.

(2) The Cross Border Rules - Rule 802

Rule 802 of the Securities Act exempts from registration (i) exchange offers for the securities of foreign private issuers and (ii) exchanges of the securities of foreign private issuers in any business combination, provided the conditions discussed below are met.<sup>152</sup>

(i) 10% Ownership Test

In a *gappei* (merger) or *kabushiki kokan* (stock-for-stock exchange), less than 10% of the security holders of the target company may be resident in the U.S.<sup>153</sup> In a *kabushiki iten* (stock transfer), the percentage of shares held by U.S. holders for the purpose of determining the availability of Rule 802 should be based on the ownership of shares of the successor company on a pro forma basis immediately following the transaction.<sup>154</sup>

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<sup>152</sup> See 17 C.F.R. § 230.802 (2004). An exchange offer is a tender offer in which securities constitute part of the consideration, *see id.* at § 230.800(c), and a business combination is “a statutory amalgamation, merger, arrangement or other reorganization requiring the vote of security holders of one or more of the participating companies.” *Id.* at § 230.800(a). As noted in Section III.B.1 *supra*, exchange offers are generally not conducted in Japan due to unfavorable tax treatment.

<sup>153</sup> The 10% calculation is based on the specific instructions set forth in the regulations. *See* § 230.800(h).

<sup>154</sup> *See* § 230.802(a).

Securities that are convertible or exchangeable into the securities that are subject to the offer are excluded from the 10% ownership calculation.<sup>155</sup> Securities owned by owners of more than 10% of the subject securities and securities owned by the offeror are also excluded from the calculation of U.S. ownership.<sup>156</sup>

The ownership calculation should be made with respect to the shareholders of record 30 days prior to the commencement of the offer.<sup>157</sup> However, offerors may depart from the 30-day standard when they are limited in their access to security holder list information prepared periodically by third parties.<sup>158</sup> In such instances the offeror may determine the percentage of U.S. holders of the shares subject to the offer by reference to the latest security holder list available, unless the offeror has access to more accurate information.<sup>159</sup> Since Japanese companies typically receive their shareholder lists from the depository at fixed intervals and cannot otherwise obtain the shareholder lists unless undergoing a capital structure change, the companies are usually required to utilize this exception to the 30-day rule.

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<sup>155</sup> See § 230.802(b)(1).

<sup>156</sup> See § 230.800(h)(2).

<sup>157</sup> See § 230.800(h)(1).

<sup>158</sup> See *Division of Corporate Finance: Third Supplement to the Manual of Publicly Available Telephone Interpretations*, Cross-Border Release (Supp. Jul. 2001), Part E, Question 9.

<sup>159</sup> See *id.*

In order to make the 10% ownership determination, the offeror must “look through” record ownership in the target company’s home jurisdiction and in the U.S. when the target company’s shares are held by brokers, dealers, banks or other nominees, and determine the number of shares held in accounts with such nominees by U.S. holders.<sup>160</sup> To the extent the offeror is unable to determine beneficial ownership after a reasonable inquiry, it may assume that the beneficial owners of securities held by nominees are residents of the jurisdiction in which the nominee has its principal place of business.<sup>161</sup> The reasonable inquiry standard is not defined in SEC rules or guidance. However, it normally requires that the offeror ask each nominee that is located in the target company’s home jurisdiction or the U.S. how many shares it is holding for the accounts of customers resident in the U.S.<sup>162</sup>

Provided not more than 10% of the target company’s securities are held by U.S. holders when a bidder commences an offer, a competing offeror need not abide by the 10% U.S. ownership requirement.<sup>163</sup> Thus, if securities move into the U.S. after the initial offer such that more than 10% of the securities subject to the offer are owned by U.S. holders, later bids are not foreclosed by the 10% ownership test.

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<sup>160</sup> See § 230.800(h)(3).

<sup>161</sup> See § 230.800(h)(4).

<sup>162</sup> See *Equant N.V.*, SEC No Action Letter, 2005 WL 1173099 (April 18, 2004). In *Equant*, the SEC approved an inquiry where the issuer retained an agent to conduct an investigation into the beneficial holders of the issuers’ shares. The agent obtained a list of holders from the depositary and sent informational requests regarding beneficial ownership to each of the nominees on the list.

<sup>163</sup> See § 230.802(a); 17 C.F.R § 240.14d-1(c)(1) (2004). See also Cross Border Release, at 61,384.

