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MINORITY SHAREHOLDER SQUEEZE-OUTS IN JAPAN: A DONE DEAL

The Japanese M&A market is in full swing. According to data from *Mergermarket*, in 2023 the total disclosed deal value of Japan inbound M&A transactions increased by approximately 53.8% in comparison to 2022. Takeover bids of Japanese publicly traded companies also increased over this same period. According to data from *Mergermarket*, in 2023 the total number of takeover bids for Japanese publicly traded companies increased by approximately 60% in comparison to 2022. The Japanese market may be luring acquirers for many reasons, including (i) Japan is the fourth largest economy in the world, with a population of approximately 125 million (offering access to a large and broad-based market of sophisticated and affluent consumers), (ii) the Japanese yen has depreciated in value by approximately 40% against the U.S. dollar since the beginning of 2022 due to differences in monetary policies (resulting in lower purchase prices in U.S. dollar terms), (iii) until only recently, wages in Japan have remained essentially flat for over a decade (allowing businesses to easily predict labor costs), and (iv) the current pivot by major industrialized economies from China due to political and industrial policy concerns has naturally placed Japan in the spotlight thanks to its stable political regime, recognition of the rule of law, and its treaty relationships with numerous countries to facilitate trade. With Japan inbound M&A gaining momentum (especially in the public markets sphere), now is an opportune time for deal-makers to gain an understanding of how to effect a going private transaction.

This edition of the *Corporate Counselor* explains the methods available to a majority shareholder to squeeze-out the minority shareholders of a Japanese company with a divergent shareholder base in a time and cost-effective manner, and the ways a dissenting minority shareholder can preserve standing and challenge the take-private efforts of a majority shareholder. While the methods to squeeze-out minority shareholders have not significantly changed over the past few years, the steps an acquirer should take to reduce court scrutiny are now clearer. This newsletter concludes that the limitations on class action lawsuits in Japan create an environment where a majority shareholder can squeeze-out the minority shareholders with little fear of impunity (unless a shareholder has deep pockets to fund litigation).

This newsletter does not address the tax implications arising from taking a Japanese company private or the tax benefits that an acquirer can realize if certain post-closing management and operational requirements over the target company are satisfied. The advice of tax experts should be obtained to understand the full ambit of these requirements and the feasibility of following them in connection with an acquisition.

Common Methods to Squeeze-Out Minority Shareholders

***Background*.** The need to squeeze-out minority shareholders typically arises in the context of a public company going private transaction given the large and diverse shareholder base of the target company. While a privately held company also can have numerous shareholders (if, for example, it is a family owned business, has granted stock options or has issued shares to several customers and suppliers), this newsletter focuses on squeeze-outs in the public company context given its greater prevalence.

Leaving a Japanese publicly traded company with a minority shareholder base is not cost efficient for an acquirer because a lingering minority shareholder base can impact the post-acquisition business plans of the acquirer due to minority shareholder rights and protocols provided under Japanese corporate law. Public company going private transactions are typically structured in Japan as a first-step cash tender offer followed by a second-step compulsory cash squeeze-out transaction so the target company can become wholly-owned by the acquirer. Share exchanges and one-step mergers are not widely used in Japan, as discussed below.

Share exchange offers are uncommon in Japan notwithstanding the changes to Japanese tax regulations in 2021 to treat a share exchange as a non-taxable event if the requirements of a *kabushiki-kofu* are satisfied (a discussion of which is beyond the scope of this newsletter). The lack of traction for *kabushiki-kofu* share exchange offers in Japan may be due to various factors, including (i) the tendency for target company shareholders to prefer cash instead of shares as consideration (so an acquirer offering cash may increase the likelihood of success for its takeover), (ii) the healthy balance sheets of many Japanese acquirers combined with the low interest rate environment in Japan and the willingness of Japanese banks to extend financing make it relatively less difficult for an acquirer to raise funds to launch an all cash tender offer, (iii) the longer time and greater expense an acquirer may incur

