Private Equity 2021

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LEXOLOGY
Getting The Deal Through

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Atif Azher
Simpson Thacher & Bartlett LLP

Lexology Getting The Deal Through is delighted to publish the seventeenth edition of *Private Equity*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Russia. The report is divided into two sections: the first deals with fund formation in 13 jurisdictions and the second deals with transactions in 18 jurisdictions.

Lexology Getting The Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.lexology.com/gtdt.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Atif Azher of Simpson Thacher & Bartlett LLP, for his continued assistance with this volume, and also extend thanks to Bill Curbow of Simpson Thacher & Bartlett LLP, the former contributing editor, who helped to shape the publication to date.

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Contents

Global overview 5
Atif Azher, Peter H Gilman, Fred de Albuquerque and Audra Cohen
Simpson Thacher & Bartlett LLP

FUND FORMATION

Australia 8
Ben Landau, Con Tzerefos, Benson Chin and Fergus Calwell
Ashurst LLP

Austria 16
Martin Abram and Clemens Philipp Schindler
Schindler Attorneys

British Virgin Islands 23
Andrew Jowett and Rebecca Jack
Appleby

Cayman Islands 32
Chris Humphries, Jonathan McLean and Simon Orriss
Stuarts Walker Hersant Humphries

Egypt 42
Nora Harb
Thebes Consultancy

Germany 49
Tarek Mardini and Sebastian Käpplinger
POELLATH

Japan 57
Makoto Igarashi and Yoshiharu Kawamata
Nishimura & Asahi

Luxembourg 63
Marc Meyers
Loyens & Loeff

South Korea 76
Sungjo Yun, Mok Hong Kim, Ho Kyung Chang, Eugene Hwang and Seung-Wan Chae
Bae, Kim & Lee LLC

Spain 82
Carlos de Cárdenas, Alejandra Font, Víctor Doménech and Manuel García-Riestra
Alter Legal

United Arab Emirates 92
Hasan Anwar Rizvi
RIAA Barker Gillette (Middle East) LLP

United Kingdom 98
Robert Lee, Yash Rupal, Amy Fox and Paul Dodd
Simpson Thacher & Bartlett LLP

United States 107
Thomas H Bell, Barrie B Covit, Peter Gilman, Olga Gutman, Jason A Herman, Jonathan A Karen, Parker B Kelsey, Steven R Klar, Rony L Rothken, Glenn R Sarno, Peter P Vassilev and Michael W Wolitzer
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TRANSACTIONS

Australia 122
Anton Harris, Ben Landau, Mark Stanbridge and Stuart Dullard
Ashurst LLP

Austria 132
Florian Philipp Cvak and Clemens Philipp Schindler
Schindler Attorneys

British Virgin Islands 139
Andrew Jowett and Rebecca Jack
Appleby

Cayman Islands 145
Chris Humphries, Jonathan McLean and Simon Orriss
Stuarts Walker Hersant Humphries

Egypt 150
Aya Sabry and Nora Harb
Thebes Consultancy

France 154
Saam Golshani, Alexis Hojabr, Estelle Philippi , Franck De Vita, Samir Berlat and Alexandre Balat
White & Case LLP

Germany 161
Tim Kaufhold and Tobias Jäger
POELLATH

India 168
Aakash Choubey and Sharad Moudgal
Khaitan & Co

Japan 180
Asa Shinkawa and Keitaro Hamada
Nishimura & Asahi

Nigeria 187
Tamuno Atekebo, Eberechi Okoh, Oyeniyi Immanuel and Oluwafeyikemi Fatunmbi
Streamsowers & Köhn

Russia 193
Laura M Brank, Evgenia Korotkova, Kirill Skopchevskiy, Pavel Dunaev, Tatiana Shlenchakova and Akop Tovmasyan
Dechert LLP

South Korea 199
Sungjo Yun, Mok Hong Kim, Ho Kyung Chang, Eugene Hwang and Seung-Wan Chae
Bae, Kim & Lee LLC

Spain 204
Lucas Palomar and Bojan Radovanovic
Cases & Lacambra Abogados SLP

Switzerland 211
Patrik R Peyer, Daniela Schmucki, Till Spillmann and Philippe A Weber
Niederer Kraft Frey

Thailand 219
Jirapong Sriwat and Apinya Sarntikasem
Nishimura & Asahi

United Arab Emirates 225
Hasan Anwar Rizvi
RIAA Barker Gillette (Middle East) LLP

United Kingdom 230
Clare Gaskell, Amy Mahon, Yash Rupal and Kate Sinclair
Simpson Thacher & Bartlett LLP

United States 237
Atif Azher, Peter Gilman and Fred de Albuquerque
Simpson Thacher & Bartlett LLP

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Japan

Asa Shinkawa and Keitaro Hamada

Nishimura & Asahi

TRANSACTION FORMALITIES, RULES AND PRACTICAL CONSIDERATIONS

Types of private equity transactions

1 What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

In Japan, there are several types of private equity fund-related transactions, such as going-private transactions of public companies by private equity funds, private investment in public equity and carve-out transactions. Among them, the most popular private equity transactions in Japan are going-private transactions of listed companies, paired with squeeze-outs of remaining minority shareholders with some members of management of the companies participating in the transactions. In addition, as is often the case with a private equity transaction, a private equity fund usually obtains financing through leveraged buyout (LBO) non-recourse loans to make investments with sufficient leverage.