(ii) Equal Treatment

U.S. holders must be allowed to participate in the exchange offer or business combination on at least an equal basis with other holders. However, offerors are permitted to offer U.S. holders cash-only consideration, even when non-U.S. holders are offered securities, provided the offeror has a reasonable basis to believe the value of the cash is substantially equivalent to the value of the securities.<sup>164</sup> Nonetheless, as noted previously, this exception to the Rule 802 equal treatment requirement is precluded by the Corporation Law.<sup>165</sup>

(iii) Documentary Requirements

An English translation of any informational document the offeror publishes or disseminates to the target company's security holders in connection with the transaction must be furnished to the SEC on Form CB not later than the next business day following publication or dissemination.<sup>166</sup> "Informational document" is not defined in the rules or guidance. Relevant factors in evaluating whether a disclosure constitutes an informational document may include (i) whether the disclosure is required in the offeror's home jurisdiction, (ii) whether it formally commences the offer, (iii) whether it is

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<sup>164</sup> See § 230.802(a)(2).

<sup>165</sup> See Corporation Law, art. 109, para. 1.

<sup>166</sup> See § 230.802(a)(3). Per Regulation S, if no offer or sale is made in the U.S. (i.e., the target company has no U.S. shareholders) there is no Securities Act registration requirement, and hence no need to comply with the Rule 802 Securities Act registration exemption. See 17 C.F.R. § 230.901 *et seq.* (2004).

addressed to security holders, (iv) whether it gives security holders the means to tender shares and (v) whether it otherwise gives shareholders material information about the offer that they have not already received.<sup>167</sup>

(iv) Parties Responsible for Filing Form CB

Pursuant to Rule 802, in an acquisition, the acquirer (or “issuer”) is required to furnish informational documents disseminated to the shareholders of the target (or “subject”) company to the SEC on Form CB.<sup>168</sup> This allocation of responsibility is consistent with U.S. securities laws regarding exchange offers and business combinations which require an acquiring company to send the prospectus/proxy statement to target company shareholders. However, in a Japanese business combination, the target company, rather than the acquirer, typically distributes informational documents concerning the transaction to its own shareholders.

(v) Dissemination

An informational document is deemed to have been published or otherwise disseminated if it is made public in any manner, such as via press release, the Internet or direct mailing.<sup>169</sup> Informational documents published or otherwise disseminated to

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<sup>167</sup> See Cross Border Release, at 61,385, 61,391.

<sup>168</sup> See § 230.802(a)(3)(i).

<sup>169</sup> See § 230.802(a)(3)(i), (ii); Cross Border Release, at 61,391, 61,394.

shareholders in the offeror's home jurisdiction must be translated into English and disseminated to U.S. holders on a comparable basis to the means by which they were provided to security holders in the offeror's home jurisdiction.<sup>170</sup> When the offeror disseminates an informational document in its home jurisdiction by means of "publication" (e.g., a press release via media outlets or a newspaper advertisement) rather than sending the informational document directly to security holders, the offeror must publish the information in the U.S. in a manner reasonably calculated to inform U.S. holders of the relevant information.<sup>171</sup> The rule does not specify what method of dissemination satisfies this requirement.<sup>172</sup> However, the adopting release makes clear that the dissemination requirement is not satisfied by posting materials on the Internet.<sup>173</sup>

The rule does not clearly identify exactly when during the course of a transaction the requirement to furnish and disseminate begins and ends. However, Japanese companies often file the following documents in English on Form CB when disseminating such documents to shareholders in Japan: (i) press release issued upon the

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<sup>170</sup> See § 230.802(a)(3)(ii).

<sup>171</sup> See § 230.802(a)(3)(iii).

<sup>172</sup> The SEC generally does not impose greater dissemination requirements with respect to U.S. holders than are imposed by the home country jurisdiction. For example, an issuer can satisfy its Rule 802 dissemination requirement with respect to (i) a press release issued in Japan and posted on its corporate website by translating the document into English, releasing it in the U.S., and posting the translation on its corporate website, and (ii) documents mailed to holders in Japan by sending English translations of such documents either directly to U.S. shareholders or the U.S. shareholders' standing agents (*jonin-dairinin*) in Japan.

<sup>173</sup> See Cross Border Release, at 61,394.

execution of the merger agreement; (ii) notice of the shareholders meeting, including any description of the transaction and related disclosure as to the offeror's securities; (iii) notice of the results of the shareholders meeting; (iv) public notice published in Japan announcing the results of the shareholders meeting and instructing shareholders how to submit shares or any similar letter of transmittal; (v) request for submission of share certificates in conjunction with the share exchange; and (vi) merger report made available at the home office and posted on the Tokyo Stock Exchange Web site following the share exchange.

