Changing commitments

Asa Shinkawa, Hiroko Shibata and James Emerson from Nishimura & Asahi explore how evolving tender-offer funding practices increase investor protection but create disclosure burdens

On March 31 2010, the Financial Services Agency (FSA), the authority that regulates tender offers in Japan, released in a Q&A format an updated version of its interpretations of Japanese tender offer regulations (Updated Q&A) which are provided in the Financial Instruments and Exchange Law and related regulations (TOB Rules).

The original version of the FSA's tender offer Q&A was issued on July 3 2009 with the aim of increasing the transparency of the TOB Rules through the publication of the FSA's views on certain issues frequently arising in practice.

Although the Q&A technically lacks the force of law and merely provides a snapshot of the FSA's current way of thinking, the new Q&A is significant because in Japan it is customary for a tender offeror to submit a draft tender offer statement (TOS) to the relevant Local Finance Bureau (LFB), which will review the TOS under the supervision of the FSA.

After such review by the LFB, and once the FSA has provided *de facto* acceptances of the draft TOS, the offeror will launch its tender offer. During the course of the review by the LFB, the LFB usually asks the offeror to make changes to the draft TOS and requests responses to questions raised by the LFB.

Although Japanese law does not require an offeror to have its TOS reviewed by the LFB or the FSA in advance, if the FSA determines that a TOS does not properly include all of the matters that are required to be described therein after it has been filed, the FSA may formally require the offeror to amend the TOS, and in doing so the formal request for an amendment of the TOS will trigger a 10-business-day extension of the tender offer period if the time remaining in the tender period is less than 10 business days at the time the amended TOS is filed.

Clearly, such extensions have the potential to frustrate the purpose, or harmfully delay the timing, of the contemplated transaction. Accordingly, to help increase the likelihood of a smooth transaction process, the FSA's statements conveyed in the Q&A ought to be taken into consideration in preparing the TOS and the attachments thereto.

While the Updated Q&A includes 17 new questions and answers, the focus of this article is on the requirement for a Funds Certificate supporting the existence of sufficient funds for the settlement of the tender offer.

> **"In Japan, the TOB Rules have been widely interpreted as prohibiting offerors from including a financing-out in their tender offers"**

Funds for tender offer settlement

The TOB Rules require an offeror to describe whether the funds necessary for the settlement of the tender offer are already available or whether they will need to be raised (and if so, how they are expected to be raised) in the TOS, to which a Funds Certificate must be attached.

For offerors utilising their own funds, a bank account balance statement indicating an existing balance that is equal to or greater than the funds for settlement is usually attached to the TOS as a Funds Certificate.

However, in the case where an offeror plans to raise funds from a third party funds provider in the form of a loan or an equity capital contribution, then a commitment letter, certifying that the funds provider is prepared to provide an agreed amount of money to the offeror, must be executed by the funds provider and attached to the TOS as a Fund Certificate 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.

The aforementioned requirement creates some complications in the case of private-equity buyers, who often desire to inject money into an offeror through multiple layers of entities after it is confirmed that a tender offer has been successfully completed.

Where multiple investment entities are strung together, a commitment letter is required not only from the entity at the end of the financing chain (i.e. the entity that will directly inject the funds into the offeror), but also from the other entities up the financing chain.

In addition, the entities that provide commitment letters may be asked by the LFB to demonstrate their creditworthiness and/or the source of their own funds, for the purpose of confirming the substantial likelihood that the funds for settlement will be available to the offeror at the time of settlement.

Consultations with the authorities

Although neither the form itself nor the content of the commitment letter is specified in the TOB Rules or the Updated Q&A, the established practice in Japan is for the TOS, including the commitment letter that is to be attached thereto as a Fund Certificate, to be finalised with de facto approvals by the FSA (such approvals will not be granted until after certain informal consultations with the LFB, under the supervision of the FSA, are concluded).

