NISHIMURA & ASAHI

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NUANCES IN CONDUCTING JAPANESE M&A LEGAL DUE DILIGENCE

Regardless of the industry in which a target company operates or the jurisdiction in which the business is conducted, core themes typically exist for the scope and objectives of a buyer's legal due diligence exercise in an M&A transaction. In a typical M&A transaction, a buyer will want to identify legal risks and impediments to a proposed acquisition by analyzing the target company's: (i) material contracts to determine if they contain change of control, anti-assignment, non-compete or "most favored nations" provisions that could erode the value of the business post-closing, (ii) related party dealings to ascertain whether the target company's financial results are artificially inflated due to favorable inter-company terms, or whether post-closing transition services will be required from the seller due to the target company's reliance on the seller's resources, (iii) debt instruments to evaluate whether repayment clauses will be accelerated due to the transaction, or whether any mandated financial ratios or maintenance tests will hinder the buyer's future operating plans for the target company, (iv) capital structure to verify that all requisite equity instruments are purchased by the buyer, and (v) contingent liabilities to confirm that the proposed purchase price is not too rich.

While conducting legal due diligence over a Japanese target company in an M&A transaction often shares the general objectives of a typical legal due diligence exercise as described above, conducting legal due diligence should be tailored to the intricacies and nuances of Japanese law, as well as local market practices. This edition of the *Corporate Counselor* discusses the nuances of Japanese M&A legal due diligence and provides suggested best practices to successfully conduct legal due diligence in the Japanese M&A context.

When conducting Japanese M&A legal due diligence, the deal team should pay special care and attention to:

- the anti-assignment clauses and the termination provisions in material contracts;
- the target company's potential links to organized crime;
- employee-related contingent liabilities;
- prior share transfers involving the target company's shares;
- the extra verification steps that should be taken concerning litigation and regulatory action in light of the inability to electronically search a national Japanese database housing such information; and
- the rights and liabilities associated with prior acquisitions completed by the target company.

Each of the foregoing items is discussed below.

Anti-Assignment Clauses and Third-Party Consents. Most Japanese commercial contracts contain a broadly drafted clause prohibiting the assignment of the agreement to a third-party. For example, the anti-assignment clause in a Japanese commercial contract might simply state that the "agreement and the rights of a party hereunder may not be assigned without the consent of the other party." It should come as no surprise, therefore, that an acquisition of a target company structured as an asset purchase arrangement would require the consent of the counter-parties to the agreements that will be assumed by the buyer. What about a transaction structured as a merger? The analysis under Japanese law in this context could be surprising. While many common law jurisdictions adopt the view that a merger or other acquisition resulting by operation of law is not considered an "assignment" or "transfer" and, therefore, the agreement can be assumed by a successor company in a merger or other form of business combination without the counter-party's consent (unless an anti-assignment clause expressly stipulates that the arrangement cannot be assigned or transferred by "operation of law" or otherwise), the same analysis may not apply under Japanese law.

Due to the absence of applicable Japanese legal precedents and the lack of consensus among noteworthy Japanese legal scholars about the scope of anti-assignment clauses and whether a deemed transfer would lead to a breach of an arrangement, Japanese legal practitioners cannot equivocally state whether an "assignment" or a "transfer" of an agreement takes place or not if the acquisition is structured as a merger, corporate split or other form of business combination (and the subject contract's anti-assignment clause is silent with respect to assignments by operation of law). Accordingly, legal counsel should be brought into the due diligence process at an early stage to evaluate material third-party consent matters and to develop a legal position , as the failure to obtain requisite third-party consents could diminish the utility of the proposed transaction.

Contract Termination Obstacles. The principle of "freedom of contract" generally governs the interpretation of termination clauses under Japanese law, so the parties to an agreement generally have the right to end their contractual relationship in accordance with the terms of the arrangement. However, in the context of an employment agreement or if a commercial arrangement is characterized as a "continuous contract," then the ability to unilaterally terminate such arrangement is restricted under Japanese law. The foregoing could have an enormous impact on the valuation of a target company if the buyer assumed it could readily reduce post-acquisition the target company's workforce or terminate an unfavorable "continuous contract" simply by complying with the agreement's termination provisions.