To take a listed company private, a private equity fund may commence a tender offer with the shareholders of a listed company. However, in practice, it is generally difficult to satisfy delisting conditions of stock exchanges in Japan with a tender offer; accordingly, private equity funds usually proceed with making target companies wholly owned subsidiaries by undertaking transactions to squeeze out minority shareholders.

There are several schemes for squeezing out the shareholders of a listed company. For example, one of the simplest is a cash merger. Here, a private equity fund establishes a shell company in Japan acquiring shares through a tender offer, the target company merges into the shell company, and the shell company pays cash to the existing shareholders of the listed company as consideration for their shares in the merger. As all of the shareholders of the target company receive cash as consideration, they are squeezed out. Nevertheless, cash mergers have not been a common choice for private equity fund squeeze-out transactions because cash mergers always forced the target companies to realise capital gains and losses on their assets as of the dates of the mergers. With that said, following a tax law amendment in 2017, capital gains/losses are no longer realised as long as the shell company established by a private equity fund holds two-thirds or more of the issued and outstanding shares of the target company. As a result, the cases where cash mergers are used for minority squeeze-outs could increase. So far, the most common structure used by private equity funds for squeeze-out transactions is a combination of a tender offer and a subsequent squeeze-out of the remaining minority shareholders not by way of a cash merger. Before the amendment to the Companies Act of Japan took effect on 1 May 2015, it was quite common to make use of a class of shares (shares subject to call) to squeeze out minority shareholders; however, after that amendment, it has become market practice to use a demand for sale of shares, which was newly introduced under the amended Companies Act, when a shareholder holds 90 per cent or more of the voting rights, and to use a reverse share split in other cases.

Typical procedural steps to squeeze out minority shareholders through a demand for sale of shares are as follows:

- a private equity fund establishes a shell company in Japan;
- the shell company commences a tender offer to acquire shares held by shareholders of the target company;
- if the shell company acquires 90 per cent or more of the voting rights in a target company, after the settlement of the tender offer, the shell company held by the private equity fund requests that the remaining minority shareholders of the listed target company sell their shares and that the board of directors of the target company approve this request ; and
- after approval by the board of directors of the target company and other relevant procedures, a mandatory sale of the shares in the target company takes place.

If the shell company does not acquire or hold 90 per cent or more of the voting rights in the target company, it is not entitled to squeeze out minority shareholders by a mandatory sale of shares under the Companies Act; however, in such cases, it has become common to use a reverse share split for a minority squeeze-out. To squeeze out minority shareholders using a reverse share split, the private equity fund has to request that the listed target company hold a shareholders meeting to approve the reverse share split with a supermajority (two-thirds) vote, the ratio of which is intentionally set at a very high level so that each minority shareholder receives only a fraction of a share as consideration. Such fractional shares cannot actually be issued; instead, the aggregate shares are sold to a third party (typically the tender offeror) or can be repurchased by the target company, with court approval, and the cash consideration is proportionately distributed to the minority shareholders who were to receive those fractional shares, which effectively leads to a minority squeeze-out. While a reverse share split generally takes more time than a demand for sale of shares, the former provides a private equity fund with more flexibility in post-squeeze-out restructuring transactions without raising adverse tax implications, if, by way of example, more than one shareholder (typically the tender offeror and a controlling shareholder, which may or may not exit after the squeeze-out) remains upon the reverse share split.

Under the Industrial Competitiveness Enhancement Act of Japan, which was amended as of 9 July 2018, an acquirer has the option to apply to relevant government ministries for approval of a business restructuring plan in order to lower the threshold from 90 per cent to two-thirds of the voting rights to use the above-mentioned demand for sale of shares. If the application under the Industrial Competitiveness Enhancement Act is approved, the acquirer may enjoy some other benefits; however, the business restructuring plan must be posted in a prescribed format on a publicly available website, and the acquirer is required to provide annual updates to relevant ministries on whether the

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milestones set under the business restructuring plan are progressing according to schedule. We recommend consulting your adviser to gain an understanding of the pros and cons of such an application in your deal.

