Chapter 12

JAPAN

Kei Ito, Taku Ishizu and Tomokazu Hayashi[1]

I OVERVIEW

i Deal activity

Buyout funds

In comparison with 2007, both the number and aggregate value of buyout deals have been at a low level in subsequent years; however, the buyout market in Japan recently shows a gradual recovery trend. According to a report published by Japan Buyout Research Institute Corporation ('the JBRIC'),[2] the aggregate value of buyout deals for the first half of 2011 amounted to ¥347.5 billion, already exceeding the ¥293.3 billion for the entirety of 2010. The number of deals in the first half of 2011 was 27, more than half of the number of deals for the whole of 2010 (44). Further, 2011 has seen some large buyout deals, such as the going-private deal of Culture Convenience Club Co Ltd and the secondary sales of Tsubaki Nanashima Co Ltd and Skylark Co Ltd (see Section III, *infra*).

The JBRIC report divides buyout deals into six categories: (1) divestment of subsidiaries or business departments, (2) turnarounds, (3) business succession, (4) recapitalisations, (5) going private and (6) secondary sales. According to the report, going-private deals was the most popular type in terms of number (13) in the first half of 2011, with their aggregate value at ¥177 billion exceeding that for the whole of 2010 (¥175.1 billion).

---

1 Kei Ito and Taku Ishizu are partners and Tomokazu Hayashi is an associate at Nishimura & Asahi.

2 JBRIC publishes *Japan Buyout Market Review*, which includes various statistics of deal activities of buyout funds for every six months. The latest edition, published in October 2011, reports statistics for the first half of 2011.

The JBRIC report also notes that private investments in public entities ('PIPEs') by buyout funds have remained inactive for three years. There were only four PIPE deals in the first half of 2011 (¥8.6 billion) compared with 33 deals (¥279.8 billion) for the whole of 2007.

Exit transactions by buyout funds have gradually increased since the second half of 2010, with 24 such deals in the first half of 2011, close in number to the 27 deals in the whole of 2010 (27 deals). Among exit transactions by buyout funds, it is noteworthy that acquisition deals by business corporations as strategic buyers have been increasing, accounting for half of all exit transactions (see Section III, *infra*). In addition, buyout funds conducted exit transactions by way of IPOs, secondary sales and buybacks by the founding family of targets.

Venture capital funds

The deal activity of venture capital funds in Japan still remains at a low level in comparison with 2007. According to a report published by Venture Enterprise Center,[3] the number of investment deals by venture capital funds decreased to 915 deals in the year ending 31 March 2011 compared with 991 deals in the previous year; however, the total value of investments by venture capital funds increased to ¥113.2 billion in the year ending 31 March 2011 compared with ¥87.5 billion in the previous year. The number and total commitment amount of newly raised funds in 2011 seemed to be slightly increased from previous years. Investment by venture capital funds is expected to grow again in coming years.

Emergence of new sponsors in the Japanese market

In recent years, business corporations in Asian countries, including China, India and Thailand, have actively invested in and acquired Japanese corporations. As a result, acquisition deals between such business corporations and buyout funds have gradually emerged as a presence in the Japanese market. Well-known examples include a Chinese strategic investor's acquisition of LaOX Co Ltd, a consumer electronics retailer and a Thai sponsor's acquisition of Ogihara Corporation, a metallic mold manufacturer, both in 2009.

ii Operation of the market

Management equity incentive arrangements

Stock options are one of the most commonly used management incentive devices. Stock options are normally granted to management in the form of stock acquisition rights, which are similar to warrants, and management may acquire the shares of the company upon their exercise. The exercise of stock acquisition rights is subject to conditions regarding exercise period, payment of the exercise price, etc.[4] The necessary

3 Venture Enterprise Center annually publishes *Investment Activities of Venture Capital*, which includes statistics of activities of venture funds. The latest edition covers statistics for April 2010 to March 2011.