In general, the funds provider is expected to take the leading role in these consultations as they pertain to the commitment letter, whereas the offeror takes the leading role in the remainder of the consultations. Because of the possible time involved in the process, offerors in Japan typically commence consultations a minimum of two weeks before launching the tender offer.

> **"Following the release of the Updated Q&A, the LFB has a tendency to review the creditworthiness of the funds provider more carefully"**

Updated Q&A

Unlike in the United States and other jurisdictions around the world where offerors are permitted to condition their obligations to settle a tender offer on their receipt of expected financing proceeds (by providing for a so-called financing-out), in Japan the TOB Rules have been widely interpreted as prohibiting offerors from including a financing-out in their tender offers, and the FSA has confirmed such view in its response to public comments associated with the Updated Q&A.

In fact, an article released on June 15 2010 entitled Commentary on the Q&A regarding Tender Offers, which was authored by FSA officials, indicated that commitment letters need not guarantee the availability of the funds for settlement with absolute

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certainty, because even if the anticipated financing stream is lost, the relevant offeror will still be required to move forward with the tender offer and to find another adequate means of financing for the funds for settlement.

The article also stated that expressions of absolute certainty in commitment letters are not required because such a requirement could make obtaining adequate levels of debt financing by the offerors much more difficult (if not impossible in some cases), which would ultimately be detrimental to investors' interests.

Although the article was released on the basis that it would not be deemed to be the FSA's official view, the Updated Q&A also suggests that in lieu of absolute certainty, commitment letters need to merely support the possibility of the offeror being able to raise the funds for settlement "with a substantial degree of certainty" (such a level of certainty is likely meant to constitute something more than a reasonable certainty, although this assumption of the authors has not yet been verified by the FSA or the LFB).

The Updated Q&A provides a few guidelines regarding when a substantial degree of certainty that the offeror will be able to secure the funds for settlement would be lacking.

For example, in the case of debt financing for an offeror, a substantial degree of certainty will not be found if: (i) the creditworthiness of the lender is clearly in doubt; (ii) a condition precedent to the signing of a relevant loan agreement or to the actual drawdown of funds lacks either specificity/concreteness or objectivity in any material respect; or (iii) the lender has not obtained all requisite internal approvals for the provision of the loan which should have been obtained by the time of the filing of the commitment letter as an attachment to the TOS. These points will each be addressed in additional detail later in this article.

On the other hand, the foregoing is not meant to suggest that an offeror is required to enter into a definitive financing agreement before the launch of the tender offer. Rather, it is often the case that only a term sheet is agreed upon between the offeror and the funds provider at the time of commencement of the tender offer, and in the Updated Q&A the FSA appears to acknowledge such practice.

Creditworthiness of the funds provider

Following the release of the Updated Q&A, the LFB has exhibited a tendency to review the creditworthiness of funds providers more carefully and to request the submission of various materials and information corroborating such creditworthiness.

Although such supporting documents are not generally disclosed to the public and are kept by the LFB and the FSA in confidence, the LFB's requests for additional information can become burdensome and, over time, such additional burdens could have a deterrent effect on the provision of financing by overseas investors for tender offers in Japan.

The necessary detail and extent of the information requested to demonstrate the creditworthiness of the funds provider is likely to depend on the financing structure of the proposed tender offer, as well as the type of entity the funds provider is, and the business area in which the funds provider operates.

If an offeror intends to borrow the funds for settlement from a major Japanese or international bank whose creditworthiness is well-known and well-established, materials demonstrating the financial soundness of such bank are unlikely to be requested. On the other hand, if a lender is a newly-established entity, the FSA is prone to having doubts about the creditworthiness of such lender, and will probably request a fairly comprehensive set of materials to confirm the creditworthiness of the entity.

According to the FSA's article, the ideal support document is a bank-account balance statement indicating an existing balance held by the lender that is equal to or greater than the loan to be provided to the offeror which will be included in the funds for settlement.

