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The Corporate Counselor

- Insights into Japanese Corporate Law -

June 2017/No.23

JOINT VENTURE TERMINATION SURPRISES IN JAPAN

A joint venture is a common ownership structure for parties to collaborate in Japan. Based on announcements made in the *Nikkei* newspaper between February 1, 2002 through July 31, 2012, approximately 650 joint ventures were formed in Japan (although the actual number should be higher as not all joint ventures in Japan are covered by the *Nikkei*). Potential benefits from operating through a joint venture structure include lowering the investment cost to each joint venture partner, creating synergies through the sharing of facilities and technology, combining the competitive advantages of the joint venture partners to create a more formidable enterprise, and allowing new market penetration for a foreign joint venture partner where local requirements preclude 100% foreign ownership in the subject industry. Despite the numerous benefits of the joint venture structure and the initial good intentions of the joint venture partners, few joint ventures survive for a long time.

A joint venture may be abandoned for numerous reasons, including cultural differences, failure to meet business objectives, joint venture agreement breaches, or the joint venture company becoming so successful that a joint venture partner desires to pursue the business on its own.

Terminating a joint venture (regardless of the jurisdiction) often requires the joint venture parties to consider a host of common issues, including the impact on key contracts arising from a change in control; the need for on-going joint venture company funding if a joint venture partner will pursue the project solo; the replacement of intellectual property, shared services and financial guarantees that may not be available after a joint venture partner exits; the handling of secondees from the exiting joint venture partner; and the tax treatment if the joint venture company's operations cease and the business will be liquidated. Japan is no different, and joint venture partners will need to consider these issues when terminating a joint venture in Japan. However, there are a host of additional special issues that joint venture partners may encounter when exiting a joint venture relationship in Japan in light of the unique aspects of Japanese law and local market practices.

Dealmakers and advisors may cringe when learning that various provisions of a joint venture agreement may not apply (despite the provision accurately reflecting the negotiated deal) or additional liabilities may accrue in the Japan context depending on (i) whether a joint venture partner will acquire the joint venture company's shares from the other joint venture partner, (ii) whether the joint venture company will be dissolved, or (iii) whether the joint venture partners will seek to enforce certain contractual rights. Each is discussed below.

SURPRISES ARISING WHEN A JOINT VENTURE PARTNER WILL ACQUIRE THE JOINT VENTURE COMPANY

Tort liability for soliciting employees

Joint venture agreements often prohibit a joint venture partner from soliciting the employees of the joint venture company during the term of the joint venture and for a period after the termination of the relationship. A joint venture partner would be incorrect to believe, however, that the absence of this standard non-solicitation covenant in a joint venture agreement allows it to have free rein to hire talent from the joint venture company during the joint venture or after it has sold its shares in the joint venture company. Quite the contrary — an employee non-solicit obligation is not solely a construct of negotiation.

Tort liability can be derived under Japan's Civil Code independent of contractual agreements if the employee solicitation activities deviate from so-called "socially accepted standards." There is no bright-line test to determine whether actions deviate from "socially accepted standards," and a determination is fact-specific. However, generally speaking Japanese courts often examine the following factors: (i) the number of employees solicited, (ii) the economic or operational impact on the subject company as a result of the loss of the departing employees, (iii) the amount of prior notice the subject company received before the departing employees ceased to work, (iv) the manner in which the employee solicitation activities were conducted (soliciting on the employer's premises is especially frowned upon by Japanese courts), and (v) the position, seniority/unique skill-set of the departing employees.

Closing delay if stock certificates are lost

Ownership interests in a Japanese company can be evidenced by either physical stock certificates or by book-entry recordings in a company's stockholders ledger (*i.e.*, scriptless). Whether a company is a stock certificate issuing company or scriptless will be stated in its articles of incorporation. If the joint venture company is a stock certificate issuing company, then a shareholder who has lost its stock certificates in the joint venture company may not validly sell the stock represented by such lost certificates because Japanese corporate law requires the delivery of physical stock certificates for the valid assignment and transfer of shares (in a stock certificate issuing company) to a third-party.