4 To align management incentives with desirable company performance, stock acquisition rights may be structured to be exercisable only upon certain conditions, such as the company

internal corporate approval process for granting of stock acquisition rights, as well as tax consequences, can vary depending on the stock option structure adopted.

The holding of shares in the company by management directly or through a management shareholding association is also widespread.

Standard sales process

The typical process of share sales by the trade sale or secondary sale in the Japanese market is:

a entering into a confidentiality agreement; buyer's basic valuation and analysis of target;
b negotiating basic deal terms;
c entering a letter of intent;
d buyer's due diligence;
e negotiating final deal terms;
f entering a definitive purchase agreement; and
g closing.

Further, sellers may employ an auction to obtain a higher sales price, which may consist of more than one bidding process. Time schedules depend largely on the pace of negotiations, *inter alia*, approval by a supervisory authority having jurisdiction over the target, tender offer requirements, antitrust pre-filing requirements and foreign investor pre-filing requirements (see Section II, *infra*).

For share sales by way of an initial public offering ('IPO'), securities firms play a critical roll, assisting the issuing company in a listing application and, normally, acting as underwriter and distributor of the shares. Such securities firm conducts due diligence on the company for underwriting. The company is subject to statutory disclosure requirements, and must file a securities registration statement and prepare a prospectus to be delivered to prospective investors. The IPO process is costly and time-consuming.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Key regulations when acquiring shares of Japanese corporations

When a buyer acquires shares of a Japanese corporation, the buyer should pay particular attention to tender offer, antitrust pre-filing and foreign investor pre-investment filing requirements. Such requirements may adversely affect the expected time schedule.

Tender offer requirements

The tender offer process is regulated by the Financial Instruments and Exchange Act ('the FIEA'). If a buyer acquires more than one-third of the total issued shares of a listed company outside the securities exchange market on which the shares are listed,

outperforming the market, profit targets being achieved or a listing of the shares on a securities market.

such acquisition must be made pursuant to a statutory tender offer process. The buyer must disclose certain information by issuing a public notice and filing a tender offer registration statement. The tender offer period must be between 20 and 60 business days. The same purchase price must apply to each shareholder responding to the tender offer. If a buyer aims to acquire more than two-thirds of the total issued shares, it must offer to acquire all issued shares.

Antitrust pre-filing requirements

Under the Antitrust Act, a buyer must file a prior notification with the Japan Fair Trade Commission, if (1) the revenues derived from business in Japan of the buyer and its affiliates exceed ¥20 billion, (2) the revenues derived from business in Japan of the target and its subsidiary exceed ¥5 billion and (3) the buyer's shareholding would result in more than 20 per cent (or, if it has already exceeded 20 per cent, 50 per cent) of the target's total issued shares after the acquisition. After such filing, the buyer is prohibited from acquiring shares of the target during a 30-day waiting period.

Foreign investor pre-filing requirements

Where the target company is engaged in certain businesses (e.g., oil-related business, agriculture), the acquisition of its shares (if it is a listed company, 10 per cent or more of its total issued shares) by a foreign investor is subject to pre-filing requirements under the Foreign Exchange and Foreign Trade Act. The buyer must file a prior notification with the Ministry of Finance and such other governmental authority as has jurisdiction over the target. After such filing, the buyer is prohibited from acquiring the shares of the target during a 30-day waiting period (in practice, shortened to 14 days or less).

Other regulations

Where the target conducts a regulated business, the buyer may be required to obtain an approval or authorisation from or make a filing with the relevant supervisory authority. For example, a buyer acquiring 20 per cent or more of a bank or insurance company must first obtain approval of the principal shareholder by the Financial Services Agency ('the FSA').

In the case of PIPEs, while the buyer normally avoids the tender offer process, it must file a 'large holding report' under the FIEA within five days of the acquisition of 5 per cent or more of the target's total issued shares.

Points to consider other than regulations

Approval of the target company

For a target that is not a public company, its articles of incorporation may subject share transfers to board or shareholders approval.