Corporate governance rules

2 What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or later become public companies?

Listed companies are subject to disclosure requirements and have to file annual securities reports that disclose company information such as financial information, governance-related information and business-related information. Listed companies are also required to disclose relevant information by filing quarterly securities reports and extraordinary reports in certain instances. When a target company satisfies certain requirements after going private, those disclosure requirements are suspended and the company is not required to file such reports. If a target company remains a listed company after a private equity fund purchases some of its shares, the target company will continue to be subject to the above disclosure requirements. In addition, if the purchase results in a private equity fund being the controlling shareholder of a company listed on the Tokyo Stock Exchange (TSE) or other stock exchanges in Japan, certain designated types of material transactions between the controlling shareholder and the listed company are subject to certain minority shareholder protection rules, including the obligation of enhanced disclosure and procuring an opinion by an independent third party (typically, independent directors) to the effect that such transactions are not disadvantageous for minority shareholders. It should be noted that, responding to growing concerns about protecting minority shareholders of listed companies with controlling shareholders, the TSE issued an interim report on 1 September 2020 stating that the TSE will consider implementing further enhanced minority protection rules.

Issues facing public company boards

3 What are some of the issues facing boards of directors of public companies considering entering into a going-private or other private equity transaction? What procedural safeguards, if any, may boards of directors of public companies use when considering such a transaction? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

A going-private transaction often includes a tender offer. Under the tender offer rules in Japan, in the event that a tender offer is launched, the board of directors of the target company is required to express its opinion with respect to the tender offer. Directors of the target company must satisfy their fiduciary duties in considering the proposed tender offer and the subsequent minority squeeze-out, which is explained by the bidder in its tender offer registration statement.

If a going-private transaction involves structural conflicts of interest, the target board of directors should be mindful to ensure that the transaction is fair in light of the interests of minority shareholders. Typical transactions that involve structural conflicts of interest are management buyouts (MBOs) and acquisitions of controlled listed companies by controlling shareholders. Two high court rulings have made it clear that target directors in an MBO transaction owe, as part of their fiduciary duties, an obligation to ensure that the 'fair value' is transferred from the acquirer to the minority shareholders (although not amounting to the *Revlon* duty in Delaware to seek as high a price as reasonably available) and an obligation to conduct a fair procedure. These rulings are construed to be applicable to other transactions with structural conflicts of interest. Subsequently, a landmark Supreme Court holding in an appraisal proceeding (where a dissenting shareholder sought a higher price than the actual transaction price) was issued in 2016 (the *Jupiter Telecommunications* case) to the effect that if the process taken for a transaction with structural conflicts of interest is found to be fair, the court will respect the actual transaction price as a fair price.

Following the Supreme Court decision, in 2019, the Ministry of Economy, Trade and Industry issued the Fair M&A Guidelines (the Guidelines) to present best practices for fair processes in transactions with structural conflicts of interest. While the Guidelines are not law, following the fairness-ensuring measures suggested in the Guidelines would increase the likelihood of courts finding terms and conditions of transactions agreed between target companies and acquirers to be fair and target directors to have satisfied their fiduciary duties. In practice, the Guidelines are taken into consideration not only in MBOs and acquisitions of controlled listed companies by controlling shareholders but also in sales of shares in controlled listed companies held by controlling shareholders to independent purchasers, because controlling shareholders likely have interests that do not always align with those of minority shareholders. One of the most important fairness-ensuring measures in the Guidelines is the deployment of an independent special committee. The mandate of a special committee is to determine if the terms and conditions of a going-private transaction are fair to minority shareholders and advise the board of directors in that regard. A growing number of special committees not only have an advisory role but also have the right to say no to the transaction, which is binding on the board of directors. Special committees may negotiate with buyers by themselves and must at least oversee the negotiations by management and the board of directors. The Guidelines clearly state that independent directors are best qualified to serve as members of a special committee, and only in the case where there are not enough independent directors should independent statutory auditors or independent experts such as attorneys, accountants or academics be appointed as members.

Disclosure issues

4 Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Generally, an offeror has to disclose a great deal of information in its tender offer documents, including the reasons for the offered price, the purpose of the tender offer, the cap and threshold of the number of shares to be purchased, and funding information for the transaction. If a going-private transaction constitutes an MBO or an acquisition of a controlled listed company by a controlling shareholder, the offeror is subject to heightened disclosure obligations owing to the structural conflicts of interest inherent in the transaction.