There is no easy fix under Japanese corporate law if a shareholder has lost its stock certificates (such as executing an affidavit of lost stock certificates and thereafter issuing new shares). If a selling joint venture partner has lost its stock

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certificates in the joint venture company, then it will need to wait until the first anniversary of the date when the subject shares were listed in the joint venture company's "lost stock certificate registration ledger" (a publicly available document intended to give notice of a person's claim over a lost stock certificate) before title to such shares can be transferred. A one-year waiting period would be untenable for most buyers given the various valuation impacting events that could transpire over this period. Furthermore, the timetable to consummate a put/call option in a joint venture agreement may not be possible to meet.

The one-year waiting period can be reduced to approximately one to two months if the joint venture company amends its articles of incorporation to become a book-entry/scriptless share ownership company. Effecting such amendment requires super-majority shareholder approval, and public notice and individual notice must be given to each shareholder and registered share pledgee no later than two weeks before the effective date of the aforementioned amendment. Upon the effectiveness of the amendment, then all previously issued stock certificates (including the lost certificates) become void by operation of law and share ownership will be reflected only through the joint venture company's stock ledger.

Board can defer the closing date for a share transfer

Most Japanese companies whose shares are not traded on a stock exchange, such as a joint venture company, require board approval for share transfers. A board, however, cannot simply reject a proposed share transfer without impunity. When seeking board approval for a share transfer, the transferring shareholder can stipulate in its share transfer request to the board that if the board rejects the proposed share transfer, then the company should repurchase the shares at the same transfer price and/or the board should locate an alternative purchaser for the shares. Within two weeks of receipt of a share transfer request, the board is required to decide whether to accept or reject the proposed share transfer (and if rejected, the board is required to notify the transferring shareholder which notified alternative will be pursued).

If the board rejects the share transfer requests and selects the option to repurchase the shares, then the company is required to repurchase the shares within 40 days of the date the transferring shareholder is notified that the board has rejected the proposed share transfer (unless the company's articles of incorporation provide for a shorter period) and if the repurchase is not timely consummated, then the proposed share transfer is deemed approved by the board. Alternatively, if the board rejects the share transfer and selects the option to locate another purchaser for the shares, then (i) the board is required to notify the transferring shareholder of the identity of the designated new purchaser for the shares within 10 days of the date the board has determined to reject the proposed share transfer (and if such designation is not timely made, then the proposed share transfer is deemed approved by the board), and (ii) the designated new purchaser and the transferring shareholder have 20 days from the date the board has notified the transferring shareholder of its determination to reject the proposed share transfer to negotiate the terms and conditions for the sale (and if such negotiations are not timely agreed, then the transferring shareholder can petition a Japanese court to resolve purchase price disputes).

A joint venture partner exercising its put rights that does not control the joint venture company's board, therefore, is exposed to potential gamesmanship if the remaining joint venture partner wants to delay the share transfer to extract concessions from the selling joint venture partner.

Joint venture partner cannot control the joint venture company

Although Japan welcomes foreign direct investment, there are a few hurdles that could prevent a foreign joint venture partner from controlling the joint venture company.

- First, Japan restricts by statute foreign direct investment exceeding 20% in broadcasters and foreign direct investment exceeding 33% in Nippon Telegraph and Telephone (Japan's former land-line monopoly telephone operator).

- Second, a foreign investor is required to make a pre-filing notification under Japan's Foreign Exchange and Foreign Trade Law if it seeks to acquire from a resident of Japan shares (and even a single share in the case of an unlisted company) of an entity engaged in a sector designated important to Japan's national interest (such as agriculture, aerospace, forestry, petroleum, electric/gas/water utilities, telecommunications, weapons, and leather manufacturing). The filing must be submitted within six months of the proposed acquisition, and the waiting period for the applicable Ministry to decide whether the transaction can proceed is 30 days (which can be shortened to two weeks, or extended up to five months if the applicable Ministry seeks additional information or time to review). Even if a foreign joint venture partner has submitted a filing under the Foreign Exchange and Foreign Trade Law in connection with its initial purchase of shares in the joint venture company, this earlier filing will not preempt a subsequent filing requirement in connection with the purchase of additional shares in the joint venture company or preclude the applicable Ministry from blocking the subsequent share sale even though the prior transfer was permitted. While very few foreign direct investments have been blocked under the Foreign Exchange and Foreign Trade Law, clearance is not an absolute certainty. In May 2008, the Japanese government refused to allow the hedge fund The Children's Investment Master Fund to increase its ownership position to 20% in Japanese electric power wholesaler J-Power.