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if shares are offered as the acquisition currency because an acquirer that is publicly listed must file a securities registration statement to offer its shares to the target company's shareholders, (iv) if the value of the acquirer's shares declines over the pendency of the exchange offer, then the acquirer may need to revise its tender offer notification securities registration statement (which may delay the completion of the transaction and potentially create completion risks that would not arise if cash is offered), and (v) the two common methods to squeeze-out minority shareholders in a second-step squeeze-out transaction (as discussed below) both require the payment of cash to the minority shareholders, so offering shares in a first-step tender offer and cash in the second-step squeeze-out transaction may raise value equivalence concerns. An acquirer not organized under Japanese law also is currently unable to acquire a Japanese company through a *kabushiki-kofu* share exchange structure.

One-step merger transactions are fully implemented upon receipt of requisite shareholder approval, so no squeeze-out transaction is necessary. However, one-step merger transactions are uncommon in Japan because an acquirer can acquire a foothold ownership position or even control over the target company (thereby securing deal certainty) quicker through a tender offer, which is especially important if there is an inter-lopper risk. Also, shareholders will receive payment more quickly through a tender offer, which could lead to greater shareholder acceptance for the acquisition. Separately, an acquirer can generally speaking more easily demonstrate through a two-step acquisition structure the fairness of its offer if a large number of shares are tendered in the first-step transaction, which can be helpful if minority shareholders subsequently challenge the acquisition. If a one-step merger is adopted and the acquirer does not own a super-majority of the voting rights of the target company at launch, then share mergers as opposed to cash mergers are common in Japan due to tax reasons (a discussion of which is beyond the scope of this newsletter).

Common squeeze-out methods. While there are several ways to squeeze-out minority shareholders in Japan, there are currently two principal methods depending on the voting rights of the target company held by the acquirer (both of which require the minority shareholders to be paid in cash):

1. Demand for sale of shares method
(for acquirers owning 90% or more of the voting rights of the target company)

The demand for sale of shares method has been available to acquirers since May 1, 2015, and is often the preferred squeeze-out method considering how quickly the process can be completed and its application to all of the target company's outstanding equity securities. Given its relative quick implementation and comprehensive impact, an acquirer must own a high percentage of the target company's shares to utilize this squeeze-out method.

A demand for sale of shares is effected as follows:

- As a first step, the acquirer (either directly or through a Japanese special acquisition vehicle) launches a tender offer to acquire the target company's shares. If the acquirer (either alone or together with its wholly-owned subsidiary) is able to purchase at least 90% of the voting rights of the target company, then it achieves the status of being a "Special Controlling Shareholder" and it is granted by operation of law with a conditional call option over all of the outstanding equity securities of the target company not owned by the acquirer (including share options and warrants of the target company, but not treasury shares held by the target company).

- The basic features of the conditional call option are: (i) it is created immediately upon an acquirer qualifying as a Special Controlling Shareholder, and no documentation needs to be prepared to issue the conditional call option to the Special Controlling Shareholder (since the conditional call option is created automatically by operation of law), (ii) it covers all of the outstanding shares, share options and warrants of the target company (not a portion or a class of securities, so it must be exercised in full), and (iii) there is no expiration date for the exercise of the conditional call option by the Special Controlling Shareholder.

- To exercise the conditional call option, the Special Controlling Shareholder must (i) notify the target company's board of directors in writing of its intention to exercise the conditional call option and provide the proposed closing date for the share purchase and the purchase price (which consideration must be in the form of cash), and (ii) request that the board of directors of the target company accept the exercise of the call option by the Special Controlling Shareholder pursuant to such terms (which is why the call option is considered "conditional").

- No shareholders' meeting of the target company is required to implement the conditional call option (which reduces completion time), no direct communications between the Special Controlling Shareholder and the minority shareholders are required for the Special Controlling Shareholder to exercise its conditional call option, and the Special Controlling Shareholder cannot assign its rights under the conditional call option to a subsidiary (wholly-owned or otherwise, even if the shares of the wholly-owned subsidiary are counted toward achieving the 90% ownership threshold).