The tender offer rules require that in the case of a going-private transaction with structural conflicts of interest, the offeror must explain the fairness-ensuring measures mainly taken on the side of the target company, as illustrated in the Fair M&A Guidelines, to cleanse the conflicts of interest. Accordingly, it is common practice to explain in detail, among other things, how the target company set up a special committee, how the negotiations regarding the price have developed, what discussions took place at the special committee about the price and other terms of the proposed transaction, and why the special committee concluded that the proposed transaction is fair. Detailed disclosure of fairness-ensuring measures also appears in sales of controlled listed companies by controlling shareholders, which likely have interests not always aligned with those of minority shareholders.

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Timing considerations

5 What are the timing considerations for negotiating and completing a going-private or other private equity transaction?

It usually takes approximately four to five months from the launch of a tender offer until completion of the squeeze-out of the remaining minority shareholders. In addition, it quite commonly takes a few months for a private equity fund and the target company or its major shareholders to negotiate and reach an agreement before the launch of the tender offer, which means that it usually takes more than six months from the beginning of negotiations until completion of the transaction. As for a short breakdown of the above schedules, the typical tender offer period for going-private transactions is 30 business days (longer than the statutory minimum 20 business days for the sake of shareholder consideration), and it usually takes five business days from the end of the tender offer period until settlement, which means that a typical going-private tender offer takes around one-and-a-half months from the launch of the tender offer until settlement. If the tender offeror does not hold 90 per cent or more of the target company's voting rights as at settlement, the target company must set a record date for a subsequent shareholders' meeting and call for a shareholders' meeting to squeeze out minority shareholders. It typically takes approximately two months before a shareholders' meeting is held because there are several procedures required for convening a shareholders' meeting, such as setting a record date, fixing the shareholders who have voting rights at the shareholders' meeting, and sending a notice for the shareholders' meeting. However, if the tender offeror succeeded in purchasing 90 per cent or more of the target company's voting rights, the tender offeror may dispense with a shareholders' meeting and squeeze out minority shareholders using a demand for sale of shares. If the acquirer plans to apply for approval under the Industrial Competitiveness Enhancement Act, it normally takes approximately two months to obtain such approval.

The necessity of domestic or foreign merger clearances sometimes has a significant impact on the deal timeline. If there is a risk that all clearances may not be obtained during the maximum tender offer period (ie, 60 business days), usually the offeror first publicly announces the plan to launch the tender offer subject to the required merger clearances, and once all the clearances have been obtained, actually commences the tender offer. All the terms and conditions of the subsequent tender offer, including the tender offer price, must be fixed at the time of the initial public announcement and be publicly disclosed, substantially at the same level of detail disclosed at the time of actual commencement of the tender offer.

Private equity funds should also consider if prior approval is required in connection with the foreign direct investment regulations. The Foreign Exchange and Foreign Trade Act of Japan requires foreign investors to obtain approvals prior to acquiring shares of Japanese companies operating in designated industries if their shareholdings will exceed a designated threshold. The designated industries had been limited to those such as infrastructure, defence, aerospace, agriculture and pharmaceuticals (only to the extent of manufacturing biological formulations), but were expanded in 2020 to include industries such as semiconductor memory media and software development in the midst of growing national security concerns and a larger segment of the pharma industry (manufacturing of pharmaceuticals treating pathogenic organisms and parasites and highly controlled medical devices) following the covid-19 pandemic. In these cases, foreign investors are required to notify the Bank of Japan and the relevant ministries in charge 30 days prior to their acquisition of Japanese companies, but this period may be shortened to two weeks to obtain approvals.

The insider trading rules also affect the timing of launching a tender offer. In the event that a potential buyer comes into possession of material non-public information of the target company, unless the target company discloses such information to the public pursuant to the manner prescribed by the insider trading rules, the potential buyer cannot commence a tender offer under the insider trading rules. It is often the case that after the end of a fiscal year or quarter, during the course of accounting closing procedures, some facts will become apparent that will constitute non-public material information but will not be sufficiently clear for the company to be able to make a public announcement in respect of them, in which case the buyer would need to wait to commence the tender offer until the company is able to make a public announcement with respect to the relevant material information. Accordingly, the initiation of tender offers immediately after the end of a fiscal year or quarter is usually avoided.

Dissenting shareholders' rights

6 What rights do shareholders of a target have to dissent or object to a going-private transaction? How do acquirers address the risks associated with shareholder dissent?

Going-private transactions are typically structured as tender offers followed by minority squeeze-outs at a price equal to the tender offer price.

It is quite uncommon in Japan for dissenting shareholders to seek an injunctive order to suspend a tender offer, as it is very difficult in practice to satisfy the requirements for such an action.