- Finally, if the joint venture company operates in a regulated industry, the acquiring joint venture partner may be required to obtain an acquisition approval or authorization from the relevant supervisory authority. For example, a person acquiring 20% or more (and in certain cases 15%) of an insurance company in Japan must obtain prior approval from Japan's Financial Services Agency, so it is conceivable that an acquiring joint venture partner's application could be blocked (which would reduce the

utility of a call option or other share purchase rights in a joint venture agreement).

Former directors may continue to have liability

A company organized under Japanese law is required to maintain a commercial registry with the Legal Affairs Bureau of the Ministry of Justice. The commercial registry is a publicly available document that discloses basic information about the company, including the names of its directors. When a joint venture partner sells its shares in the joint venture company, the director designees of the departing joint venture partner normally submit resignation letters. A resigning director should insist that his/her name is promptly removed from the company's commercial registry because it is theoretically possible that a person listed therein maintains director fiduciary duty liability despite having submitted a resignation letter (unless the claimant knew that the subject director actually was no longer serving in such capacity).

A joint venture company may fail to properly update the director listings in its commercial registry after a director designee of a joint venture partner submits his/her resignation due to neglect or legal impermissibility. While there can be various motivations leading to neglect, legal impermissibility may arise from Japanese corporate governance requirements. A Japanese company adopting a board of directors corporate governance scheme is required to have at least three directors. If the departing joint venture partner had a director designee serving on the board of the joint venture company, then such director's resignation will not be accepted by the Legal Affairs Bureau if the joint venture company will be left with less than three directors.

Accordingly, a departing joint venture partner should include covenants in the exit documentation that the remaining joint venture partner will cause the joint venture company to take all steps necessary to promptly update its commercial registry to reflect the resignation status of the resigning directors, including the appointment of replacement directors if required by law. While this covenant is not a perfect fix, the passage of a short time to update the commercial registry should be manageable under most circumstances. If the joint venture company breaches its commercial registry updating covenant due to (i) neglect, then the resigning director could petition a court to have the Legal Affairs Bureau correctly reflect his/her resignation status in the joint venture company's commercial registry, or (ii) failure to appoint the requisite number of replacement directors, then the departing joint venture partner should have a breach of contract claim and could seek a remedy pursuant to the dispute resolution procedures under the exit documentation.

SURPRISES ARISING WHEN THE JOINT VENTURE COMPANY WILL BE DISSOLVED

Commercial agreements could be difficult to unilaterally terminate

A joint venture company will likely enter into various commercial agreements with third parties. If the joint venture company has entered into a "continuous contract" with a third party, then it may be difficult to freely terminate this relationship despite the dissolution of the joint venture company. A "continuous contract" is generally understood in Japan as a contract under which a party is required to perform an obligation continuously by virtue of the nature of the duty (*i.e.*, the duration of the agreement does not directly dictate whether an agreement is considered continuous, but the underlying type of obligation and whether such obligation by its nature should be performed continuously are the determining factors. Many Japanese lower court precedents treat distribution agreements, franchise agreements and supply contracts as "continuous contracts" due to the ongoing and long-term requirement of one party to supply and the other party to purchase the subject matter of the particular contract.

If a commercial agreement is characterized as a "continuous contract," a Japanese court is likely to require a "justifiable and unavoidable reason" in order to allow the unilateral termination of the arrangement, even if the agreement specifically permits a unilateral termination. The concept of "justifiable and unavoidable reason" is not clearly defined and is subject to court discretion depending on the facts and circumstances, but an overarching concern is to protect legitimate business decisions based on the expected duration of the subject agreement. Solely relying on the dissolution of the joint venture company as a "justifiable and unavoidable reason" may not be sufficient to shield liability, therefore, legal counsel should develop a plan on how to approach the termination of a "continuous contract" to mitigate monetary damage claims that could be made against the joint venture company or even directly against the joint venture partners.