- The target company's board of directors is required to act on behalf of the minority shareholders to protect their interests and to inform them of the details of the conditional call option exercise by the Special Controlling Shareholder. If the target company's board of directors approves the conditional call option exercise by the Special Controlling Shareholder (which is common, as discussed immediately below), then the board must notify the minority shareholders and the target company's share option and warrant holders through a notification and/or a written public notice at least 20 calendar days prior to the proposed closing date for the share purchase.

A target company's board often will approve the conditional call option exercise by a Special Controlling Shareholder due to local deal-making dynamics. A target company is required to publicly disclose its views of a proposed takeover. The support of the target company is pivotal to the success of a takeover transaction. To garner the support of the target company for the acquisition, it is a frequent Japanese M&A practice in friendly transactions for an acquirer and the target company to discuss in advance the proposed transaction and conceptually agree on material terms (and to expressly execute an agreement in some cases), which agreement typically includes that the consideration offered to the minority shareholders in the second-step squeeze-out transaction will equal the price paid in the first-step tender offer to avoid the appearance of minority shareholder coercion. By framing upfront the purchase price in the squeeze-out transaction, it is normally a foregone conclusion that the target company's board of directors will approve the conditional call option exercise by the Special Controlling Shareholder.

The approximate time to complete the demand for sale of shares method is normally three to five weeks.

If the acquirer does not own 90% or more of the total voting rights in the target company, then the acquirer can apply to the relevant government ministries under the Industrial Competitiveness Enhancement Act of Japan to lower the threshold from 90% to two-thirds of the voting rights of the target company. As there are numerous procedural requirements, disclosure obligations and minority shareholder protection provisions provided under the Industrial Competitiveness Enhancement Act of Japan, its availability is neither automatic nor a panacea. For acquirers interested in this route, the advice of legal counsel should be sought to determine whether it is prudent to proceed under this alternative. For a summary of the requirements under the Industrial Competitiveness Enhancement Act of Japan, please visit here.

If the acquirer does not own 90% or more of the total voting rights in the target company and relief under the Industrial Competitiveness Enhancement Act of Japan will not be pursued, then use of a reverse share split is a common alternative.

2. Reverse share split
(for acquirers owning two-thirds or more of the voting rights of the target company)

As a first step, the acquirer (either directly or through a Japanese special acquisition vehicle) launches a tender offer to acquire the target company's shares. If the acquirer purchases at least two-thirds of the voting rights of the target company, then a special meeting of the target company's shareholders is held to approve the reverse share split. Upon approval by shareholders owning at least two-thirds of the voting rights of the target company (which threshold includes the shares owned by the acquirer, so passage of the resolution is assured), then the target company can effect a reverse share split pursuant to which the consolidation ratio is set to a level that is sufficiently high to render after the split all (or a targeted number) of minority shareholders with fractional share ownership. Since fractional shares cannot be issued under Japanese corporate law, the sum of the fractional shares are either sold to a third party designated by the target company (typically the acquirer) or are repurchased by the target company itself upon receipt of court approval (which approval is a standardized procedural step as opposed to a potential substantive challenge, and it normally takes approximately two to four weeks to obtain such court approval), and then cash consideration is distributed to the minority shareholder in an amount equal to the quantity of shares owned by the minority shareholder multiplied by the offer price in the first-step tender offer.

While easy to implement, a drawback of a reverse share split is that it may not apply automatically to holders of share options or warrants of the target company (unlike the demand for sale of shares method, as discussed above), so an examination of these instruments will be necessary to determine if a reverse share split is beneficial. On the other hand, a reverse share split can be particularly helpful if the acquirer plans to own the target company with co-investors since the consolidation ratio can be set to a level that will not eliminate the ownership of consortium members.

Considering the time to obtain court approval and to follow the record date, notice period and meeting formalities under Japanese corporate law, the approximate time to complete a reverse share split is normally three to four months.

