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## **MEMORANDUM**

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### **PITFALLS IN JAPAN'S NEW TENDER OFFER REGIME**

This memorandum outlines in summary form certain pitfalls arising in connection with Japan's new tender offer regime, as implemented through the Amendment to the Securities and Exchange Law (the "Law") promulgated on June 14, 2006 and the subordinated regulations promulgated thereunder. These pitfalls, as explained in more detail below, arise due to the new regime's treatment of shares owned by entities deemed to constitute "specially related persons" vis-à-vis the tender offeror. If disregarded, they may result in such tender offeror unexpectedly finding itself legally required to purchase shares in excess of its planned target, up to 100% of the outstanding shares, and accordingly appropriate care in the tactical and strategic planning of tender offer transactions is vital.

A concrete example might arise in a contemplated readjustment of shareholdings between two major shareholders in a listed company, in which the combined holdings thereof (including the number of shares to be purchased by one from the other) exceed two-thirds of the voting rights of all outstanding shares, and in which such holders are party to a major shareholders agreement that includes a right of first refusal. One such holder may wish to acquire only a portion of the other's shares, with the remainder to remain subject to the right of first refusal in the future. In such case, however, the proposed purchaser may be forced to abandon the right of first refusal with respect to the unpurchased shares, or be forced instead, due to the seller's status as a "specially related person", to conduct a tender offer under which it will be legally required to purchase all tendered shares, up to 100% of the outstanding shares of the listed company.

(For the sake of simplicity in the discussion below, we assume that the target company in each example has only one class of voting common shares, which are listed.)

#### **I. Background**

As you may be aware, the Law (together with such amendment) shall be transformed into a new law called "Financial Instruments and Exchange Law", and the bulk of its provisions, together with the applicable subordinated regulations, are expected to come into effect in the latter part of 2007. Certain portions of the amended Law, however, together with applicable regulations, have already begun to come into effect. Among these, the portions of the amended Law and applicable regulations pertaining to tender offers came into effect in December 2006.

The new Japanese tender offer regime incorporates a variety of changes. Japanese tender offer rules have always required that a would-be purchaser of common shares whose shareholding in the event of success will exceed one-third of total outstanding common shares must make such purchase by means of a tender offer. This requirement remains unchanged. Previously, however, a purchaser by tender offer was entitled to determine the number of shares for which it would accept tenders, and, regardless of its

target number of shares, was under no obligation to purchase any more shares than the maximum number specified in its tender offer.

This aspect of the regime is significantly changed under Article 27-13, Paragraph 4 of the Law, which imposes a mandatory purchase obligation for all tendered shares if a specified threshold level is reached. Specifically, under the new regime, if an offeror initiates a tender offer for common shares that, if successful, will result in such offeror becoming the holder of two-thirds or more of all such common shares outstanding, the offeror will be required to accept tenders from all shareholders who choose to respond, up to the total number of outstanding common shares. This mandatory purchase obligation is triggered even if the two-thirds threshold is reached inadvertently due to the existence of one or more "specially related persons" and without intention to do so on the part of the offeror. The issue is made more complicated due to the somewhat generic definition of such persons under the Law.

## **II. Calculation Pitfalls**

The mandatory purchase obligation described in I. above generally is fairly straightforward from a tactical and strategic planning perspective. There are, however, certain pitfalls in the calculation method in respect of the two-thirds threshold that, if not taken into account, may cause a tender offeror inadvertently to reach such threshold. The seriousness of the consequences require that due care be paid to this issue.

Specifically, pursuant to the Article cited above and Article 27-2, Paragraph 7 of the Law, the holdings of so-called "specially related persons" are required to be added to those of the tender offeror in calculating such offeror's holdings in respect of the two-thirds threshold of the mandatory purchase obligation. The provision establishes two categories of specially related persons. The first such category includes, in the case of individuals, certain specified close family members, and in the case of corporations, defined affiliates thereof. In general, any entity that owns 20% or more of the tender offeror or is 20% or more owned by the tender offeror will constitute such an affiliate. Taking into account the holdings of this first category of specially related persons will usually be relatively straightforward, although in certain circumstances detailed knowledge regarding the number of shares owned by such affiliates may not be readily available.

The second category of specially related persons, however, is comprised of persons "specially related by agreement", and may be more complicated. This category is broken down into three subcategories, as follows:

(i) persons who agree to buy or sell shares of the same class as those targeted in the tender offer jointly with the tender offeror;

(ii) persons who agree to vote or otherwise exercise shareholder rights with respect to shares of such class jointly with such offeror; and

(iii) persons who agree to transfer to, or acquire from, the tender offeror shares of such class after the completion thereof.