(vi) Form CB and Form F-X Filing Deadlines

Informational documents must be furnished to the SEC on Form CB by the first business day after the date of publication or dissemination.<sup>174</sup> The entity furnishing the Form CB must also file a Form F-X, which serves as an appointment of an agent for service of process in the U.S. in connection with an action by the SEC.<sup>175</sup>

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<sup>174</sup> See § 230.802(a)(3)(i).

<sup>175</sup> By appointing an agent for service of process in the U.S., the filer agrees that the SEC may commence any proceeding by service of process (or notice) upon such agent. The agent for service of process may be any person located in the U.S., such as a corporate services company or an affiliate of the issuer.

(vii) Legends

Any informational document distributed to U.S. holders must bear a legend as set forth in Rule 802(b).<sup>176</sup> Where appropriate, informational documents disseminated to U.S. holders may include a further legend making clear that the document does not itself constitute an offering of securities in the U.S.

(3) The Cross Border Rules - Tender Offers

Tier I and II provide limited relief from the tender offer rules for bidders seeking to acquire the shares of a foreign private issuer through a cash tender offer or exchange offer.

(i) Tier I

Tier I exempts bidders seeking to acquire the securities of a foreign private issuer with U.S. security holders through a tender offer<sup>177</sup> from most of the Exchange Act tender offer rules, subject to certain conditions.<sup>178</sup>

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<sup>176</sup> See § 230.802(b).

<sup>177</sup> The “tender offer” includes exchange offers. See 17 C.F.R. § 240.14d-1(b) (2004).

<sup>178</sup> See § 240.14d-1(c). Specifically, Tier I exempts the bidder from complying with Sections 14(d)(1) through 14(d)(7) of the Exchange Act, Regulation 14D and the attendant procedural, disclosure and dissemination requirements, Schedule TO, Rule 14e-1 regarding the conduct of the offer, Rule 14e-2 regarding the dissemination of the target company’s position with respect to the offer, and Rule 14e-5 prohibiting purchases outside of the tender offer. It should be noted that since Sections 14(d)(1) through 14(d)(7), Regulation 14D and Schedule TO are only applicable to transactions in which the target company has shares registered in the U.S., in the context of a tender offer for a Japanese company, the only benefit of Tier I is usually the release from Rules 14e-1, 14e-2 and 14e-5.

- *10% Ownership.* The Tier I exemption is only available where fewer than 10% of the class of shares sought in the bid are held by U.S. persons, subject to the same conditions and exceptions as the Rule 802 10% ownership test.<sup>179</sup> Provided not more than 10% of the target company's securities are held by U.S. holders when a bidder commences an offer, a competing offeror need not abide the 10% U.S. ownership requirement.<sup>180</sup> In the case of a tender offer by a bidder other than an affiliate of the target company (*e.g.*, a hostile bidder), the target company is deemed to be a foreign private issuer and the 10% or less of the shares subject to the tender offer are deemed to be owned by U.S. persons unless: (i) the tender offer is made pursuant to an agreement between the bidder and the target company; (ii) the aggregate trading volume of the targeted securities in the U.S. for the 12 month period ending 30 days before the commencement of the offer exceeds 10% of the worldwide aggregate trading volume of such securities over the same period; (iii) the target company's annual report indicates 10% or more of the targeted securities are

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Transactions falling within the Tier I exemption are also not required to comply with the rules regarding going private transactions and issuer self tenders. *See* §§ 240.13e-3(g)(6), 240.13e-4(h)(8).

<sup>179</sup> *See* § 240.14d-1(c)(1).

<sup>180</sup> *See id.*

owned by U.S. holders; or (iv) the bidder otherwise knows 10% or more of the targeted securities are owned by U.S. holders.<sup>181</sup>

- *Filing Requirements.* Similar to Rule 802, bidders must furnish English translations of the offering materials on Form CB, file a Form F-X consent to service, and provide U.S. security holders with the tender offer circular and other offering documents in English on a comparable basis to that provided to other security holders.<sup>182</sup> However, bidders are only required to submit Form CB and Form F-X if the target company shares are registered under the Exchange Act or the bidder is making a self tender.<sup>183</sup>
- *Equal Treatment - Cash Alternative.* Once again in keeping with the requirements under Rule 802, the Tier I exemption requires bidders to allow U.S. holders to participate in the transaction on terms at least as favorable as those offered to other holders and permits the bidder to offer U.S. holders a cash alternative where securities are part of the consideration.<sup>184</sup> This method of remitting cash to U.S. holders allows bidders to include U.S. holders in the tender offer without registering the shares in the U.S. or relying on the Rule

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<sup>181</sup> See § 240.14d-1(c), Instruction 3.

