Japan – Recent trends in Japanese M&A

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According to a market review published by Recof Corporation, there were a total of 1,957 M&A transactions involving Japanese companies in 2009, representing a decrease of 18.4% from 2008's total of 2,399 transactions. The largest M&A transactions relating to Japanese companies that were announced in 2009 were: Mitsui Sumitomo Financial Group's acquisition of Nikko Cordial Securities Inc. (transaction value of ¥574.8bn, or approximately US$6.4bn); the business integration among Mitsui Sumitomo Insurance Group Holdings, Inc, Aioi Insurance Co., Ltd, and Nissay Dowa General Insurance Co., Ltd. ¥534.5bn, or approximately US$5.9bn); and Suntory Holdings Limited's acquisition of Orangina Schweppes Group (¥300bn, or approximately US$3.3bn).

Recent M&A trends in Japan include, (a) mergers or integrations between companies in the same business (such as the integration of Nippon Oil Corporation and Nippon Mining Holdings, Inc. and the management integration of Sumitomo Trust and Banking Co, Ltd. and Chuo Mitsui Trust Holdings, Inc.); and (b) M&A transactions relating to J-REITs (such as the merger of Nippon Residential Investment Corporation and Pacific Residential Corporation).

New regulations of dilutive share issuances

On the regulatory front, there has recently been movement to curtail dilutive share issuances to a specific party (so-called 'third-party allotments'). Japanese corporate law permits a listed company to issue new shares by resolution of the board of directors without shareholders' approval as long as the terms of the issuance are not "specially favourable" for the subscriber. Japanese corporate law also allows a listed corporation to amend its articles of incorporation in order to increase the number of authorised shares to an amount not more than quadruple the amount of outstanding shares.

Many Japanese listed companies have taken advantage of these relatively easy procedures for share issuances to raise capital. However, concerns have been raised about issuances that have been excessively dilutive, as well as issuances made at the discretion of the board that have resulted in a change of control. In an extreme example, a listed company effected a 10:1 reverse share split and simultaneously issued warrants at a discount, resulting in the subscriber obtaining 96.8% of the outstanding shares at a 2,000% dilution rate.

Regulatory agencies have recently taken steps designed to enhance the attractiveness of Japanese capital markets to individual and foreign investors. In 2009, both the Financial Services Agency (FSA) and Tokyo Stock Exchange (TSE) published reports suggesting regulatory improvements. In response to these reports, the TSE imposed new regulations on July 30, 2009, with respect to third-party allotments. Under the new regulations, a company can be delisted if a third party allotment results in a dilution ratio exceeding 300%, unless the TSE determines that such dilution will cause little harm to the interests of shareholders and other investors. A listed company can also be delisted if, (a) a third-party allotment has resulted in a change in the controlling shareholder; and (b) the TSE determines that the soundness of the transactions between the listed company and the controlling shareholder have become considerably impaired in the three years following the fiscal year in which the change of control occurred.

There are also new approval and disclosure requirements in connection with third-party allotments. In order to proceed with a third-party allotment that has a dilution ratio of 25 or more or that results in a change of controlling shareholder, the company must either confirm acceptance by existing shareholders (for example, through approval at a shareholders' meeting) or obtain an opinion from a party independent of management regarding the necessity and appropriateness of third-party allotment. The new regulations also require the issuer to disclose information about the issuing company, the subscriber, and relationship between them. Information required to be disclosed includes the plan for the use of the new capital, any relationship between the company and the subscriber, details of the business and capital of the subscriber and its shareholding policy, and details about the basis of calculation of the paid-in amount. The TSE may also require an opinion from the issuer's statutory auditors (*kansayaku*) and audit committee as to whether the terms of the subscription are specially favourable to the subscribers. Disclosure is also required with respect to the financing and source of funds used to purchase the new shares.

The Financial Instruments and Exchange Act (FIEA) was amended at the end of 2009 and now requires almost the same disclosure as is required by the TSE in connection with third-party allotments. This disclosure must be included in a registration statement and means that the issuer will be subject to liability under the FIEA for misstatements and omissions in the disclosure.

Corporate governance

Recent corporate and accounting scandals, together with significant disruptions in general economic conditions, have led to greater emphasis on protections for minority shareholders. A number of papers have been published by governmental agencies regarding corporate governance issues in this regard. (See *Corporate Governance Study Group Report* published by Corporate Governance Study Group, Ministry of Economy, Trade and Industry on June 17, 2009 and *Report by the Financial System Council's Study Group on the Internationalisation of Japanese Financial and Capital Markets* published by the Financial System Council, FSA, on June 17, 2009). There has been particular focus on potential conflicts of interest between directors and minority shareholders (for example, in the context of MBO transactions and the introduction of defensive measures such as poison pills) and the need for independent board members for the purpose of protecting the interests of the minority shareholders.

On December 30, 2009, the TSE imposed new regulations pertaining to corporate governance systems of listed companies. The new regulations present models of corporate governance to secure the confidence of shareholders, investors, and others. They require a listed company, (a) to have at least one independent director or statutory auditor (*kansayaku*) who has little possibility to have conflicts of interest with general shareholders; and (b) to submit a report by the end of March 2010 on the steps to obtain and maintain such independent person.

