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The New Japanese Corporation Law in Relation to M&A

The new Japanese Corporation Law has the potential to significantly change the landscape of M&A transactions in Japan, which as you can see from several recent high-profile takeover battles, is rapidly evolving. What will you be able to do under the new Corporation Law which you cannot do under the current law? By Hiroki Kodate of Anderson Mori & Tomotsune in Tokyo, Japan.

Hiroki Kodate

On March 22, 2005, the Japanese Cabinet submitted bills to the Japanese Diet to create the new *Corporation Law of Japan*. The Diet is currently reviewing the proposed bills, and was expected to pass them around the time of this magazine going to press, at the earliest. The proposed bills are being introduced for the purpose of modernizing the Japanese law in respect of corporations, and strive to accomplish this through both structural and substantive changes to the law.

In terms of structural changes, there are two major changes worthy of note that should improve both the clarity and accessibility of the law. The first of these changes is the phasing out of the katakana-based writing style prevalent in the *Japanese Commercial Code* and other laws which regulate corporations. The katakana-based writing style was used for official and formal documentation prior to the Second World War, and people outside the legal profession in Japan therefore find it extremely difficult to read and understand. While a fairly simple change, phasing out a writing style which is over a century old should make the new *Corporation Law* far more accessible than its predecessors.

The second of the changes is that the new Japanese *Corporation Law* will be a piece of stand-alone legislation. Currently, what we refer to as Japanese corporation law is an amalgam of provisions taken from the *Japanese Commercial Code*, the *Law for Special Exceptions to the Commercial Code Concerning Audits of Joint Stock Corporations*, and a variety of other laws which deal with the affairs of corporations. One may need to consult several pieces of legislation in order to check a single legal issue. The relevant sections will be removed from their respective pieces of legislation and included in the new Japanese *Corporation Law* in their entirety. As a result, several pieces of legislation will also be abolished. Again, these changes are geared to making the relevant law easier to access and understand.

Although the intention is to make the law more accessible and comprehensible, it may be worth mentioning that these bills are said to represent one of the most voluminous pieces of Japanese legislation in history. This is due to the fact that there are over 300 other pieces of legislation, such as the *Banking Law and the Securities and Exchange Law*, which refer to and cite provisions of the *Japanese Commercial Code* and other laws directly regulating matters related to corporations which are to be incorporated into the new Japanese

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Corporation Law. Each of these laws will also need to be amended to reflect the newly created provisions of the new *Corporation Law*.

The substantive changes are designed to bring the law up to speed with the fast-paced social and economic changes surrounding Japanese corporations. A great number of issues are being addressed substantively and changed in the new *Corporation Law* in the hope that the end product of the modernization of the law in respect of corporations will be a worthy piece of legislation. Many of these changes have been introduced to provide Japanese corporations with a greater degree of flexibility in their management. The changes relating to M&A, which will be discussed below, fit into this category. Some of the changes, however, are intended to strengthen and protect the interests of shareholders and creditors. For example, the introduction of provisions which oblige the directors of large corporations (including corporations which have no less than ¥500 million, approximately US$4.6 million, in capital) to establish internal control/compliance systems falls within this second category.

The structural changes to the law are largely uncontroversial. It is perhaps unsurprisingly the substantive changes to the law that have drawn the most attention. Foremost among the changes that have drawn scrutiny and been the focal point of debate is a change to the law applicable to mergers concerning the 'flexibility of merger currency'. Flexibility of merger currency will be discussed below in greater detail. This article will also touch upon some of the other regulations regarding M&A under the new *Corporation Law* which relate to the introduction of short-form mergers, the relaxing of requirements for a process called the 'simplified merger process,"' and amendments related to defensive tactics against hostile takeovers.

Flexibility of merger currency

'Flexibility of merger currency' means that, instead of being largely limited to using shares of the surviving entity as consideration for the merger, corporations involved in a merger will now be able to provide cash or other assets to shareholders of the dissolved entity by way of consideration. Under the current law, cash can also be used as consideration for the merger, but only together with the shares of the surviving entity. Cash and the shares of corporations other than the surviving entity may also be used as consideration for a merger if the requirements of the *Industrial Revitalization Act*, such as receiving approval of the relevant Japanese Ministers, are met.

The introduction of the flexibility of merger currency is an attempt to completely deregulate the restrictions on consideration (in terms of the kinds of consideration available and prerequisites for using assets other than shares of the surviving entity) used for mergers. This amendment will make 'cash-out mergers' and 'triangular mergers' possible, thereby adding a level of flexibility for corporations looking to pursue a merger and facilitating the merger process.

'Cash-out mergers' mean mergers whereby only cash is provided to the shareholders of the dissolved entity as consideration for the merger; the shareholders of the dissolved entity end up having no interests in the surviving entity or its affiliates. For various business reasons, corporations in a merger may want to cash the minority shareholders out of the resulting corporation and its affiliates. Cash-out mergers can be expected to be used, for instance, when a corporation goes private and an all-cash tender offer to acquire all of the shares in the target listed corporation has been made, but a small percentage of the shareholders have not tendered their shares. In such a case, the tender offeror will merge the target corporation into itself and grant cash considerations to the remaining shareholders of the target corporation.