<sup>182</sup> See § 240.14d-1(c)(3).

<sup>183</sup> See § 240.14d-1(c)(3)(iii); § 240.13e-4(h)(8)(iii)(A).

<sup>184</sup> See § 240.14d-1(c)(2)(iii).

802 registration exemption. Nonetheless, in the case of exchange offers Japanese law precludes forcing a group of shareholders to accept cash consideration when other shareholders are offered securities.<sup>185</sup>

(ii) Tier II

Tier II provides more limited relief to the tender offer requirements where a bidder makes an offer for the securities of a foreign private issuer and more than 10% but fewer than 40% of the securities of the target are held by U.S. persons.<sup>186</sup> Under the Tier II exemption, the bidder must make filings ordinarily required by the tender offer rules and comply with certain procedural rules,<sup>187</sup> but is granted leeway with respect to the manner in which the tender offer is conducted so as to minimize or eliminate conflicts with home jurisdiction law.<sup>188</sup> There is no Form CB or F-X filing requirement for Tier II

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<sup>185</sup> See Securities and Exchange Law, art. 27-2, para. 3.

<sup>186</sup> See § 240.14d-1(d).

<sup>187</sup> In particular, the bidder is required to comply with the disclosure requirements of Regulations 14D and 14E (and Rule 13e-3 or 13e-4 relating to going private transactions and issuer tender offers, respectively, if applicable) and must file a Schedule TO with the SEC and provide notice of the offer to the target company's shareholders. Moreover, since greater than 10% of the target company's securities are held by U.S. persons, any securities offered as part of the consideration will not be exempt from registration pursuant to Rule 802. Therefore, any such securities must be registered with the SEC and a prospectus must be delivered to the target company's shareholders.

<sup>188</sup> See § 240.14d-1(d). Pursuant to Tier II, the bidder may make different offers to U.S. and non-U.S. holders provided the value of the consideration is consistent with the equal treatment principle, and the bidder is subject to the notice of extension and prompt payment requirements stipulated in its home jurisdiction tender offer rules rather than the U.S. tender offer rules. See § 240.14d-1(d)(2)(ii)-(iv).

because the rule does not exempt bidders from filing the standard tender offer disclosure documents.

(iii) Regulation 14E

Tender offers for the shares of a foreign private issuer with no securities registered under the Exchange Act, which is likely to be the case for a Japanese target company, need only comply with Section 14(e) of the Exchange Act<sup>189</sup> and Regulation 14E. Therefore, bidders for the securities of Japanese issuers not listed in the U.S. who are unable to take advantage of Tier I can nonetheless comply with U.S. securities laws without a substantial burden. The primary Regulation 14E requirements for bidders are that the offer must be kept open for 20 business days, the offer must remain open for 10 business days following a change in the number or percentage of securities sought or the amount of consideration offered, and the bidder must provide notice of any extension of the offer to investors and promptly pay the offered consideration or return the tendered securities upon termination or withdrawal of the offer.<sup>190</sup>

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<sup>189</sup> Section 14(e) of the Exchange Act prohibits fraudulent, deceptive or manipulative acts or practices in connection with tender offers. *See* 15 U.S.C. § 78n(e).

<sup>190</sup> *See* § 240.14e-1(a), (b), (c), (d). In addition, Regulation 14E prohibits the (i) trading on the basis of material nonpublic information relating to the tender offer during the tender offer and communications by the transaction parties that could result in such trading, *see* § 240.14e-3, (ii) tender of shares in which the tender offeror has a short position, *see* § 240.14e-4, (iii) purchase of securities by the offeror outside of the tender offer (subject to certain exceptions), *see* § 240.14e-5, and (iv) announcement of an offer where the offeror (a) does not anticipate commencing and completing the transaction within a reasonable time, (b) intends to use the announcement to manipulate the target company share price or (c) does not have a reasonable belief it will complete the transaction, *see* § 240.14e-8. Moreover, Rule 14e-2 requires that within 10 business days of the commencement of the offer that the target company announce its position with respect to the offer.