Taxation

Non-resident buyers should pay attention to the '25 per cent/5 per cent rule'. A non-resident shareholder of a Japanese corporation having no permanent establishment in Japan is generally not subject to tax on capital gains on the shares; however, even if a non-resident shareholder has no permanent establishment in Japan, where such shareholder has held 25 per cent or more of the shares of a Japanese corporation at any time within three years prior to the last day of the calendar year (for an individual shareholder) or the shareholder's fiscal year (for a corporate shareholder) containing the date of transfer and transfers 5 per cent or more of such shares within that year, resulting capital gains are taxable as 'income generated in Japan'.

Non-resident buyers should note Japanese taxation of capital gains on sales by a non-resident without a permanent establishment in Japan of shares of a target 50 per cent of whose assets are directly or indirectly composed of real estate in Japan. Such gains are taxable if the non-resident holds more than 2 per cent (if the target is a listed company, otherwise 5 per cent) of the target's total issued shares as of 31 September of the year (or, if such non-resident is a foreign corporation, the last day of its fiscal year) immediately prior to the sale.

The above rules may be modified by applicable tax treaties.

ii Fiduciary duties and liabilities

Under the Companies Act, a company director owes a fiduciary duty to the company and also, it is generally understood, to shareholders. The director will be liable for any damages they incur due to his or her breach of such duty. Further, the Companies Act provides for equal treatment among shareholders. In addition, a company may not grant any interests or benefits to a shareholder in connection with its exercise of rights as shareholder. In the current prevailing practice in leveraged buyouts, if there remain minority shareholders before the contemplated freeze-out, the target may not provide any guarantee or create any security interest over its assets for the benefit of lenders that extend loans to the buyer for the acquisition, as such may constitute a breach of the directors' fiduciary duty or prejudice shareholders' equal treatment. Further, a director may owe a special tort liability to a third party who suffers damages as a result of a violation of the director's duty committed with wilful misconduct or gross negligence. In contrast, Japanese law has not yet generally accepted the concept of majority shareholders owing a fiduciary duty to minority shareholders.

As discussed in Section V, *infra*, the Companies Act's rules are now under review. In particular, there is discussion on whether liability should be imposed on majority shareholders (i.e., a parent company) for damages to minority shareholders caused by any conflict of interest in transactions between the majority shareholder and the company (i.e., the subsidiary).

III YEAR IN REVIEW

i Recent deal activity

Although the number and value of deal activities by private equity funds still remain at a low level compared with 2007, a larger value of deals appeared in 2011 than in the preceding two years. One notable deal in 2011 was a large-scale purchase of shares in Skylark as a secondary sale (see below). Another, closing in March 2011, was a secondary sale of shares in Tsubaki Nakashima Ltd, a manufacturer of precision balls for ball bearings, from a major Japanese financial group affiliate to a US-based buyout fund.

A notable trend in Japan, especially from the second half of 2010, is that business corporations have actively and strategically made investments by using their ample cash in order to expand their scope of businesses and pursue synergy through mergers and acquisitions. Such activities have provided private equity funds with more exit opportunities. In a notable case, in March 2011 Sapporo Holdings Ltd, the holding company for a major beer and beverage manufacturer, acquired a majority shareholding in Pokka Corporation, a well-known food and beverage manufacturer, from a buyout fund. In May of the same year, Ito En Ltd, a major beverage manufacturer, acquired all of the shares in Chichiyasu Company, a well-known dairy products manufacturer, from an investment fund.

While buyout funds have continued to play an important role in going-private deals, 2011 saw many going-private deals in the form of management buyouts without financial sponsors, including that of Culture Convenience Club Co Ltd, which operates Tsutaya, a nationwide chain of DVD rental shops and bookstores, in March 2011. Such deals happen partly because Japanese banks are capable of providing sufficient funds for management to make the acquisition if the target is in good standing. Further, those buyout funds that closed acquisition deals around the time of the collapse of Lehman Brothers have in particular been seeking opportunities for divestment, so secondary sales by funds have attracted attention in the Japanese market.

ii Financing

Types of acquisition financing

Loans are commonly used to raise funds for acquisitions in the Japanese market, often with syndication where the sum is large. We frequently see combinations of a term loan for the acquisition itself and a revolving facility for the target's post-acquisition working capital.