In general terms, 'triangular mergers' mean mergers between a wholly-owned subsidiary (the surviving entity) and an entity that is to be dissolved as a result of the merger. In this form of merger, the shares of a parent corporation are provided to the shareholders of the dissolved entity, with the result that they end up being shareholders of the parent corporation. The parent corporation, however, maintains its 100% shareholding in the subsidiary.

Triangular mergers enable foreign corporations to utilize their own shares as consideration for a merger between their wholly owned Japanese subsidiaries (again being the surviving entity) and the target Japanese corporation (being the dissolved entity). An aspect of the law which has remained unchanged from the current law under the new *Corporation Law*, is that mergers and other statutory schemes for corporate reorganization, such as share exchanges may only take place between Japanese companies.

As such, the introduction of triangular mergers in the new *Corporation Law* will give a significant degree of flexibility to foreign corporations in the merger context. It should be noted, however, that in the context of a tender offer, which does not directly involve the issuing corporation but is instead a share purchase from each of the shareholders, there is no restriction on the type of consideration used under the *Securities and Exchange Law*. Accordingly, under the current law, a foreign corporation is able to make a tender offer, which offers shares in the foreign corporation, in order to acquire shares in a Japanese publicly-held corporation. To the knowledge of the author, it is not contemplated that this will change as a result of the introduction of the new *Corporation Law*.

In relation to triangular mergers, one issue worthy of note is the restriction on the acquisition of shares by a corporation subsidiary in its parent. Under the current law, a subsidiary may not, in principle, acquire the shares of its own parent corporation except in very limited circumstances, which, in addition to the restrictions on the type of merger consideration, effectively prevents triangular mergers. The new *Corporation Law* will maintain the principle that a subsidiary may not acquire shares in its parent, but will expand the exceptions so as to allow the subsidiary to acquire shares in its parent for the purpose of implementing a triangular merger.

The driving force behind the flexibility of merger currency has been demand from both Japanese and foreign businesses, though for differing reasons. The Japanese business sector has pushed for this reform primarily in order to facilitate their corporate restructuring within group companies. On the other hand, the foreign business interests have been pushing for greater flexibility to make M&As and foreign direct investment easier.

This amendment was, however, the subject of heated debated in the course of finalizing the bills for the new *Corporation Law*. Concern was expressed by some politicians and Japanese companies that, with the

introduction of triangular mergers, a marked increase would be seen in the number of hostile takeovers by foreign interests. In part this is because the market capitalization of leading foreign companies in many industries is much larger than that of leading Japanese companies. This concern, coupled with the fallout from the recent Livedoor hostile takeover attempt of the Nippon Broadcasting System, has become a major political issue.

In an attempt to assuage the concern that the added flexibility will create a firestorm of foreign investment-driven hostile takeover activity, the triangular merger reform is due to take effect one year after the new *Corporation Law* takes effect (this date falling within 18 months of the issue of the new *Corporation Law*, will be designated by Cabinet Order). This one-year window was deemed necessary to give Japanese companies an opportunity to adopt defensive measures such as 'golden shares' (classes of shares assigned special rights such as veto rights with respect to mergers or other important corporate actions), or 'poison pills' (defensive schemes which, upon the appearance of a hostile buyer, serve to dilute its shareholding). These defensive measures are made easier to introduce by the new *Corporation Law*. This article will briefly touch upon the amendments relating to defensive tactics below.

Further, with respect to the triangular mergers utilized by foreign companies, there is one issue which remains unresolved in the new *Corporation Law*. This issue concerns the requirements for shareholder resolutions approving a merger. Under the new *Corporation Law*, as well as the current law, shareholder approval for the merger agreement from each corporation in the merger generally requires a supermajority vote affirmed by at least two-thirds of the voting shares represented at a shareholders' meeting wherein a majority of all voting shares must be present to constitute a quorum. However, an exception to this rule exists under the new *Corporation Law*, making it more difficult to receive shareholder approval.

Under the new *Corporation Law*, a special majority vote on the part of the dissolved entity is required for mergers. This involves shareholders of the dissolved entity holding shares that are not subject to any transfer restrictions that are granted assets designated by the *Ministerial Regulations* as being subject to limitations on transferability, as consideration for their shares in the dissolved entity. Special majority votes require approval from at least half of all shareholders with voting shares, holding at least two-thirds of all the voting shares. With regard to a listed corporation, this special majority vote could be extremely difficult to obtain. The question here is whether the shares of a foreign corporation, particularly listed on a stock exchange in a foreign country but not in Japan, would fall within the range of assets designated by the *Ministerial Regulations*. A draft of the *Ministerial Regulations* has yet to be published.

In addition to corporate law considerations, tax implications are always an important issue in deciding whether to proceed with an M&A transaction. With respect to the deregulation of merger consideration under the *Industrial Revitalization Act*, tax is not deferred for shareholders receiving shares of corporations other than the surviving entity and therefore the law has often been considered to be unworkable or unusable. It is uncertain as to whether this situation will be remedied by the merger currency flexibility amendment in the new *Corporation Law*. Indeed, the tax treatment regarding transactions carried out under the new *Corporation Law* has yet to be decided on. This is certain to be a topic of ongoing debate between now and the time the amendment is slated to come into effect.