(4) Emerging Issues: Application of U.S. Securities Laws to Japanese Rights Plans

As discussed previously, Japanese companies have reacted to the increase in hostile takeover activity by adopting various types of rights plans. However, Japanese companies with U.S. security holders are required to comply with U.S. securities laws when issuing shares to U.S. persons pursuant to a rights plan. Under a typical trust pill, for instance, the company issues share purchase warrants to the trust which are exercisable at a nominal price and are distributed to company shareholders in the event of a hostile takeover bid. The Securities Act does not require warrants distributed under a rights plan to be registered because such issuance does not involve an “offer” or “sale.” However, the Securities Act requires the registration of shares issued to U.S. holders upon the payment of a share purchase warrant exercise price unless either an exemption from registration exists or the issuance of shares does not involve an offer or sale. Accordingly, while the issuance of Japanese rights plans does not give rise to a registration requirement, the possible exercise of share purchase warrants under such rights plans will involve issues under the U.S. securities laws that should be considered as part of the overall transaction in question.

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In most tender offers for the securities of a Japanese company, the target publicly disseminates an opinion regarding the offer.

(5) Consequences for Failure to Comply with the Cross Border Rules and Informational Document Liability

The Securities Act provides that an issuer must either file a registration statement with the SEC or comply with an exemption from registration before publicly offering securities in the U.S. Therefore, if an issuer offers or sells securities in the U.S. without either registering such securities or complying with Rule 802 or another exemption, the issuer will be in violation of U.S. securities laws regardless of the number of persons to whom the offer is made.

Failure to provide informational documents on Form CB or disseminate them to U.S. holders would constitute a failure to comply with the Rule 802 exemption. As a result, the exemption would not be available to issue stock in the U.S. The subsequent issuance of stock without the benefit of registration or another exemption would result in violation of Section 5 of the Securities Act. This violation could give rise to a civil enforcement action by the SEC,<sup>191</sup> and would give U.S. investors a right of rescission with regard to the shares received in the exchange.<sup>192</sup> Moreover, the SEC could seek an injunction from a U.S. federal district court prohibiting the issuer from including U.S. holders in the offer,<sup>193</sup> and as a result of a civil enforcement action such a court could

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<sup>191</sup> See 15 U.S.C. § 77t (1997).

<sup>192</sup> See § 77l.

<sup>193</sup> See § 77h-1.

impose monetary penalties.<sup>194</sup> Individuals found to have willfully violated Section 5 could face additional fines and imprisonment.<sup>195</sup> If an issuer willfully disregards U.S. securities laws, the likelihood and severity of fines would increase. Bidders would face similar consequences for failure to comply with provisions of the Exchange Act in the context of a tender offer.<sup>196</sup>

If an issuer is only late in filing or disseminating a document, it is unlikely the SEC would take the view that the transaction does not fall within the Cross Border Rules unless the information not disseminated materially impaired security holders' ability to make an investment decision. Indeed, pursuant to the SEC's recent guidelines regarding financial penalties, remedial steps taken by the corporation to protect investors militate against the assessment of fines.<sup>197</sup>

Companies that furnish informational documents to the SEC on Form CB are not subject to liability for false or misleading statements made within documents filed with the SEC pursuant to Section 18 of the Exchange Act because documents furnished on

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<sup>194</sup> See § 77t(d)(2). Monetary penalties range from \$5,000 to \$50,000 or the "gross amount of pecuniary gain" resulting from the wrongful action for individuals and \$50 to \$500,000 or the "gross amount of pecuniary gain" resulting from the wrongful action for entities. See *id.*

<sup>195</sup> See § 77x. Individuals found to have willfully violated the Securities Act may be fined up to \$10,000 or imprisoned for up to 5 years.

<sup>196</sup> See 15 U.S.C. § 78u.

<sup>197</sup> See SEC News Digest, Issue 2006-02, *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2005), <http://sec.gov/news/digest/dig010406.txt> (hereinafter "Statement Concerning Financial Penalties").

Form CB are not deemed “filed.”<sup>198</sup> Nonetheless, companies may be subject to liability for material misstatements or omissions contained in informational documents furnished on Form CB under Rule 10b-5 of the Exchange Act, which subjects companies to liability for making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading in connection with the purchase or sale of a security.<sup>199</sup> Individuals and entities face significant fines, criminal penalties and private lawsuits for 10b-5 violations.<sup>200</sup> Liability under Rule 10b-5 requires proof of scienter as an element of the cause of action, which requires knowing or reckless conduct.<sup>201</sup>

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<sup>198</sup> See § 78r.

<sup>199</sup> See 17 C.F.R. § 240.10b-5 (2004).