· *Employment Agreements.* An employer in Japan cannot terminate the employment of an employee without good cause. Even if an employment contract stipulates that an employer

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may terminate the employment relationship for any reason or no reason, such provision normally will be held unenforceable as an unlawful attempt to bypass Japanese labor laws. Article 16 of Japan's Employment Contract Act stipulates that the termination of an employee in Japan is invalid unless there is an "objective good reason" for the termination and it is "acceptable in light of socially accepted standards." The foregoing standard is not defined or explained by Japanese statutes, which has left Japanese courts with broad discretion to interpret this standard. Given the lack of precise criteria endorsed by Japanese courts to support a termination for cause, most employers in Japan opt to negotiate severance agreements with the affected employees that call for payments exceeding several months' salary in exchange for the employee's voluntary resignation.

· *Continuous Contracts.* A "continuous contract" is generally understood under Japanese law to mean a contract pursuant to which a party is required to perform a duty continuously by virtue of the nature of the obligation (*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 requirements 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," then a Japanese court is likely to require a "justifiable and unavoidable reason" in order for a party to unilaterally terminate the agreement. Similar to the employment agreement context, Japanese courts place a high burden on a party seeking to terminate a "continuous contract" (even if the agreement permits unilateral termination) because the non-terminating party typically will have made business decisions relying on the expected long duration of the agreement (and Japanese courts ordinarily believe that such reasonable expectations should be protected). Accordingly, a one-sided immediate cancellation right is normally unenforceable and legal counsel should be contacted to discuss methods to ultimately terminate a "continuous contract" (which termination procedures often involve the payment of a termination fee and/or the provision of many months' prior notice of termination).

Links to Organized Crime. The value of an investment can quickly dissipate if Japanese organized crime (referred to as the *bo-ryoku-dan*) is implicated with a company's business. Recent reports indicate that Japanese crime syndicates have made bold attempts to move into white-collar crime after crackdowns on traditional sources of income, and the largest *bo-ryoku-dan* gang may have as many as 40,000 members. If a company in Japan is exposed as being involved with organized crime, then the impact on such company's business reputation can be devastating and long-lasting. Furthermore, Japanese regulators often impose harsh remedial measures if unsavory business practices are uncovered at a regulated company, which remedial measures often include the shutting down of the business for a period of time and the institution of strict compliance methods that the subject company is required to follow. Needless to say, the negative publicity arising from such administrative sanctions can leave a company crippled.

Last year's notorious investigation of a Japanese mega-bank accused of having extended loans to individuals tied to the *bo-ryoku-dan* is a recent example of the shattering impact that can result from having links to the *bo-ryoku-dan*. Accordingly, an important aspect of Japanese due diligence should include an evaluation of the target company's internal controls and a background check on the target company's senior management and founding shareholders (if still active in the business) to ascertain if there are any material risks not visible from the balance sheet. It is also local market practice to include a representation and warranty in the acquisition agreement regarding the target company's lack of links to organized crime, though the inclusion of this standard clause should not be relied upon as a substitute for independent confirmatory due diligence.

Employee Related Contingent Liabilities. Japan has a unique approach to dealing with overtime wages owed to employees and paying compensation to employees for inventions created on-the-job. In light of the large amounts of money that could become due and payable by the target company and the negative publicity that could surface if employee litigation is initiated, the due diligence team should devote significant attention to employee-related liabilities to evaluate the existence of any material risks.

· *Overtime Payments.* It is a fundamental principle under the Labor Standard Law of Japan that employers should not compel their employees to work longer than forty hours per week or longer than eight hours per day. If an employee needs to work overtime, then the employee is entitled to receive overtime pay. The right to receive overtime pay, however, is not applicable to certain high-level employees/managers who use their own judgment to control their working hours (in addition to other factors). Some Japanese companies are notorious for requiring their employees to work long hours without receiving overtime pay, and such type of company is colloquially referred to as a "Black Company" (*black kigyo*). The actual existence of this perceived tendency should be promptly evaluated at a Japanese target company because the failure to properly accrue and pay overtime wages to employees can leave a buyer with a large off-balance sheet liability (unless the acquisition is structured as a business transfer/asset purchase arrangement). Underpayments to employees typically arise from either an outright failure to pay accrued overtime or a company inaccurately designating an employee as a manager (since a manager can be exempt from receiving overtime payments).