Less Common Methods to Squeeze-Out Minority Shareholders

If an acquirer purchases at least two-thirds of the voting

rights of the target company, squeezing out minority shareholders by way of a cash-out merger (*genkin kōfu gappei*) or a cash-delivery-share-exchange (*genkin kōfu kabushiki kōkan*) are other effective methods to squeeze-out minority shareholders considering the Japanese taxation reforms effective from October 1, 2017. However, these procedures are rarely used in Japan because (i) each can be relatively more burdensome if the acquirer directly acquires the target company's shares (as opposed to acquiring shares through a special acquisition vehicle), (ii) each can cause some tax disadvantages or unintended tax incentives for shareholders to oppose the first-step tender offer in order to be bought-out in the second-step squeeze-out transaction, and (iii) normally neither has any material advantages over the reverse share split method (which method has been widely tested by Japanese courts and considered an acceptable way to squeeze-out minority shareholders, so the reverse share split method adds to deal certainty).

Remedies Available to Dissenting Shareholders

Shareholders who object to a squeeze-out transaction can (i) petition a court to appraise the fair value of their shares, (ii) pursue a legal action against the directors of the target company claiming that they acted in bad faith or with gross negligence when performing their duties (e.g., the directors did not pay sufficient attention to the interests of the minority shareholders), (iii) request an injunction to prevent the closing of the squeeze-out transaction, or (iv) seek to nullify the squeeze-out transaction in its entirety.

An appraisal is the most common remedy selected by dissenting shareholders when challenging a squeeze-out transaction because a dissenting shareholder may realize a direct financial gain if it is awarded an increase in the purchase price for its shares (which economic incentive may motivate a dissenting shareholder to undertake the time and expense to challenge a going private transaction). While pursuing a legal action against the directors of the target company also can lead to financial gain for a dissenting shareholder, such suits are uncommon in Japan due to the high burden of proof that must be satisfied and comprehensive discovery is not available in Japan (so a dissenting shareholder will face an uphill battle to meet its burden of proof to succeed). Seeking an injunction or nullification of a squeeze-out transaction is uncommon in Japan too because neither approach will likely confer a monetary benefit to the dissenting shareholder. In light of the foregoing, this newsletter focuses on the appraisal remedy.

Appraisal Process

A dissenting shareholder must follow certain procedures to exercise its appraisal rights, and the target company can reduce the likelihood of an appraisal award if it follows safe harbor procedures, each as discussed below.

Standing to invoke. To initiate an appraisal proceeding, a dissenting shareholder must not tender its target company shares in the first-step tender offer, and it must comply with additional procedures depending on the squeeze-out method utilized by the acquirer:

- In a demand for sale of shares, the dissenting shareholder must be a shareholder of the target company prior to the date the target company's board of directors issues its notification or public notice concerning its approval of the call option exercise by the Special Controlling Shareholder. In addition, the dissenting shareholder must petition a court to appraise the value of its shares between 20 days prior to the effective date of the squeeze-out and the day immediately preceding the effective date of the squeeze-out.

- In a reverse share split, the dissenting shareholder must vote against the reverse share split at the relevant shareholders' meeting, deliver a repurchase demand to the target company between 20 days prior to the effective date of the reverse share split and the day immediately preceding the effective date of the reverse share split, and if the target company and the dissenting shareholder are unable to agree on a fair price for the target company shares owned by the dissenting shareholder within 30 days from the date discussions are requested to commence, then the dissenting shareholder or the target company can petition a court to appraise the value of the target company shares owned by the dissenting shareholder.

The purchase price discussions between the target company and a dissenting shareholder in the reverse share split context are held in confidence, so a dissenting shareholder ordinarily will not become aware of the price paid to another dissenting shareholder unless a dispute is brought to trial and a final court decision is published.