<sup>200</sup> 10b-5 violations can give rise to civil enforcement actions by the SEC. See § 78u (criminal prosecution); § 78ff (private action for damages). In the context of a civil enforcement action by the SEC, individuals can be fined between \$5,000 and \$100,000 or the “gross amount of pecuniary gain” resulting from the wrongful action. See § 78u(d)(3)(B)(i). Entities can be fined between \$50,000 and \$500,000 or the “gross amount of pecuniary gain” resulting from the wrongful action. See § 78u(d)(3)(B)(ii). The SEC also has the authority to apply to enjoin any further violation of the Securities Act, see § 78u(d)(1), and prohibit an individual to act as a director of a company with securities registered under the Exchange Act, see § 78u(d)(2). 10b-5 violators could also face criminal prosecution, which carries a maximum penalty of \$5,000,000 and 20 years in prison for individuals and \$25,000,000 for entities. See § 78ff(a). Pursuant to the Sarbanes-Oxley Act, where the SEC obtains a judgment under the securities laws or reaches a settlement agreement for the disgorgement of funds and also obtains a civil judgment, the civil judgment can be added to the disgorgement funds held for the benefit of the victims of the securities law violation. See 15 U.S.C. § 7246(a) (2006).

<sup>201</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976) (finding scienter or “a mental state embracing intent to deceive, manipulate, or defraud” a prerequisite to 10b-5 liability); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (finding recklessness sufficient to create 10b-5 liability).

To date, the SEC has not conducted a civil enforcement action in the context of a business combination or tender offer involving a foreign private issuer with a small number of U.S. holders who failed to take advantage of, or improperly utilized Rule 802 or Tier I or II. However, the SEC's Statement Concerning Financial Penalties suggests that the SEC would impose civil penalties should it detect a foreign private issuer's failure to comply with the Securities Act or the Exchange Act. The SEC's primary considerations are whether the company in question benefited from its wrongful acts and whether a penalty will compensate or harm injured shareholders.<sup>202</sup> Some of the factors that weigh in favor of the assessment of civil penalties are intent to circumvent the law, the difficulty in detecting the offense which calls for "an especially high level of deterrence," and the absence of remedial action and the lack of cooperation with the SEC.<sup>203</sup> Moreover, the SEC and FSA recently announced terms of an agreement for increased cooperation and collaboration, the objectives of which are "to identify and discuss regulatory issues of common concern, and promote cooperation in the exchange of information in cross-border enforcement matters."<sup>204</sup> The SEC – FSA agreement

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<sup>202</sup> See Statement Concerning Financial Penalties.

<sup>203</sup> See *id.* Similarly, the SEC's previous guidance on the subject emphasized the importance of self-policing, self-reporting, remediation and cooperation with the SEC. See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Securities Exchange Act Release No. 44969, Accounting and Auditing Enforcement, Release No. 14780 (Oct. 23, 2001), <http://www.sec.gov/litigation/investreport/34-44969.htm> (commonly referred to as the "Seaboard Report").

<sup>204</sup> Press Release, SEC 2006-14, *SEC and Japan Financial Services Agency Announce Terms for Increased Cooperation and Collaboration* (Jan 30, 2006), <http://sec.gov/news/press/2006-14.htm>.

reflects a global trend of international cooperation in securities law enforcement.<sup>205</sup>

Therefore, despite the absence of past SEC action relating to Japanese transactions, the current climate of international regulatory cooperation makes clear that compliance with U.S. securities laws should be a key concern when doing Japanese deals.

#### F. Additional Strategic Considerations

In addition to the aforementioned issues that should be taken into account when engaging in Japanese deals, there are a few other practical issues that may be helpful to keep in mind throughout the negotiations with a Japanese company. Cultural differences are always a challenge when doing a cross-border deal, but even beyond the ubiquitous differences in negotiation styles and societal norms there are often certain methods and approaches in which successful Japanese deals are done. In a given transaction, this may include some or all of the following factors.