The most common avenue used by dissenting shareholders in going-private transactions in Japan is the exercise of shareholder appraisal rights available in relation to minority squeeze-outs, whether by way of reverse share splits or demands for sale of shares. By exercising appraisal rights, dissenting shareholders may require an issuing company to repurchase its shares at a fair value, which dissenting shareholders argue to be higher than the tender offer price. The Companies Act also requires the issuing company to pay interest on the appraisal value of shares at a rate equal to 6 per cent per annum, payable in the period from (i) the effective date of the minority squeeze-out by way of a demand for sale of shares, or (ii) the date 60 days after the effective date of the minority squeeze-out by way of a reverse share split, to the date of payment for the relevant shares. Dissenting shareholders who exercise appraisal rights may negotiate the price of the shares to be repurchased by the company; however, since an issuing company normally does not agree to pay more than the tender offer price, such dissenting shareholders may make a petition to a court to decide the price for the shares to be purchased by the company.

As appraisal rights are the remedy most commonly used by dissenting shareholders, an acquirer's protection from dissenting shareholders mainly relates to how the acquirer can prove the price it proposed is fair. The Supreme Court held in an appraisal proceeding that if the process taken for a going-private transaction, even one with structural conflicts of interest, is found to be fair, the court will respect the actual transaction price as a fair price. The best practice for a 'fair process' is illustrated as a combination of the fairness-ensuring measures in the Fair M&A Guidelines. In practice, deploying these measures in the Guidelines, such as installing a well-functioning independent special committee, is believed to be the best way to prove that the process was fair, which would in turn prove that the price was fair.

Purchase agreements

7 What notable purchase agreement provisions are specific to private equity transactions?

In a going-private transaction, if there are shareholders with a large stake in the target company, it is common for the buyer to enter into a purchase agreement with those shareholders where the shareholders commit to tender their shares in the contemplated tender offer. When

TRANSACTIONS

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shares are acquired through a tender offer, in light of restrictions under the tender offer rules, various unique features are observed in tender offer purchase agreements. First, unlike in the United States and other jurisdictions around the world where offerors are permitted to condition their obligation to settle a tender offer on receipt of expected financing proceeds, in Japan, the tender offer rules restrict the withdrawal of a tender offer to specific cases listed under law, and the tender offer rules have been widely interpreted as prohibiting financing outs for tender offers. Accordingly, a tender offeror cannot withdraw a tender offer even if it fails to borrow money from banks for the tender offer. Second, the tender offer rules in Japan limit the remedies for breach of representations and warranties made by counterparty shareholders. For example, a tender offeror may not walk away from a tender offer even if it discovers a breach of representations and warranties by the counterparty shareholders, unless such a breach falls within a category of events of withdrawal that the tender offer rules specifically provide for. In addition, some argue that the tender offer rules do not allow indemnification by counterparty shareholders of the target company, even if the shareholders make representations and warranties in an agreement and then breach them.

Participation of target company management

8 How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations for when a private equity acquirer should discuss management participation following the completion of a going-private transaction?

It is quite common for a private equity fund to provide some members of management of the target company and key employees with an opportunity to enter into an equity-based incentive plan, such as an opportunity to acquire a minority stake or stock options or to participate in an employee stock ownership plan in the target company after the closing. However, such equity-based incentive plans should be carefully structured as it is possible for the target company to become ineligible for release from its obligation to file a securities report. In addition, if a private equity fund commits in advance to providing members of management of the target company with an opportunity to participate in such an equity-based incentive plan after the closing of the transaction, it means that those members of management will have the above-mentioned conflict of interest because of their future interest in the company. For this reason, it is often the case that private equity funds make a commitment to provide an incentive plan after minority shareholders are squeezed out.

Tax issues

9 What are some of the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

One of the major tax issues in relation to a minority squeeze-out transaction is potential capital gains tax on the assets of the target company. Depending on the structure of the squeeze-out, it is possible to realise capital gains on assets held by the target company. However, it is possible to avoid that tax by utilising the reverse share split structure or a demand for sale of shares newly provided in the amendment of the Companies Act (or even in the case of a cash merger as long as the acquirer holds two-thirds or more of the issued and outstanding shares of the target company).

As to the deductibility of interest, interest is deductible even if it is for subordinated loans; however, a company issuing preferred stock cannot deduct the amount of preferred dividends even if the preferred stock is very close in nature to a subordinated loan.

With respect to tax issues related to executive compensation, golden parachutes are not common in Japan, so there is no special tax treatment for such a payment, but if a retirement allowance amount is excessive, the Tax Code does not allow a company to include such excessive amount in its general expenses. Tax treatment for stock options depends on whether the issued stock options are tax-qualified or not. If the stock options are tax-qualified, tax is imposed only when the shares obtained by exercising the stock options are sold. However, if the stock options are not tax-qualified, the holders of those options may be taxed as follows:

- when the options are issued;
- when the holders exercise the stock options; and
- when the shares obtained by exercising the stock options are sold.

In general, share acquisitions cannot be classified as asset acquisitions under the Japanese Tax Code.