The monetary penalties arising from unpaid overtime can be significant. For example, a large Japanese electronics retailer paid JPY3 billion to approximately 110 employees for back overtime wages, and after losing a widely publicized lawsuit filed by one of its store managers for failure to pay him overtime wages, a large international fast food restaurant chain introduced a nation-wide system to provide overtime pay to approximately 2,000 outlet managers and area developers in Japan who previously had not been receiving overtime pay.

Accordingly, the due diligence team should carefully examine the target company's payroll practices and designated mix of managers and employees. The statute of limitations for an unpaid overtime wage claim is two years.

· *Employee Inventions.* Under Japanese patent law, when an employee creates an invention in the course of performing his or her professional duties, the right to obtain a patent for the invention rests with the employee-inventor. However, the employer is automatically granted a royalty-free, non-exclusive license to use such invention because the employer contributed to the origination of the invention, such as by employing the employee-inventor, providing research facilities to the employee-inventor, and bearing research and development costs (the so-called "work for hire" doctrine). As an alternative to the right to receive a royalty-free, non-exclusive license, the employer is allowed to reserve ownership rights in the patent or patent right (or obtain an exclusive license right) over the invention if these additional rights are provided in the employer's work rules and/or in an employment-related agreement with the employee-inventor. When an employer succeeds to the ownership rights of its employee's invention (or obtains an exclusive license right), then the employee has the right to receive reasonable compensation from his or her employer in connection with such invention ownership conversion. If the employee has not received a reasonable amount of compensation for his or her converted invention ownership rights, then the employee can demand the difference between a court determined reasonable compensation amount for his or her converted invention ownership rights and the amount of money actually received by the employee from his or her employer for such converted invention ownership rights.

Significant amounts have been awarded to disgruntled employees who have disputed the reasonableness of the compensation paid to them in connection with the employer succeeding to the employee's invention ownership rights. For example, in 2004 the Tokyo District Court awarded JPY20 billion as the "reasonable value" that should be paid to an employee-inventor at Nichia Corporation in exchange for his transfer to the company of his invention rights in blue-light-emitting diodes, and around the same time Japanese courts awarded employee-inventors at Hitachi and Ajinomoto approximately JPY170 million and JPY190 million, respectively, as the "reasonable value" for invention ownership transfers. Subsequent to these court decisions, Japanese patent law was amended to show greater deference to a company's work rules concerning compensation for employee inventions so long as (i) the employee is afforded "due process" when discussing the compensation terms for inventions (with "due process" not defined), (ii) the company's invention compensation rules are readily available to employees, and (iii) the company listens in good faith to the views of the employee-inventor when addressing invention compensation grievances. Accordingly, the due diligence team should carefully review how the target company acquired material employee-created inventions to evaluate the exposure risk of the target company to claims by employees for invention-related compensation.

Validity of Share Ownership When Share Certificates Issued. Ownership interests in a Japanese company can be evidenced by either physical stock certificates or by book-entry recordings in a company's share registry (*i.e.*, scriptless). Whether a company is a stock certificate issuing company or scriptless will be stated in its articles of incorporation. If the target company is a stock certificate issuing company, then special care should be paid during the due diligence process to confirm the validity of the issued and outstanding shares of the target company. In particular, when a shareholder of a stock certificate issuing company wants to sell or transfer his or her shares, then the stock certificates representing such shares must be physically delivered to the new buyer in order for the share transfer to be valid and binding under Japanese law. Counsel for a buyer, therefore, should confirm at a minimum that the seller of the subject shares (i) believed without gross negligence, at the time the seller acquired the subject shares, that it was purchasing the shares from the genuine owner, and (ii) received physical stock certificates when it acquired the subject shares. In addition, selling shareholders who have lost their stock certificates in the target company may not validly sell their shares without waiting for one year to elapse after the subject shares have been listed in the target company's "lost stock certificate registration ledger" (*kabuken soushitsu touroku bo*), which is a publicly available document intended to give notice of a person's claim over a lost stock certificate. During the period a stock certificate is listed in the company's lost stock certificate registration ledger, title to such shares cannot be transferred.