Further, subordinated loans are often used as mezzanine debt in relatively large-scale acquisition deals, to reduce the amount of equity required from the sponsor. Mezzanine debt (which may take the form of preferred shares) is subordinate in priority of payment and security to senior loans, but senior in rank to common shares. Also, an 'equity kicker' in the form of stock acquisition rights is sometimes granted to mezzanine finance providers to raise their expected internal rate of return.

In the case of buyout deals, the financiers normally receive security packages comprising almost all assets of the target.

Bridge loans, a short-term financing option, are sometimes used before a buyer obtains a permanent financing.

Sources of finance

According to JBRIC,[5] in the first half of 2011 buyers used loans to fund acquisitions in 21 buyout deals, with the aggregate amount of such loans at ¥292.7 billion. Banking entities and non-banking entities, such as insurance companies and leasing companies, are the main finance providers for acquisitions in the Japanese market. Further, funds

5 See footnote 2.

and finance providers have existed specialising in the provision of mezzanine financing. In addition, vender financing is sometimes used for acquisition deals.

Key terms for financing

Documentation of acquisition financing in Japan has been influenced by US and UK practices.[6] Thus, a normal facility agreement includes provisions for maturity, interest rate, conditions precedent for drawdown, mandatory prepayment, representations and warranties, affirmative and negative covenants, financial covenants, and events of default.

In the Japanese market, loans extended by finance providers in buyout deals normally have a maturity of between five and seven years. While interest rates depend largely on the target's credit assessment, an interest rate is sometimes made up from a base rate plus a spread that is based on a pricing grid tied to a financial covenant, such as the leverage ratio.

Conditions precedent usually include a so-called 'material adverse change' ('MAC') or 'material adverse effect' ('MAE') clause, and are sometimes subject to 'certain funds' provisions. A typical facility agreement in Japan has a MAC clause that encompasses market MAC (such as a deterioration of a loan, finance or capital market, or an outbreak of a natural disaster or war) as well as business MAC, which provides for events relating to the target (such as events affecting its business, operations, assets or financial conditions). 'Certain funds' provisions are intended to limit the lenders' ability to walk away from the acquisition finance during the 'certain funds period,' which is, in the case of a public deal, typically the tender offer period. Once the tender offer period starts, the borrower or offeror has no choice but to settle the transaction and thus absolutely needs the loan. To that end, only a limited scope of conditions precedent need be met for the drawdown of loans during the 'certain funds period'.

Proceeds from the disposal of assets, issuance of debt or equity, and insurances over assets are all normally subject to mandatory loan prepayment requirements.

A number of the affirmative and negative covenants are provided in the facility agreement, such as information undertakings, limitations on investments, M&A transactions and financial indebtedness, and restrictions on issuance of securities, payment of dividends, changes to the target management and granting of security. Various financial covenants, such as permitted interest coverage ratio, debt service coverage ratio, fixed charge coverage ratio, leverage ratio or net worth ratio, are also provided in the facility agreement. Such financial covenants are important to lenders for monitoring purposes.

iii Key terms of recent control transactions

Price adjustment clauses are sometimes included in a stock purchase agreement ('SPA') in order to adjust the sales price by reflecting events occurring between the relevant cut-off

6 The Japan Syndication and Loan-trading Association (JSLA) has published sample provisions of term loan facility agreements and revolving facility agreements for syndicated loans. Those sample provisions have affected the documentation of facility agreements for buyout deals in Japan.

date and the closing or which are revealed after the closing. Under a price adjustment clause, the sales price is typically adjusted pursuant to a prescribed formula based on specific events or based on figures, such as net assets, inventory, net working capital or EBITDA (earnings before interest, taxes, depreciation and amortisation). As well as such relatively straightforward price-adjustment provisions, in the case of purchases of shares in non-public companies, an earn-out clause may be used to effect a price adjustment, although such clauses have not yet become popular in the Japanese market. Under an earn-out clause, the buyer pays an additional sale price to be calculated based on the indices such as EBITDA showing the performance of the target's business during a certain period (normally between one and three years) after the closing, so that the buyer may reduce the sales price to be paid initially at closing.