SURPRISES ARISING WHEN THE JOINT VENTURE PARTNERS ENFORCE CONTRACTUAL RIGHTS

Termination events may not be enforceable

Joint venture agreements normally allow the parties to terminate the arrangement upon the occurrence of enumerated events. Two common joint venture termination events may not apply or be enforceable in Japan:

- **Initial public offering event**. Joint venture agreements typically provide for automatic termination upon the closing of an initial public offering, as various corporate governance provisions for a company with only a few shareholders are not suitable for a publicly traded company. The listing practices of the Tokyo Stock Exchange, however, call for the termination *at the time the listing application is submitted* to the Tokyo Stock Exchange of agreements with shareholders that contain, in the view of the Tokyo Stock Exchange, "objectionable" corporate governance schemes (such as providing a shareholder with proportional board representation or veto rights, which are common provisions in joint venture agreements) because the listing rules require a newly listed company to treat every shareholder equally. As the listing process can take months to complete and the submission of a listing application does not guarantee listing acceptance, joint venture partners are placed in an

awkward position of relinquishing upfront joint venture contractual rights without assurances that the listing will be completed. Joint venture partners may consider entering into a side agreement addressing how the joint venture company will be operated pending a determination over its listing application and the consequences of a listing failure, but legal counsel should be consulted to develop an approach that will not be viewed by the Tokyo Stock Exchange as a deliberate circumvention of its listing practices.

- **Bankruptcy or insolvency of the joint venture partner event**. Joint venture agreements typically include an automatic termination right upon the bankruptcy or insolvency of a joint venture partner. In relation to a joint venture partner that undergoes a Japanese workout proceeding, Japan's Supreme Court has held that a clause providing for the automatic termination of an agreement due to a party undergoing a Japanese corporate reorganization (a trustee led workout process) or a Japanese civil rehabilitation (a debtor in possession workout process) is unenforceable under Japanese law. In relation to a joint venture partner that undergoes a workout proceeding outside of Japan, Japanese conflict of laws analysis normally defers this termination right ability to an analysis under the laws of the jurisdiction where the proceedings commence. For example, if a joint venture partner that is a party to a Japanese law governed joint venture agreement undergoes a U.S. Chapter 11 reorganization proceeding, then the non-defaulting joint venture partner could not exercise a bankruptcy termination right under the joint venture agreement because Section 365(e)(1) of the U.S. Bankruptcy Code provides that *ipso facto* provisions (such as termination rights due to the occurrence of a bankruptcy or insolvency proceeding) in executory contracts (such as joint venture agreements) are not enforceable.

Confidentiality covenant not an effective deterrent

Joint venture agreements normally require each joint venture partner during the term of the arrangement and for a period after the termination of the arrangement to maintain the confidentiality of the proprietary information of the joint venture company and the other joint venture partner, and not to use such proprietary information except for the benefit of the joint venture company (subject to limited exceptions). If a joint venture partner breaches this covenant with respect to unpatented proprietary information that is not a trade secret (as trade secret infringement is handled under Japan's Unfair Competition Prevention Act), then the non-breaching joint venture partner may have few effective options. Except with respect to material non-trade secret intellectual property that is not covered by a patent, Japanese courts rarely grant injunctions or award significant damages for confidentiality clause breaches. As a result, the non-breaching joint venture partner can be left with a right that does not have a meaningful remedy. A potential fix to this conundrum (when preparing a joint venture agreement for Japan) is to provide upfront in the joint venture agreement for a payment to be made upon a breach of the confidentiality covenant. Counsel should be consulted to develop a scheme that will not be voided as an improper payment and one that also will not prevent the pursuit of other legal remedies.

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While none of the "surprises" mentioned in this edition of the *Corporate Counselor* should dissuade investors from investing in Japan, principals and advisors may wish to use the information herein when negotiating a joint venture agreement to avoid making concessions in exchange for a right that will not be enforceable and to request certain covenants to reduce the ability of a counter-party to manipulate the exit process. For those investors who are considering the termination of an existing Japan joint venture agreement, then the information in this newsletter can be used for strategic considerations to better understand rights and obligations during the exit process.