DEBT FINANCING

Debt financing structures

10 What types of debt financing are typically used to fund going-private or other private equity transactions? What issues are raised by existing indebtedness of a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

In private equity transactions, the most commonly used type of debt in Japan is leveraged buyout (LBO) loans as syndicated loans, and they are usually made with term loans for the share purchase price and revolving credit for the target company's working capital. The terms and conditions of existing debt should be carefully checked to see if a transaction made by a private equity fund triggers any provision, such as early redemption in the case of a change of ownership. There is no specific financial assistance rule in connection with a target company's support for others to purchase the shares of the company. However, if a shell company established by a private equity fund holds shares in a target company, until completion of the squeeze-out of minority shareholders, the target company would be prohibited from providing financial benefits to such shareholder in connection with an exercise of shareholder rights. In addition, if, after the settlement of a tender offer, the offeror holds a majority of the shares in the target company, the granting of any security interests in the assets held by the target company for the LBO lenders is not normally done until after the squeeze-out of minority shareholders, because of the fiduciary duties of the target company's directors to the shareholders, including minority shareholders.

Debt and equity financing provisions

11 What provisions relating to debt and equity financing are typically found in going-private transaction purchase agreements for private equity transactions? What other documents typically set out the financing arrangements?

For debt financing such as LBO loans, the following are commonly provided terms:

- conditions precedent regarding tender offer matters, including completion of the tender offer procedure;
- mandatory repayment of excess cash flow;
- early redemption in the event of default; and

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- financial and performance covenants in connection with the business activities of the target company.

In the event that a private equity fund finances through mezzanines such as preferred stock, the payment structure would be one of the most important terms, and an inter-creditor agreement between senior lenders and mezzanine investors would also be made.

Where a tender offeror plans to raise funds from a third-party funds provider in the form of a loan or an equity capital contribution, a commitment letter, certifying that the funds provider is prepared to provide an agreed amount of money to the tender offeror, must be executed by the funds provider and attached to the tender offer registration statement unless the funds provider has or will have already injected the relevant cash into the offeror's account before the launch of the tender offer (in which case, the offeror can attach a bank account balance statement). It is common for a private equity fund to negotiate with the loan provider in respect of detailed terms of the definitive loan agreement during the tender offer period and enter into a definitive loan agreement after the tender offer period before the settlement of the tender offer.

Fraudulent conveyance and other bankruptcy issues

12 Do private equity transactions involving debt financing raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

If a shell company established by a private equity fund sources most of the funds used to purchase a target company through a loan and subsequently merges with the target company, then it is possible that such a merger may be detrimental to the existing creditors of the target company. Existing creditors may state their objections to the merger and receive payment or reasonable security if there is a risk of harm to existing creditors owing to such merger. However, even if the target company gets into financial trouble following the merger because of the high leverage, it would be hard for creditors to the pre-merger target company to invalidate the merger.

SHAREHOLDERS' AGREEMENTS

Shareholders' agreements and shareholder rights

13 What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms or other equity co-investors? Are there any statutory or other legal protections for minority shareholders?

The key provisions in shareholders' agreements for private equity transactions are not substantially different from those for other transactions. Namely, it is quite common to place transfer restrictions on shares in the shareholders' agreements, including rights of first offer or refusal, tag-along rights and drag-along rights, a right to appoint directors, and veto rights. However, if a portfolio company continues to list its shares on a stock exchange, a shareholder owning more than 5 per cent of the voting rights is required to disclose its shareholding and certain agreements, such as ones to jointly exercise voting rights with other shareholders or to set a first refusal right on the shares, pursuant to the large shareholding reporting system.

As statutory legal protection for minority shareholders, the Companies Act requires votes by two-thirds of the voting rights present at a shareholders' meeting in connection with fundamental matters such as mergers, demergers, transfers of a significant part of business and amendments of articles of incorporation, which means that a minority shareholder holding more than one-third of issued shares has a veto right under the Companies Act.

ACQUISITION AND EXIT

Acquisitions of controlling stakes

14 Are there any legal requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

When a private equity fund purchases shares of a listed company, it must comply with the Japanese tender offer rules. The rules are quite complicated, and we cannot provide a full description of the tender offer rules here owing to space limitations. However, we recommend consultation with Japanese counsel regarding this point prior to initiating a transaction.

One of the key points to be aware of is that a mandatory tender offer is triggered upon acquisition of more than one-third of the voting shares in a listed target company. An acquirer cannot purchase more than one-third of the voting shares of a listed target company through a method other than a tender offer or an on-market purchase. As a result, even if a major shareholder holding more than one-third of the voting shares would like to sell its shares to a private equity fund, the private equity fund has to commence a tender offer and provide other shareholders with the opportunity to tender for the shares.