Safe harbor procedures. Appraisal cases in Japan were historically treated as non-contentious cases in which courts had reasonable discretion to determine fair value. Some Japanese lower courts made their fair value determinations by analyzing the value of the target company prior to the M&A transaction versus the increase in value to the target company after the M&A transaction. The bifurcation of value analysis exposed transactions to unpredictable outcomes because courts were inconsistent in their valuation methodologies, and some courts even considered the tender offer price as the baseline to determine the increase in value to the target company after the M&A transaction. This baseline approach to valuation exposed going private tender offer transactions to an inherent risk of challenge since courts ordinarily would award a dissenting

shareholder an amount equal to at least the tender offer price, so a dissenting shareholder theoretically had little to lose when challenging a transaction (other than time, advisor expenses, and reputation risk). In one fell swoop, Japan's Supreme Court changed the appraisal valuation rubric in a controlling shareholder going private transaction.

On July 1, 2016, Japan's Supreme Court issued its historic ruling in the *Jupiter Telecommunications* case, which abruptly ended the Japanese lower court's discretion to independently value the shares owned by minority shareholders in contested squeeze-out transactions, unless specified procedural safeguards were not followed. The Supreme Court held that if the tender offer price is agreed in accordance with a process "generally accepted to be fair" to avoid conflicts of interests between the majority shareholder and the minority shareholders (such as by seeking an advice from an independent expert) and the acquirer pays the same purchase price in the first-step tender offer and the second-step cash squeeze-out transaction, then courts (absent special circumstances) should not formulate their own views on the price paid to minority shareholders and accept the tender offer price as fair value. The Supreme Court also held that the approximate 60% rise in the *Nikkei* 225 over the nine month period from the date of the Jupiter Telecommunications tender offer announcement to the closing of the squeeze-out transaction would not qualify as a "special circumstance" warranting court intervention because such fluctuation is not unprecedented in Japan and ordinarily should be taken into consideration when a tender offer is agreed in accordance with a process "generally accepted to be fair." Therefore, unless stock market indexes increase beyond historic fluctuation levels over the subject period, the occurrence of a bull market will not be considered a "special circumstance" opening the door for courts to make their own valuation determination.

While the Supreme Court noted the steps undertaken by the target company in the *Jupiter Telecommunications* case supported a view that the tender offer was made in accordance with a process "generally accepted to be fair," it was arguable whether such steps were applicable only to the transaction at hand. This ambiguity was laid to rest a few years later.

On June 28, 2019, Japan's Ministry of Economy, Trade and Industry published its "Fair M&A Guidelines," an influential paper addressing how a management buyout and a controlling shareholder going private transaction should be conducted. While non-binding, the Fair M&A Guidelines call for a target company to adhere to the following steps to support the view that a management buyout or a controlling shareholder going private tender offer was made in accordance with a process "generally accepted to be fair" (thereby obviating the need for court intervention to determine fair value): (i) establishing a special committee composed of independent outside directors, independent outside statutory auditors and/or independent outside professionals to either make a recommendation towards the transaction or to directly negotiate the transaction, (ii) obtaining the advice of external experts concerning the fairness of the transaction and valuation from a legal and financial point of view, (iii) undertaking a market check (including a go-shop), (iv) imposing a "majority of the minority" approval requirement, (v) implementing full disclosure of the acquisition process to create transparency, and (vi) excluding compulsory pressure tactics towards the minority shareholders (such as assuring that an appraisal remedy will be available and disclosing upfront that the second step squeeze-out price will be no lower than the first step tender offer price). The target company may elect to adopt all or some of these measures by considering the severity of the conflict of interest between the acquirer and the shareholders, as well as other considerations.

Among the Fair M&A Guidelines, the existence of an independent special committee is regarded as especially important since the independent committee is expected to directly represent the interests of both the target company and its shareholders. On the other hand, Japanese courts have generally not yet placed weight on the "majority of the minority" approval requirement, perhaps due to concerns that a wily shareholder could thwart an M&A transaction by simply acquiring a small strategic block of target company shares. If a court determines that a tender offer was not made in accordance with a process "generally accepted to be fair," then the court can determine fair value. The recent *Family Mart* appraisal case provides insights on the procedural factors a court considers unfair.