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<sup>205</sup> See, e.g., Press Release, SEC 2004-116, *Royal Dutch Petroleum Company and the “Shell” Transport and Trading Company, P.L.C. Pay \$120 Million to Settle SEC Fraud Case Involving Massive Overstatement of Proved Hydrocarbon Reserves* (Aug. 24, 2004), <http://sec.gov/news/press/2004-116.htm>. The SEC, the United Kingdom Financial Services Authority and the Dutch Autoriteit Financiële Markten jointly pursued the investigation of Shell’s overstatement, and the \$120 million settlement was made in conjunction with a £17 million settlement with the UK FSA. See also Press Release, SEC 2005-1, *SEC Charges TV Azteca And Its Chairman—Ricardo Salinas Pliego—with Fraudulent Scheme to Conceal Salinas’ \$109 Million Windfall Through Related Party Transactions* (Jan. 4, 2005), <http://sec.gov/news/press/2005-1.htm> (discussing the cooperation between the SEC and the Comisión Nacional Bancaria y de Valores in Mexico); SEC Litigation Release No. 18527, *SEC Charges Parmalat with Financial Fraud* (Dec. 30, 2003), <http://sec.gov/litigation/litreleases/lr18527.htm> (discussing the cooperation between the SEC and the Italian Commissione Nazionale per la Società e la Borsa); and Press Release, SEC 2003-184, *Commission Settles Civil Fraud Action Against Vivendi Universal, S.A., its Former CEO, Jean-Marie Messier, and its Former CFO, Guillaume Hannezo* (Dec. 23, 2003), <http://sec.gov/news/press/2003-184.htm> (discussing the cooperation between the SEC and the French Autorité des Marchés Financiers).

(1) Practical Difficulties for the Hostile Deal

Although the number of hostile and contested deals in Japan has increased of late, it should be noted that friendly deals are still the norm. The approximate success rate of hostile deals in the U.S. is 35% and in Europe is 50%.<sup>206</sup> In Japan, however, there have been few instances in the past decade where a hostile acquirer has eventually succeeded in obtaining control of a Japanese company.<sup>207</sup> Moreover, as more Japanese companies adopt rights plans and the rules on permissible defensive measures become clearer, it is likely that the acquirer will at some point need to enter into serious negotiations with the target company—the risks of going “all in” on a tender offer or proxy contest should probably be the gamble of last resort.

There are a number of reasons why this may be the case. For instance, the acquirer will probably not have sufficient information as part of the due diligence process to be able to determine with confidence what its top line should be for a possible acquisition. While Japanese companies provide some information in their filings with

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<sup>206</sup> See THE CORPORATE VALUE STUDY REPORT, at 11.

<sup>207</sup> In 1999, Cable & Wireless succeeded in its hostile tender offer for IDC shares despite NTT’s friendly tender offer. Prior to the tender offer, Cable & Wireless was a 17.69% shareholder of IDC. In 2000, Boehringer Ingelheim succeeded in its tender offer for SS Pharmaceutical shares, even though SS Pharmaceutical did not expressly approve the tender offer and remained silent on the issue. Boehringer Ingelheim was a 19.6% shareholder of SS Pharmaceutical before launching the tender offer. However, note that in a recent hostile deal involving Origin Toshu Co. Ltd. (the target company), Don Quijote Co., Ltd. (the hostile bidder) decided to sell its shares in the target to Aeon Co., Ltd. (a white knight) even though Don Quijote acquired approximately 47.8% of the target shares through market purchases. See The Yomiuri Shimbun, *Don Quijote, Aeon TOB Oubo Top Kaidan de Taio Tenkan* [Don Quijote accepted Aeon’s tender offer. It changed its approach after a senior management meeting], February 27, 2006, <http://www.yomiuri.co.jp/atmoney/mnews/20060227/mh06.htm> (last visited on March 19, 2006).

Japanese securities regulators, such as summaries of material contracts, the amount of disclosure is not as extensive as would be the case for a company that is subject to Exchange Act reporting requirements.<sup>208</sup> In cases where the hostile deal may involve competition law issues under the Anti-Monopoly Law, it could be difficult to perform a market share analysis without the cooperation of the target company. Finally, the recent investigations into the accounting practices of Livedoor could mean that target companies and their investors will react more defensively to hostile bids than would otherwise be the case in the absence of Livedoor's alleged accounting fraud.<sup>209</sup> Therefore, the preferred approach in Japanese deals remains to be friendly first, and then negotiate in earnest on those matters that the acquirer considers its vital business interests.

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<sup>208</sup> For example, it is rare to find an explanation regarding change-of-control provisions in Japanese securities filings. The instruction for securities reports under the Securities and Exchange Law provides "if the company has entered into a material business agreement such as a lease or management consignment agreement of all or a material part of its business, an agreement that the company shares all business profits and losses with others, technical support agreements and so on, such agreements must be disclosed in an outline format." Kigyonaityoto no Kaiji ni kansuru Naikakufurei [Cabinet Order regarding Disclosure of Business Contents and Others], Financial Ministry Order No. 5 of 1973, form 3, note (12); form 2, note (33).