Another major point to be aware of is the tender offer rules on setting a cap. An acquirer may generally set a cap on a tender offer, and if the number of shares tendered in the offer exceeds the cap provided by the offeror, the tender offeror must purchase the applied shares on a pro rata basis. However, an acquirer cannot set a cap if the acquisition through the tender offer could result in the offeror's shareholding exceeding two-thirds of the voting shares. Even if an acquirer would like to set the cap at, for example, 70 or 80 per cent, such a cap is not allowed, and the acquirer is required to purchase all shares tendered if it sets a cap above the threshold. The Japanese tender offer rules allow a tender offeror to set a minimum threshold for a tender offer (ie, if the number of tendered shares is less than the threshold, the tender offeror is not required to purchase any shares). As two-thirds of the voting rights present at a shareholders' meeting are necessary to approve a reverse share split to squeeze out minority shareholders, tender offerors sometimes set the minimum threshold of a tender offer at two-thirds of the voting rights.

Exit strategies

15 What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a strategic or private equity acquirer?

In the event that a private equity fund pursues an IPO exit of portfolio companies purchased through a management buyout transaction, the Tokyo Stock Exchange (TSE) states in its booklet that more detailed scrutiny of such companies should be made than that of other non-management buyout companies. In such cases, the TSE will additionally check whether the price offered at the time of the management buyout was fair, whether the purpose of the management buyout was rational and the extent to which the business plan made for the management buyout was achieved.

If the target company is not listed and is wholly owned by a private equity fund (and its related parties), there would be little restriction on a private equity firm's ability to sell its stake in the target company to a third party, except for lock-up restrictions and restrictions under the articles of incorporation of the target company or a shareholders' agreement, if any.

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Private equity funds generally resist providing a long-term post-closing indemnification for breach of representations and warranties or covenants and negotiate hard to limit the period for such an indemnification. There are cases where private equity funds agreed to set up an escrow holding part of a purchase price for a limited period (eg, six months) as a sole recourse that the buyer may have after the closing, but such an arrangement has not yet developed into 'market practice'. Recently in Japan, an increasing number of sellers seeking 'clean exits' (whether private equity or not) have been demanding that buyers procure transaction insurance, which allows a buyer to recover its damages owing to a breach of representations and warranties by a seller.

Portfolio company IPOs

16 What governance rights and other shareholders' rights and restrictions typically survive an IPO? What types of lock-up restrictions typically apply in connection with an IPO? What are common methods for private equity sponsors to dispose of their stock in a portfolio company following its IPO?

During the review process made by a stock exchange in Japan, the stock exchange generally requests that an agreement between a shareholder and the target company be terminated at the time of filing an application for listing, because listing rules require a newly listed company to treat every shareholder equally. Accordingly, a major shareholder of a portfolio company, including a private equity fund itself, cannot hold special rights such as board appointment rights or veto rights after the IPO.

Japanese law does not have the concept of 'registration rights' as used in the United States, because in the event that a company completes an IPO and applies for listing of its shares, it is required that the company list all shares in the class subject to the listing as well as any new shares in such class when issued. There are cases where a target company will provide a shareholder with a right to file a registration statement if so requested by the shareholder, but such an agreement would need to be terminated at the time of filing an IPO application as explained above.

As to lock-up restrictions, under the listing rules of the TSE, any existing shareholders who were allotted shares within a one-year period prior to the effective date of an IPO must hold (ie, must not transfer or dispose of) those shares until six months after the effective date of the IPO or one year after the effective date of such allotment of shares, whichever comes later. More importantly, from the perspective of private equity funds, it is common practice in Japan for underwriters of an IPO to require major shareholders of the company to abstain from selling the remaining shares of the company for 180 days after the date of the IPO, when they believe such restriction is necessary in light of market circumstances. After these lock-up periods, shareholders are allowed to sell their shares in the market.

Subject to the above-mentioned lock-up restrictions, following an IPO, all shareholders, not limited to private equity sponsors, may sell their shares in the market. Of course, such sales are subject to market conditions. Shareholders may also choose to sell their shares pursuant to a secondary distribution of securities after the securities registration statement filed by the portfolio company comes into effect. In some cases, major shareholders negotiate with and sell their shares to a purchaser who intends to buy a large portion of the shares; however, note that in Japan such a transfer may be subject to the tender offer rules.

Target companies and industries

17 What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in industry focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Previously, it was sometimes said that private equity funds tended to choose companies in industries with relatively stable cash flows, such as the food or beverage industry, because it is relatively easy to agree with loan providers if the target company expects stable cash inflow. However, for recent going-private transactions, the industries are fairly diverse, and we cannot say that there are many going-private transactions focused on a specific industry. There are not many industry-specific regulations that block private equity fund transactions; however, there are some industry-related laws, such as the Broadcast Act, which may restrict private equity transactions.