According to a White Paper published by the TSE in June 2009, 55.6% of listed companies did not have any independent director. There is an issue, however, as to the requirements of "independence". Under Japanese corporate law, a person can be an "independent" director of a corporation even if the person is or was a director or employee of the corporation's parent or sister company. The only requirement for independence is that the person not be a full-time director or employee of the corporation itself or a director or employee of the corporation's subsidiary. According to the White Paper, out of listed companies that have a parent company, 67.5% of the independent directors and 51.7% of the independent auditors of such listed companies were directors or employees of the parent company.

Listed companies are now required to disclose the names of independent directors and statutory auditors and the basis of independence, including reasons why a person who has any relationship with the company should be designated as an independent director or auditor. A listed company must consult with the TSE at least two weeks before designating an independent director or auditor if such person is, (a) an executive officer or employee of the listed company itself or its subsidiary, business counterparty or partner, such as a subcontractor or consultant obtaining remuneration for the company or a close relative or similar person who could be significantly controlled by management; or (b) an executive officer or employee of the listed company's parent company or its business counterparty or partner, such as a main bank, a close relative or similar person who could have considerable control over management.

Recent amendments to antimonopoly regulations

Recent amendments to Japan's Antimonopoly Act (AMA) may have an impact on M&A transactions, particularly transactions involving entities in corporate groups that have Japan-related business. A pre-closing filing must generally be made with the Japan Fair Trade Commission (JFTC) in connection with M&A transactions if certain thresholds are met. There is then a waiting period of 30 days after the filing before the transaction can be closed. Recent amendments to the AMA have modified the relevant thresholds in a manner that is likely to increase the necessity of making pre-closing filings with the JFTC. They have also expanded the applicability of pre-closing filings to include stock acquisitions (as opposed to mergers or asset acquisitions). Stock acquisitions were previously only subject to post-closing notification requirements.

One important change is the introduction of a new definition of "domestic turnover" (sales revenue in Japan), instead of gross assets in Japan, as the basis of a threshold for the filing requirement. Prior to the amendment, the amount of gross assets in Japan was generally used as the threshold for Japanese companies and the amount of Japanese domestic turnover was used as the threshold for foreign companies. Domestic turnover was calculated based only on sales from

offices located in Japan. Therefore, direct sales to Japanese customers from outside of Japan were not recognised as "domestic turnover" for this purpose. The amended AMA applies a single standard for "domestic turnover" to both Japanese companies and foreign companies, and "domestic turnover" is defined to include, in the case of the acquirer, the Japan-related turnover of its "Corporate Consolidated Group", which would include all subsidiaries of the acquirer's ultimate parent company, regardless of the location of the offices making the sale of goods or services to Japanese consumers. This amendment of "domestic turnover" means to catch acquisitions by foreign companies for purposes of the filing requirements on the same basis as Japanese companies.

The amended AMA also now treats a stock acquisition by a partnership (including limited partnerships or similar partnerships established in foreign countries) as a stock acquisition by the company that has control over the partnership. This change may have a large impact on investment funds that invest in Japan through a partnership structure. On the other hand, the amended AMA dispenses with a filing requirement in connection with acquisitions between/among companies in the same "Corporate Consolidated Group". Previously, an exemption was only available for acquisitions between a parent company and its direct subsidiaries or between a company and its sister companies.

While the basis of the filing threshold has been expanded with the introduction of a new definition of domestic turnover, the monetary amount at which the threshold is set has also been increased. A filing is now generally required in an acquisition if domestic turnover of the Corporate Consolidated Group of the acquirer exceeds ¥20bn (almost US$222m) and that of the acquired company and its subsidiaries exceeds ¥5bn (almost US$55.6m). Prior to the amendment, the thresholds were ¥10bn and ¥1bn, respectively.

As noted, pre-closing filings now apply to stock acquisitions. A filing is required when, (a) the ratio of the target company's shares held by the Corporate Consolidated Group of the acquirer crosses the 20% or 50% threshold as a result of the stock acquisition; and (b) the relevant turnover thresholds are met by both parties. This change also has implications for acquisitions that are made by way of a tender offer. In Japan, the maximum tender offer period is 60 business days. Ordinarily, this would not be problematic in the context of the 30-day waiting period under the AMA. However, the 30-day period can be extended if the JFTC commences an examination and requests additional information. In such case, the waiting period is the longer of 120 days from the filing and 90 days from the submission of additional requested information. Thus, it is possible that the maximum tender offer period will expire prior to the waiting period under the AMA. In such case, the tender offeror may be able to withdraw the tender offer if certain disclosure has been made (tender offers can generally not be withdrawn unless specific requirements are met). To avoid the risk of a required withdrawal, an acquirer may consult with JFTC prior to the commencement of the tender offer in order to obtain preliminary approval from JFTC. However, in the case of a hostile tender offer, the acquirer may face difficulty because it may not have sufficient information about the target company that would be required to obtain pre-approval from the JFTC.

Enhanced penalties for securities law violations

An administrative monetary penalty system was implemented in 2005 in connection with violations of the disclosure and filing requirements under the FIEA. The FIEL has expanded the scope of administrative penalties to cover tender offer statements and large holding reports, which are generally required to be submitted by a shareholder who holds at least 5% of the shares of listed companies. While the FIEL had already provided for civil and criminal liability in connection with violations of the tender offer regulations, administrative penalties can now be imposed in connection with material misstatements and omissions in tender offer statements and large shareholding reports without proof of negligence. In addition, the penalty amounts were raised in connection with unfair trading, including insider trading. According to an FSA publication, there were 40 administrative penalty cases during the period from April 1, 2009 to February 1, 2010, whereas there were only 31 cases during the previous full fiscal year (from April 2008 to March 2009).

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