Should the due diligence team be unable to confirm that stock certificates were physically delivered to the seller of the subject shares, then legal counsel should be consulted to ascertain whether potential fixes exist to confirm the validity of the selling shareholder's ownership interest in the shares to be sold. Potential fixes include converting the target company into a scriptless company, but the process of completing such conversion could have its own detriments that outweigh the benefits of expediting the ability to confirm share ownership rights.

Extra Due Diligence Efforts due to the Lack of National Databases. Discovering regulatory action or the existence of litigation involving a target company or its management requires extreme finesse in Japan. There are no publicly available national databases in Japan to confirm the existence of regulatory action or civil or bankruptcy litigation involving a target company. Instead, these matters can be accessed only by searching the files of the applicable regulator or the court where the action was heard, which requires an initial understanding of which ministries regulate the target company and where the target company most likely could be involved in litigation. If the target company is not forthcoming in its disclosures or the buyer is skeptical about the veracity of the information provided by the target company's management, then legal counsel will need to develop a litigation search strategy in order to avoid a costly search of all court dockets in Japan. Also, criminal records are not publicly available in Japan, so a comprehensive due diligence check will require a thorough media scan (in Japanese) of pertinent blog and gossip websites to identify alleged criminal violations involving the target company's directors and top management (the results of which should be tactfully confirmed with the target company).

Prior Acquisitions. While a host of issues could arise from a target company's prior M&A activities, the following areas warrant special attention during the legal due diligence process in light of Japanese legal requirements:

- *Copyrights.* Generally speaking, Article 27 of the Copyright Act of Japan provides that an author will have the exclusive right to translate, musically arrange or otherwise adapt his or her work, and Article 28 of the Copyright Act of Japan provides that the author of an original work will have the same rights as those possessed by the author of a derivative work. The rights under Articles 27 and 28 can be assigned by an author of a work to a purchaser, so long as the copyright transfer agreement specifically references that the purchaser is also acquiring the rights under Articles 27 and 28 of the Copyright Act of Japan. Accordingly, the due diligence team should carefully review the target company's copyright transfer agreements and if one simply states that the target company acquired "any and all rights and ownership rights to the subject copyright," then most likely the target company will not have acquired the critical adaptation rights under Article 27 and the derivative work rights under Article 28 (and the valuation model may need to be adjusted if the subject copyright is a material asset of the target company).

- *Non-competes.* If a target company has ever sold a business pursuant to an asset purchase transaction or a de-merger (as opposed to a stock purchase transaction or a statutory corporate combination), then the due diligence team should confirm that the acquisition agreement clearly states that the seller is not subject to the non-compete obligations proscribed under Article 21 of Japan's Companies Act. Without a clear provision waiving the application of such provision, then the target company (as the seller of the business) will be subject to a statutory 20 year obligation not to compete in the same activities of the transferred business within the same city where the business is located (and the immediately surrounding areas). Clearly a shocking consequence and loss of value if the buyer planned to engage in such competing activities through the target company.

- *Indemnification Survival Period.* While the scope and the monetary amount of indemnification are key considerations when reviewing a target company's prior sale and commercial transactions, the inclusion of a specific survival period also should be confirmed. Without a clear statement concerning the survival period for the representations and warranties, then there is a strong argument under Japan's Commercial Code that the representations and warranties in a commercial transaction should survive for a period of five years after the closing date.

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Conducting M&A legal due diligence in Japan often results in a significant time and cost commitment, so the deal team should be focused on adopting methods to extract maximum value from the legal due diligence exercise. Wholesale application of a foreign buyer's domestic due diligence standards to a Japan M&A transaction can cause delay, waste time and resources, and result in the due diligence report omitting key issues. A buyer's due diligence methods should take into account Japan's legal regime and, of particular importance in a competitive auction situation, take into account Japanese local due diligence customs and practices. For example, conducting a management due diligence session at the start of the legal due diligence process and periodically throughout, and sharing key due diligence findings with the full advisory team is critical in light of the Japanese legal regime.

Local counsel with experience in cross-border M&A transactions can provide invaluable guidance on how to organize and structure an effective buy-side legal due diligence review over a Japanese target company.

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