SPECIAL ISSUES

Cross-border transactions

18 What are the issues unique to structuring and financing a cross-border going-private or other private equity transaction?

The Foreign Exchange and Foreign Trade Act restricts inbound investment by foreign companies in certain designated industries, such as power generation, broadcasting, agriculture, natural resources, nuclear-related industries and transport, which were expanded in 2020 to include industries such as semiconductor memory media and software development and a larger segment of the pharma industry (manufacturing of pharmaceuticals treating pathogenic organisms and parasites and highly-controlled medical devices), by requiring prior approval. Whether an acquisition of a company by a foreign entity is allowed depends upon various factors such as the nature of the target company's business, what percentage of the shares the purchaser intends to purchase, and the purchaser's plans after the acquisition. There are not many cases publicly discussed regarding whether a foreign entity's specific purchase of shares in a restricted industry will be approved or not. One example of a public case, however, is the Children's Investment Fund's plan to purchase more than 10 per cent of the shares in Electric Power Development Co, Ltd, which was not approved by the relevant government authority.

Club and group deals

19 What are some of the key considerations when more than one private equity firm, or one or more private equity firms and a strategic partner or other equity co-investor is participating in a deal?

In club or group deals, parties need to agree to, before the closing of the deal, the ownership structure of a buyer consortium, post-closing governance rights, share transfer restrictions and exit mechanisms, which are typically crystalised in a shareholders' agreement. The governance structure depends on which shareholder takes the lead in the post-closing operation. A key consideration is how to formulate the exit right of a private equity participant (or private equity participants). Typically, there is a flat no-transfer period, followed by a relaxed transfer restriction period subject to pre-emptive rights, rights of first refusal, tag-along rights and drag-along rights. Sometimes, shareholders' agreements require parties to first seek a coordinated and collaborative exit or set a certain threshold for a qualified IPO or qualified drag-along sale.

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Issues related to certainty of closing

20 | What are the key issues that arise between a seller and a private equity acquirer related to certainty of closing? How are these issues typically resolved?

In private equity fund buyer transactions without a tender offer, conditions precedent for closing are likely to be negotiated extensively by the relevant parties. However, sellers and private equity fund purchasers do not usually negotiate so hard on conditions precedent in transactions where a private equity fund plans to acquire shares through a tender offer, because the Japanese tender offer rules essentially do not allow a tender offeror to withdraw a tender offer except in limited cases provided for by law.

UPDATE AND TRENDS

Key developments of the past year

21 | Have there been any recent developments or interesting trends relating to private equity transactions in your jurisdiction in the past year?

One of the most significant recent developments in private equity transactions in Japan is the issuance of the Fair M&A Guidelines (the Guidelines) in 2019 by the Ministry of Economy, Trade and Industry, which present best practices for fair processes in transactions with structural conflicts of interest. In practice, the Guidelines are taken into consideration not only in management buyouts and acquisitions of controlled listed companies by controlling shareholders but also in sales of controlled listed companies' shares held by controlling shareholders to independent purchasers, since such shareholders are likely to have interests that do not always align with those of minority shareholders.

Private equity funds should also note that the Tokyo Stock Exchange (TSE) issued an interim report on 1 September 2020 stating that the TSE will consider implementing further enhanced minority protection rules to protect minority shareholders of listed companies with controlling shareholders, which might further prompt an increase in carve-out deals of listed subsidiary shares.

Last but not least, the Foreign Exchange and Foreign Trade Act, which subjects certain inbound investments to prior regulatory approval, was amended in 2020 to protect technologies important for national security and to avoid impairment of defence-related fundamentals and, in response to the covid-19 pandemic, was further amended to protect companies manufacturing pharmaceuticals treating pathogenic organisms and parasites and highly controlled medical devices.

Coronavirus

22 | What are some of the significant developments and initiatives relating to the covid-19 pandemic that have impacted private equity transactions in your jurisdiction?

In response to the covid-19 pandemic, the Foreign Exchange and Foreign Trade Act, which subjects certain inbound investments to prior regulatory approval, was amended to expand the designated industries to include manufacturing of pharmaceuticals treating pathogenic organisms and parasites and highly controlled medical devices, while previously the pharma industry was designated only to the extent of manufacturing biological formulations (which itself continues to constitute a designated industry after the amendment). As this is quite a recent amendment, it is advisable that foreign private equity funds contemplating an investment in such industries consult with their legal advisors and the relevant ministries (the Bank of Japan, the Ministry of Economy, Trade and Industry, and the Ministry of Health, Labour and Welfare) to get a better view of the deal process.

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