Depending on the negotiations between the seller and buyer, an SPA may include a financing-out clause and, in cases of share purchase deals involving buyout funds, such clauses have become increasingly common in Japan, particularly after the 'credit crunch' in 2008. A financing-out clause enables the buyer to walk away from the deal if the buyer cannot obtain the expected financing from lenders. In contrast, reverse break-up fees have rarely been used in the Japanese market. Further, SPAs often include MAC clauses and the sellers and buyers negotiate heavily on what events it should encompass. In this regard, if there is no financing-out clause, it is important for buyers to ensure conformity between the MAC clause in the SPA with the MAC clause in the relevant financing agreement.

iv Exits

The 2006 management buyout of Skylark Co Ltd, a Japanese restaurant franchisor, sponsored by a Nomura affiliate and another co-investor fund, was widely remarked upon as one of Japan's largest buyout transactions. Subsequently, in November 2011 an entity managed by a US-based buyout fund acquired the shares of Skylark from the first investors, and this deal was the largest buyout deal in Japan after the collapse of Lehman Brothers. Such deals as Tsubaki Nakashima Ltd, Chichiyasu Company and Pokka Corporation, previously mentioned, were also high-profile exit transactions in 2011.

IV REGULATORY DEVELOPMENTS

i Supervisory authorities

The FSA is the main governmental authority supervising private equity funds and their activities. Besides regulations concerning fundraising, the manager of a private equity fund is, in general, required to be registered as 'financial instruments business operator' ('FIBO') for conducting the 'investment management business' pursuant to the FIEA in order to manage a fund's assets. A FIBO will, however, be subject to strict regulatory requirements under the FIEA. Thus, most fund managers elect to be special fund operators, which may manage funds without such registration by relying on the 'QII-targeted fund exemption'. Under such exemption, a fund operator may only accept funds from 'qualified institutional investors' ('QIIs') and less than 50 non-QII investors. Where this exemption is available, a fund operator is subject to relaxed regulatory requirements, including the requirement to file a prior notification before starting the management fund assets. The FSA has supervisory authority over such special fund operators and may order them to report information and submit materials, and conduct on-sight examination of their offices, but does not have the authority to impose administrative sanctions.

Further, as mentioned in Section II, *supra*, investment activities undertaken by private equity funds may be subject to tender offer requirements, antitrust pre-filing requirements, foreign investor pre-filing requirements or other regulatory approval, authorisation or filing requirements.

ii Recent regulatory developments

Over the past decade, various regulatory frameworks applicable to private equity funds have been in a state of continual development in Japan. These developments have corresponded to the fact that private equity funds have expanded their activities and have played increasingly important roles in the Japanese economy. Many such new regulatory frameworks have aimed to better regulate fund activities and protect investor interests. One of the most notable of such developments is the FIEA's introduction in 2007 of a new regulatory framework for managers of investment funds, under which a fund manager must generally register as a FIBO and thereby be subjected to strict regulatory requirements.

Further, the FSA has recently focused on the fact that fraudulent transactions often have involved investment funds relying on the QII-targeted fund exemption, resulting in an amendment to the notification requirement. From 1 April 2012, the notification must clearly state the name of the fund to be managed and the name of at least one QII investor.

Further, among recent regulatory developments, in 2010 the FSA published a practical Q&A guide in respect of tender offer regulations. This guide provides fund managers with a better idea of how the tender offer regulations apply to a tender offer process involving an investment fund. Another development is that in 2010 the Antitrust Act introduced pre-filing requirements, as mentioned in Section II, *supra*.