If the funds provider is an investment fund, there are generally two ways to demonstrate the creditworthiness of the funds provider: (i) by pro-

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viding evidence in support of the creditworthiness of an investment fund, itself; or (ii) by providing evidence in support of the creditworthiness of the limited partners of the investment fund (LPs).

The problem with trying to establish the creditworthiness of the investment fund itself is that a bank account balance statement a%nd/or the financial statements of the funds provider as of the date of the launch of the tender offer may not always reflect a sufficient level of cash or cash equivalents to completely cover the funds for settlement.

That said, if the investment fund has a bank financing commitment line or the availability of another borrowing facility from a reputable financial institution on which it can draw down, and the amount of the funds available is equal to or exceeds the amount to be provided to the offeror for inclusion in the funds for settlement, and there are no (or only reasonable) conditions to such financing, then the LFB is probably going to be willing to find, with a substantial degree of certainty, that the funds provider possesses sufficient creditworthiness to perform its obligations in connection with the contemplated tender offer.

More challenging is the scenario where the creditworthiness of the LPs must be established. If the LPs are widely-known, major entities, there may be no issue, but otherwise the LPs may be required to demonstrate that they have a sufficiently high level of credit, by providing supporting documents such as bank account balance statements or financial statements.

The result is that where LPs desire to keep their identities unknown, or in cases where the number of LPs is relatively large, this creditworthiness confirmation process could be problematic. In our experience, a possible workaround may exist if the applicable limited partnership agreement for the LPs contains a provision that would require the other LPs not only to make their own individual share of the capital contribution, but also to make up for the shares of any LP that defaults in the obligation to make a needed capital contribution. In practice, the existence of such an arrangement is often described in the commitment letter, and in such a case, redacted copies of the limited partnership agreements are generally requested by the LFB. However, the LFB may request additional evidence suggesting that such an arrangement will actually cover any applicable financing gaps. In that case, our experience has shown that the LFB may accept an explanation and description of how other LPs could in theory make up for the non-performance of the LP obliged to make the largest capital contribution.

Events that could prevent the receipt of adequate financing

Before the release of the Updated Q&A, commitment letters typically shied away from detailed disclosures of the conditions precedent to the implementation of the relevant financing, or of the events that could result in a termination of the relevant financing agreements.

In fact, commitment letters typically included only a brief remark to the effect that the financing would be "in accordance with all conditions precedent provided for in the definitive financing agreement". By way of contrast, commitment letters filed after the release of the Updated Q&A now include a comprehensive list, or at least a detailed summary, of the condition precedents and termination events to be provided in the relevant financing agreement.

This change in practice stems from the FSA's viewpoint, as stated in the Updated Q&A, that in order for there to be a substantial degree of certainty regarding the receipt by the Offeror of tender-offer financing, the conditions precedent to the financing must be both concrete and objective in all material respects and should not include any conditions that would allow the funds provider to exercise its own discretion arbitrarily, along with the notion that the possibility of the cancellation of any necessary financing should be sufficiently disclosed to the public.

With respect to what would likely constitute concrete and objective conditions, the Updated Q&A does not provide any specific guidelines on this point; however, an analysis of recent commitment letters reveals that the FSA seems

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to accept most types of provisions, including, without limitation, material adverse change-outs, which are commonly witnessed in financing agreements in Japan.

Although the Updated Q&A stated that full disclosure of every condition precedent is not always necessary and that due consideration must be given to privacy, trade secrets and deal confidentiality, it is now very often the case that an exact copy or a precise summary of all of the conditions precedent and financing termination events are described in the commitment letter.

The Updated Q&A also indicates that in cases where a failure to satisfy representations and warranties could lead to the funds provider's right to walk away from the transaction, a detailed description of such representations and warranties should also be described in the commitment letter. In addition, the LFB now regularly asks to see a copy of the relevant term sheet or definitive agreement containing the key conditions precedent, representations and warranties and/or termination events during the course of the consultations described earlier.