<sup>209</sup> On January 16, 2006, the Tokyo District Public Prosecutors Office began an investigation into Livedoor's possible violation of the Securities and Exchange Law in connection with its M&A activities and allegedly fraudulent accounting practices. In the days thereafter, Livedoor's share price took a beating—dropping from a closing price of 696 yen on January 16, 2006 to a closing price of 61 yen on February 13, 2006. On March 13, 2006, the Tokyo Stock Exchange announced Livedoor's delisting. Since the Livedoor – Fuji Television transaction is regarded as a symbol of the hostile deal, with the former Livedoor CEO Takefumi Horie as the public face of the hostile acquirer, future acquirers of Japanese companies should carefully consider whether such a climate will be conducive to certain offensive M&A strategies.

(2) Obtaining “Corporate Value” in the Acquisition

The Defensive Measures Guidelines provide that “defensive measures should be adopted, activated and cancelled for purposes to secure and increase corporate value, and in turn work to the shareholders’ common benefit.”<sup>210</sup> Furthermore, the Corporate Value Study Report notes that an acquisition proposal which will increase corporate value should not be excluded.<sup>211</sup> The concern over better understanding and assessing “corporate value” is an issue that an acquirer will probably confront in some manner when negotiating a Japanese deal. In this regard, it should be noted that corporate value does not necessarily mean only the temporal interests of the company shareholders, but also the long-term effects that a possible acquisition could have on the company. The Defensive Measures Guidelines define corporate value as “a company’s attributes and the degree thereto that contribute to the shareholders’ benefit such as the company’s assets, profitability, stability, efficiency, growth potential and so forth.”<sup>212</sup> Such a principle is not foreign to Delaware takeovers jurisprudence.<sup>213</sup> Accordingly, the acquirer would serve itself well by appreciating the importance of obtaining corporate value in order to achieve a successful Japanese deal.

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<sup>210</sup> See THE DEFENSIVE MEASURES GUIDELINES, at 3.

<sup>211</sup> See THE CORPORATE VALUE STUDY REPORT, at 83.

<sup>212</sup> See THE DEFENSIVE MEASURES GUIDELINES, at 2.

<sup>213</sup> “[T]he directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long term value of the corporation under its present management plan.” *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1376 (Del. 1995).

### (3) Defining the Acquisition Proposal

As mentioned in the discussion of the Yumeshin – JEC deal, a Japanese target company will probably require that an acquirer provide sufficient information on its proposed acquisition. From the perspective of the target, such information is necessary in order to evaluate the potential impact of the proposed acquisition on corporate value. Thus, an acquirer should anticipate that the process of completing such procedures may take more time than it is accustomed to when compared to similar transactions in the United States. Furthermore, there is the likelihood that the target company will respond to an unsolicited acquirer by noting that any information provided by such acquirer is insufficient. In the Yumeshin – JEC deal, JEC insisted that Yumeshin announced its tender offer without providing JEC with sufficient information.<sup>214</sup> As you may recall, however, the Tokyo District Court suggested that JEC could have obtained the necessary information by responding to Yumeshin’s proposal of a business alliance.<sup>215</sup> The acquirer, therefore, should use its best efforts to provide as much information as possible in such situations, and be open to negotiations with the target company.

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<sup>214</sup> See JEC, TOSHA KABUSHIKI NI TAISURU KOKAIKAITSUKE KETSUGI HE NO TAIO NITSUITE [Re: Reaction to Resolution of Tender Offer for Shares of the Company], 1 (July 11, 2005), available at [http://www.jecc.co.jp/topics/kaituke\\_3.pdf](http://www.jecc.co.jp/topics/kaituke_3.pdf) (last visited Mar. 7, 2006).

<sup>215</sup> See *supra* note 49.

#### IV. Conclusion

The current Japanese M&A market presents opportunities for U.S. companies and their advisors that are arguably the most promising in recent history. Perhaps an important observation to keep in mind, however, is that Japanese M&A is experiencing historic changes for which the full effects will probably only be completely appreciated in hindsight. While one can note the changes on a play-by play basis, the ultimate outcomes of various transactions, tender offers, and proxy contests can only be known with certainty after their completion. To draw a parallel to the U.S. experience with takeovers, Japan in 2006 may well be like Delaware in 1985 shortly before the Delaware Supreme Court issued its historic rulings in *Moran*,<sup>216</sup> *Unocal* and *Revlon*. Thus, in Japan much has happened, but more is likely coming. With this in mind, given the challenges posed by the opportunities in the Japanese M&A market, the importance of well informed and considered decision-making will be essential in order to ensure that U.S. companies compete and succeed in doing Japanese deals.

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<sup>216</sup> *Moran v. Household Int'l Inc.*, 500 A.2d 1346 (Del. 1985).