V OUTLOOK

Although the earthquake in March 2011 in north-east Japan caused huge damage to the Japanese economy, and slowed its recovery from the global financial turmoil of 2008, investments by private equity funds and acquisition-financing activities have been showing gradual recovery in the latter half of 2011. As discussed in Section III, *supra*, there have been some fairly large buyout deals, such as Skylark and Tsubaki Nakashima, and M&A transactions involving strategic buyers have offered good exit opportunities for private equity funds. Nonetheless, unpredictable events, such as credit uncertainty in the EU and the continued appreciation of the yen, might have material adverse influence on private equity investments and acquisition financing activities in the near future.

As explained in Section IV, *supra*, there have been continual developments in regulatory frameworks applicable to private equity funds and their activities, responding to the increasing presence of such funds in the Japanese economy, and it is expected that such developments will continue. In this connection, amendments to the framework of the Companies Act and that of contract law in the Civil Code are under discussion and may soon become hot topics, although the precise schedules for such amendments and their contents are still unclear. As to the Companies Act, a committee organised by the Ministry of Justice has reviewed the current framework and in December 2011 published preliminary proposals. An important objective of these amendments is to create structures for more effective corporate governance in Japanese corporations. One item under discussion, for example, concerns parent-subsidiary dealings where their conflicting interests have adverse effects on the subsidiary's minority shareholders, and whether to hold parent companies liable for resulting damages experienced by subsidiaries.

The Civil Code – especially, its contract law provisions – is also being reviewed by another committee organised by the Ministry of Justice. This might have influence on agreements for share purchase deals and other acquisition transactions and acquisition financing.

Appendix 1

ABOUT THE AUTHORS

TAKU ISHIZU

Nishimura & Asahi

Taku Ishizu is a partner at Nishimura & Asahi, and his practice mainly focuses on asset management, leveraged buyouts, capital markets, corporate finance transactions, other international finance transactions and banking.

He received his law degree from the University of Tokyo in 1995, and a master of laws degree from the Boston University School of Law in 2003.

Mr Ishizu acts in a wide range of matters in relation to fund formation, fundraising, governance, and organisational structure for the sponsors of private equity funds including buyout funds and venture capital funds. Further, he assists clients with the structuring, negotiation and execution of transactions and with portfolio company matters.

He has published many articles and books in the finance area, and has served as a lecturer at several seminars. He is also a lecturer at Keio Law School.

KEI ITO

Nishimura & Asahi

Kei Ito is a partner at Nishimura & Asahi, specialising in asset management, mutual funds, derivatives, securities, banking, and other financial and international transactions.

He received his law degree from the University of Tokyo in 1990, and a master of laws degree from the New York University School of Law in 1997.

Mr Ito has significant experience ranging from traditional asset management business, such as investment trusts (mutual funds) and investment advisers, to alternative investments, such as private equity funds, buyout funds, infrastructure funds and hedge funds. He has also advised Japanese and non-Japanese clients in all aspects of asset management. His asset management practice covers the offer and sale of various offshore funds, notably the sale and cross-listing in Japan of exchange-traded funds listed on foreign stock exchanges. He is also a lecturer at Keio Law School and Hitotsubashi Law School.

TOMOKAZU HAYASHI

Nishimura & Asahi

Tomokazu Hayashi is an associate at Nishimura & Asahi, specialising in the fields of international transactions, acquisition finance, asset management, structured finance and securitisation, and financial taxation.

He received his law degree from the University of Tokyo in 2002 and his JD from Keio Law School in 2006.

NISHIMURA & ASAHI

Ark Mori Building
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029
Japan
Tel: +81 3 5562 8500
Fax: +81 3 5561 9711
k_ito@jurists.co.jp
t_ishizu@jurists.co.jp
t_hayashi@jurists.co.jp
a_shimoda@jurists.co.jp
www.jurists.co.jp/en/