Due to the broad possible interpretation of these subcategories, a variety of commonly-existing corporate control arrangements may cause parties thereto to fall within one or more of these subcategories, with the holdings thereof consequently being added to those of the tender offeror in the calculation of the two-thirds threshold. For example, it is common for the shareholders of enterprises that begin their existence as joint ventures to incorporate provisions into their joint venture agreements that may fall within the coverage of one or more of the above subcategories. Similarly, shareholders in enterprises having a limited number of shareholders, or a limited number of major shareholders, may commonly enter into major shareholders agreements, which may include provisions also falling within such coverage. Specific examples of provisions which may appear in such agreements, and which may fall within one or more of the above subcategories, include right of first refusal provisions, and so-called "drag along" and "tag along" provisions, among others. (Under a literal reading, the first is likely to fall within the coverage of subcategory (iii) above, while the latter two are likely to fall within the coverage of subcategory (i) above.) There may be an argument that a right of first refusal is a right of final resort and as such should not be deemed to comprise concerted action between the parties, but literal reading of the text of the Law may not allow such interpretation and a closer review of the right of first refusal provision would be imperative.

By way of example, consider the situation in which a holder of 40% of the outstanding common shares of a listed company wishes to acquire an additional 15% from a specific entity. It is well known that a tender offer is required, because the one-third minimum threshold for tender offers is already exceeded. So long as none of the shareholders of the company is a specially related person vis-à-vis the offeror, however, there is no risk that the two-thirds threshold of the mandatory purchase obligation will be exceeded. On the other hand, if the specific entity from which shares are sought is a 30% shareholder and is a party to a major shareholders agreement with the offeror that includes, e.g., a right of first refusal with respect to all the shares held by the other party, then calculation in respect of the two-thirds threshold will require that the offeror's initial 40% and the target 15% be added together, and that the 30% held by such specific entity must also be aggregated therewith, due to its status as a specially related person under the Law. The result is 85%, well in excess of the two-thirds threshold, and accordingly the offeror will be legally obligated to purchase all shares tendered in response to its offer, up to 100% of the outstanding shares, notwithstanding having made its tender offer for only 15%. To avoid this, the offeror may have to abandon the right of first refusal at a time when it does not wish to do so. A similar situation may occur in the case of an agreement under which a purchaser agrees to gradually acquire control from a current large shareholder or shareholders, rather than buying all shares at once, and in which certain voting agreements with such shareholder(s) are also included.

(We note a variation on the above, illustrated by the example in which a 10% holder of a listed company agrees to acquire an additional 30% interest therein from a specially related person who holds a 50% interest, and accordingly launches a tender offer. Calculation with respect to the two-thirds threshold by means of simple aggregation will require that the purchaser's initial 10% be added to its target 30% and that the 50% interest of the specially related person then be added to this, producing a result of 90%, well in

excess of the two-thirds threshold. However, an argument can be made that following addition of the purchaser's initial 10% and its target 30%, only a 20% interest should be added in respect of the holding of the specially related person, to avoid double counting of the 30% which such person has already agreed to sell to the purchaser. If this argument is accepted, then the result is only 60%, which is below the two-thirds threshold. A counterargument exists, however, to the effect that other shareholders may elect to participate in the tender, and accordingly the specially related person is not assured of selling the 30% as to which it has agreed with the purchaser. Accordingly, since the interest to be purchased from the specially related person cannot be known prior to completion of the tender, the only viable alternative in calculating the two-thirds threshold at the time when the tender is initiated is to include the entire holding of such specially related person. If this counterargument prevails, then in this example, even agreement that the 50% holder will tender only a 30% interest will not save the offeror from exceeding such threshold.)

### **III. Appropriate Precautions**

The above complication is due to the somewhat broad definition of specially related persons, which may inadvertently cover transaction that ought not to be considered genuinely problematic. The mandatory purchase obligation, however, is imposed regardless of the intention of the parties, and accordingly special care must be taken.

In light of the above, we strongly advise that tactical and strategic preparation for any tender offer for common shares in Japan include comprehensive due diligence as to the possible existence of agreements between the prospective tender offeror and (other) shareholders that might result in specially related person status for the latter. Such due diligence should include both the corporate documents of the target company and any agreements entered into between the tender offeror and (other) shareholders of such target.

In the event that arrangements are identified that might have the effect of creating specially related person status, such arrangements must either be terminated prior to commencement of the contemplated tender offer, or the holdings of all specially related persons must be taken into account in determining whether or not the two-thirds threshold for the mandatory purchase obligation is exceeded, with target percentages adjusted as and if appropriate.

Please note that this memorandum is not intended to provide a comprehensive analysis of the tender offer regime established under the Law, but rather to call your attention to certain specific pitfalls thereunder. In the event that we can provide advice in further detail with respect to these or related matters, please do not hesitate to contact us.

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