Involvement of the offeror

The consultations that relate to the commitment letter are usually conducted by the funds provider, insofar as the funds provider is the person that is attempting to demonstrate its creditworthiness to the LFB and is the one who is expected to respond to the LFB's questions. Nevertheless, the offeror should pay close attention to the progress of such consultations and should independently confirm the creditworthiness of the funds provider for several reasons.

In the post-Updated Q&A issuance environment in Japan, unless the creditworthiness of the fund provider is apparent to the LFB, offerors are now often asked to state in the TOS the reason(s) why they believe that the relevant funds provider(s) will be able to provide the amount to be provided to the offeror for inclusion in the funds for settlement. The precedents show that a simple or brief statement is often accepted by the FSA, such as a statement indicating that the offeror determined the creditworthiness of the funds provider based on the funds provider's past investment activities and achievements.

However, to the extent the FSA concludes that any descriptions in the TOS were insufficient, the FSA could require the offeror to amend its TOS, which could, in turn, delay the closing of the tender offer. Moreover, and perhaps most importantly, since the TOB Rules provide that commitment letters constitute a part of the TOS, any material misstatement or omission in any material respects in the commitment letter could result in an administrative monetary penalty (equivalent to 25% of the aggregate market value of total purchased securities as of the day before the filing of the notice of tender offer) imposed on the offeror even though the commitment letter was prepared by the funds provider.

Furthermore, an offeror that knowingly makes such a material misstatement in the commitment letter would be subject to criminal sanctions. Therefore, the offeror should carefully consider how it can both arrive at (in its own decision-making process regarding the funds provider), and communicate (directly or indirectly through the LFB) to the FSA in the TOS a substantial degree of certainty regarding the planned financing.

The post-Updated Q&A era

In summary, there are three points worth emphasising. First, in creating a timeline for the tender offer, it is important for offerors to ensure that there will be adequate time for consultations with the LFB/FSA, especially in cases where the funds provider is an investment fund and cash is to be injected into the offeror, indirectly, through a series of intermediary entities. While the normal duration for the consultations is approximately two weeks, if the planned flow of the funds for settlement is expected to be complex, or where they are multiple funds providers, then it would be prudent to set aside at least one additional week for the process.

Second, regarding the structure of the proposed financing, if the funds for settlement are designed to flow through layers of different investment vehicles, it is preferable to include in the financing cascade an entity that will be in a position to provide persuasive materials in support of its creditworthiness.

In this regard, apart from bank-account balance statements or financial statements that capture a sufficient cash balance (or highly liquid cash-equivalents), documents certifying the availability of a bank financing commitment line or other financing facilities capable of covering completely the amount of the funds for settlement, with no (or only reasonable) conditions thereon, could be useful in trying to establish with substantial certainty the financing sources that should lead to sufficient funds for settlement. In addition, the timing of the cash injection by the investment vehicles within layers of funding should be structured so that the necessary funds would be expected to arrive at the designated account of the offeror by the settlement date for the tender offer.

Third, during the course of the consultations a variety of explanatory materials could be requested by the LFB for their internal review, including, without limitation, an excerpt from the relevant proposed financing agreement, equity subscription agreement, or limited partnership agreement. From a logistical standpoint, this means that consents from the applicable parties to such documents regarding the disclosure of the terms thereof to the Japanese authorities should be sought early in preparing for a tender offer.

Since the issuance by the FSA of the Updated Q&A, Japan has witnessed significant changes in the practices that relate to commitment letters for tender-offer financing, with the introduction of the need for a substantial degree of certainty when it comes to the availability in the end of funds for settlement.

Although this policy can be said to bolster investor protections on the one hand, it also creates disclosure burdens and other obligations on the various parties to agreements that could become relevant in Japanese tender offer contexts, that involve financing, so we hope that through the efforts of practitioners in their ongoing discussions with the regulatory authorities the practice of using commitment letters as part of financed Japanese tender offers will continue to be refined and that an optimal balance will ultimately be struck between the need for investor protections and the resulting burdens that such protective measures entail.