Short-form Mergers

As mentioned above, under the new *Corporation Law* shareholder approval of the merger agreement by supermajority vote of each corporation in the merger is generally required. A new exception to this rule has been introduced concerning mergers between controlling and controlled corporations. Controlled corporations, as referred to in this paragraph, mean corporations whose controlling corporation holds no less than 90% of its voting shares. This provision allows mergers between controlling and controlled corporations to take place without requiring shareholder approval from the controlled corporation. It removes a purely bureaucratic step in the merger, and might also be used in an attempt to squeeze out minority shareholders of the target corporation, which remain after a purchasing corporation has managed to acquire 90% of the voting shares in the target corporation through a tender offer.

On the other hand, to protect minority shareholders in the controlled corporation - if (i) the merger violates the law or the Articles of Incorporation, or (ii) if the terms of the merger in respect of the merger consideration are egregiously unreasonable, thereby threatening to have an adverse effect on the shareholders of the controlled corporation - then such shareholders may demand that the controlled corporation suspend the merger.

Simplified merger process

Another amendment to the law also concerns when shareholder approval of the merger agreement is required. Under the current law, shareholder approval from the surviving entity is not required if generally speaking, the number of shares issuable upon merger does not exceed 5% of the issued shares of the surviving entity. This is such as the scale of such a merger is not deemed to constitute a fundamental change of the surviving corporation.

This figure, however, will be raised to 20% when the new *Corporation Law* takes effect. It should be noted that, with the deregulation of the merger currency, this 20% threshold will need to be calculated based on the ratio of the merger consideration to the net assets of the surviving corporation. This amendment will help facilitate the merger process.

Defensive tactics

It has been widely stated in the media that the new *Corporation Law* will make defensive measures against hostile takeovers easier to adopt. However, there are no provisions in the new *Corporation Law* specifically put in place to make the adoption and use of such defensive measures easier. As a part of the substantive changes which provide Japanese corporations with greater flexibility, however, a number of changes and improvements have been made in the provisions regarding classes of shares and stock options. By using a combination of such provisions, it could become possible to design a new defensive scheme which would not be permissible under the current law.

For instance, with regard to golden shares under the new *Corporation Law*, a corporation could make the transfer of such shares, as opposed

to ordinary shares, subject to approval by the corporation. Under the current law, a corporation may impose such a restriction only if it is applicable to all classes of its shares, and not on a class by class basis, which is permissible under the new *Corporation Law*. This amendment to the allowable features in respect of classes of shares will make golden shares more workable.

With respect to poison pills using stock options, the new *Corporation Law* effectively permits stock options, in which the issuing corporation has the option to put. Poison pills using stock options may become more readily available as a result of this amendment.

It will be interesting to see how these amendments operate in practice - in conjunction with guidelines issued on May 27, 2005 jointly by the Ministry of Economy, Trade and Industry and the Ministry of Justice and the Tokyo High Court ruling on June 15 2005 to preliminarily suspend issuance of poison pills by Nireco - with respect to defensive tactics.

Conclusion

By loosening the strictures on merger currency as well as streamlining the merger process for short-form and minor mergers, the new *Corporation Law* should greatly facilitate M&As in Japan, while also making it easier for corporations to introduce defensive techniques against hostile takeovers. That being said, however, there are a number of issues in relation to the implementation of the new *Corporation Law* that cannot, as of yet, be answered. It would be advisable to watch for any developments which occur prior to the new *Corporation Law* taking effect in its entirety.

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About the firm

The Japanese law firms of Anderson Mori and Tomotsune & Kimura merged their law practices as of January 1 2005. The name of the merged firm is Anderson Mori & Tomotsune, with principal offices located in Izumi Garden Tower, 6-1, Roppongi 1-chome, Minato-ku, Tokyo 106-6036, Japan. The combination of practices enables Anderson Mori & Tomotsune to provide an even higher level of legal services in a broader number of practice areas, with enhanced capability to handle extremely large and complex transactions such as large M&A and finance projects, global securities offerings and other cross-border investment transactions.

The firm currently has approximately 180 Japanese attorneys (bengoshi). All attorneys at Anderson Mori & Tomotsune are fluent in English and almost all its partners and senior associates have obtained accreditation and training overseas in the US, the UK or Australia. In addition, the merged firm has over 10 foreign attorneys licensed to practice in common law jurisdictions, including one US attorney licensed as a Foreign Lawyer Qualified to Practice in Japan (Gaikokuho Jimu Bengoshi). The Tokyo office of Anderson Mori & Tomotsune also has the support of a Japanese patent attorney and a Chinese lawyer licensed to practice in China. The firm also provides services from its Beijing office, as a natural outgrowth of its commitment to serving domestic and foreign clients with respect to all aspects of business law in Asia, including clients with new and existing business in China.

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