On July 8, 2020, an affiliate of Itochu Corp, which indirectly owned 50.1% of the Family Mart convenience store chain at the time, publicly announced a $5.4 billion tender offer to take Family Mart private. In response to the controlling shareholder going-private offer, the target company established a special committee to evaluate the fairness of the tender offer price. An outside expert provided the special committee with a price range that it considered fair value for the shares of Family Mart. Although the acquirer proposed a tender offer price that was below the bottom range of the outside expert's suggested price range, the special committee nonetheless agreed with the offer and the going private transaction was completed. Certain minority shareholders objected to the second-step squeeze-out effected through a reverse share split, and brought an appraisal proceeding. On March 23, 2023, the Tokyo District Court held that the special committee of Family Mart did not properly function, partly because it failed to maximize shareholder value by accepting without justifiable reason a tender offer price that was below the outside expert's price range. As such, the Tokyo District Court held that the tender offer was not made in accordance with a process "generally accepted

to be fair" given the failure of the special committee to fulfill its critical role, and awarded the plaintiffs an increase in their per share purchase price from JPY 2,300 to JPY 2,600 in the squeeze-out transaction.

Appraisal interest. A shareholder undertaking an appraisal has a statutory right to receive interest at the variable-rate stipulated in the Civil Code of Japan, which is currently 3% per annum. Until only recently, the Bank of Japan has maintained its key short-term interest rate near zero since 1999, so a dissenting shareholder winning an appraisal proceeding could receive a substantial interest payment. However, the interest receipt bonanza collapsed in 2014 when Japanese corporate law was amended to permit the target company or the acquirer to make a tentative prepayment to dissenting shareholders pending a court's fair value determination. By paying an amount per share equal to the tender offer price to dissenting shareholders, interest will accrue only on the difference between the court's determination of fair value and the tender offer price, thereby reducing the economic incentive for a shareholder to object to a transaction based on an interest award calculus.

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Japan has experienced a renaissance in corporate governance and shareholder communications over the past decade. The Stewardship Code was introduced by the Financial Services Agency in 2014 (and updated in 2017 and 2020), the Corporate Governance Code was introduced by the Tokyo Stock Exchange in 2015 (and updated in 2018 and 2021), and the Guidelines on Fair M&A and the Guidelines for Corporate Takeovers were published by the Japanese government in 2019 and 2023, respectively. Pundits believe that these reforms have contributed to increased engagement between Japanese companies and investors, corporate Japan enacting reforms to increase shareholder value, and Japanese boards becoming more accountable for governance and performance issues, all of which have made Japanese equities increasingly more attractive. The foregoing culminated on July 11, 2024, when the *Nikkei 225* hit an all-time high of 42,224. Nonetheless, the average P/E Ratio of companies trading over the *Nikkei 225* still lags far below the *S&P 500*. While many factors may be contributing to this divergence, the inability of minority shareholders to effectively exercise their appraisal rights should be on the list.

There are various roadblocks a shareholder must circumvent to initiate an appraisal proceeding. For example, the appraisal process can take years to complete, over which a dissenting shareholder will need to devote time and effort to pursue an action. Legal fees, expert fees, and other costs associated with the appraisal process will build and can be prohibitively expensive for shareholders to manage (except for institutional minority shareholders with deep pockets), which is especially poignant since Japan does not permit class action lawsuits outside the consumer context. While a Japanese court may elect to consolidate appraisal cases, such decision will be made after the minority shareholders have progressed an appraisal demand and already have incurred significant time and expense to make their respective filings. As such, a dissenting shareholder will need to assume from the outset that it will solely bear all the fees and expenses in an appraisal proceeding since case consolidation is not guaranteed.

While the *Jupiter Telecommunications* case and the Fair M&A Guidelines greatly advanced the appraisal process in Japan by providing dissenting shareholders with the requisite ammunition to argue their cases, at the same time, dissenting shareholders have been left without an effective weapons delivery system. Until the appraisal process becomes more accessible to dissenting shareholders, controlling shareholders may have little fear of retribution and dissenting shareholders will be left with a stockpile of arguments. Should Japanese law address this disparity, care should be taken that the changes do not open the floodgate to financial arbitrageurs abusing an appraisal legal remedy that was not genuinely meant for them.