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NEW METHOD TO SQUEEZE-OUT MINORITY SHAREHOLDERS IN JAPAN – A TWIST ON AN EARLIER APPROACH

Acquirors in Japan now have greater assurance that they will be able to purchase all of the outstanding shares of a target company, which could lead to a boom in Japan M&A. Effective July 9, 2018, Japan's Industrial Competitiveness Enhancement Act improves upon a prior amendment to Japanese corporate law to now allow a shareholder (or a group forming a consortium) owning as little as 66 2/3% of the outstanding voting rights in a target company to implement a mandatory cash squeeze-out of the minority shareholders (the "Enhanced Squeeze-Out Amendments"). Previously, an acquiror needed to (i) own at least 90% of the outstanding voting rights in a target company to squeeze-out minority shareholders, or (ii) orchestrate a recapitalization at the target company level to render the minority shareholders with only fractional share ownership (which fractional shares then would be cashed out by the acquiror). The prior squeeze-out methods applied against all minority shareholders of a target company, which placed an acquiror teaming with other shareholders in an awkward position of having to eliminate the ownership of its consortium members.

The Enhanced Squeeze-Out Amendments provide a welcome new solution to enable a controlling shareholder to squeeze-out minority shareholders and preserve the target company shares owned by consortium members. However, the numerous procedural requirements and minority shareholder protection provisions afforded under the Enhanced Squeeze-Out Amendments may discourage its wide-scale adoption.

The Enhanced Squeeze-Out Amendments – The Benefits

The Enhanced Squeeze-Out Amendments essentially provide a new twist to a prior amendment to Japanese corporate law. The July 2014 edition of the *Corporate Counselor* (available [here](#)) explained a new squeeze-out approach under which a shareholder owning 90% or more of the total voting rights in a target company would receive by operation of law a conditional call option over all of the outstanding shares and derivative equity securities of the target company, so long as certain procedures were followed.

The Enhanced Squeeze-Out Amendments also provide for the issuance of a conditional call option to an acquiror with comparable benefits and adherence to similar procedures, except:

- the acquiror needs to own only 66 2/3% of the total voting rights in the target company in order to receive the conditional call option (as opposed to 90%);
- the 66 2/3% ownership threshold can be satisfied by including target company shares owned by the acquiror and shares owned by other shareholders who team with the acquiror to form a consortium to purchase the target company (and there is no limit on the number of shareholders who can join the consortium for purposes of such share aggregation); and
- the consortium members will not have their target company shares (and those of a wholly-owned subsidiary) automatically cashed out upon the exercise of the conditional call option, which is particularly helpful as it can avoid a consortium member from most likely recognizing an immediate gain arising from the forced disposition of its target company shares.

However, with the easing of the prior restrictions on squeezing-out minority shareholders under the Enhanced Squeeze-Out Amendments also comes additional requirements that must be satisfied, presumably to ensure that an acquiror will not take economic advantage of the minority shareholders.

The Enhanced Squeeze-Out Amendments – The Hurdles

The Enhanced Squeeze-Out Amendments can be utilized only if the following conditions are satisfied, which could prove burdensome to an acquiror:

Target Company Must Be An Affiliated Business Entity.

In addition to meeting the 66 2/3% ownership threshold, a single acquiror (and not the consortium as a whole) also must own 50% or more of the total issued shares in the target company before the exercise of the conditional call option (total issued shares can be different from voting rights if one share does not equal one vote). For example, a consortium consisting of five members each owning 15% of the total issued shares in the target company would not satisfy the ownership requirement under the Enhanced Squeeze-Out Amendments. While it is technically possible to utilize the Enhanced Squeeze-Out Amendments if an acquiror owns as little as 20% of the total issued shares in the target company, under such scenario the acquiror also is required to appoint 50% or more of the officers of the target company (presumably through a secondment arrangement), which could be difficult to achieve if the target company has a deep management bench.



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Practice Point

- **Condition to Tender Offer Permissible.** An acquiror can launch a first step tender offer and condition the acceptance of its tender offer on satisfying the requirements under the Enhanced Squeeze-Out Amendments.

Acquiror Must Have an Approved Business Restructuring Plan. Before the exercise of the conditional call option, the applicable ministry must approve the acquiror's business restructuring plan demonstrating that as a result of the squeeze out, the acquiror's business will improve from both a financial and business innovation perspective over the ensuing three years (or five years if the acquiror seeks to borrow a large amount of long-term debt for capital expenditures from Development Bank of Japan). Japan's Ministry of Economy, Trade and Industry should be consulted in the first instance to determine which ministry will oversee and consider the acquiror's business restructuring plan. If the acquiror intends to form a consortium (in order to satisfy the 66 2/3% ownership threshold and/or to avoid having consortium members automatically cashed out upon the exercise of the conditional call option), then the acquiror and the consortium members must jointly apply for the approval of the business restructuring plan. It is conceivable that the Ministry of Economy, Trade and Industry may deem itself the appropriate authority, as it is the ministry that sponsored the Enhanced Squeeze-Out Amendments. The business restructuring plan must follow a prescribed format with various key performance indicators enumerated to serve as benchmarks whether the acquiror's business has improved. The acquiror also must endeavor to maintain employment levels.

Practice Points

- **Financially strong target companies are also eligible.** Despite the requirement to prepare a so-called business restructuring plan, the Enhanced Squeeze-Out Amendments are not limited to target companies experiencing financial difficulties. The Enhanced Squeeze-Out Amendments can apply to practically any company so long as the acquiror intends to grow the applicable business.
- **Time and expense.** The acquiror should submit its business restructuring plan in draft form to the applicable ministry for its review and comment before formal submission. An acquiror does not need to own any shares in the target company before its submission of the business restructuring plan, which could be helpful for an acquiror to gauge the likelihood of satisfying the Enhanced Squeeze-Out Amendments (although an early submission also could

jeopardize the confidentiality of the takeover leading to an increase in the target company's share price). The consultation process with the ministry should take approximately two months, with an estimated additional one month thereafter for the issuance of the formal acceptance by the ministry. There is no charge to submit the business restructuring plan to the applicable ministry for its review.

- **Unclear status of individual shareholder as the acquiror or consortium member.** The business restructuring plan should be prepared by an entity that operates its own business. Therefore, it is not clear whether an individual who owns target company shares but does not operate his/her own business separate from the target company (such as management of the target company) can apply for the approval of the business restructuring plan so that he/she can exercise the conditional call option as an acquiror or avoid having his/her shares automatically cashed out upon the exercise of the conditional call option as a member of the consortium. Since the target company management could be large shareholders, counsel should be consulted to consider the proper composition of the consortium.
- **Publication requirement.** The approved business restructuring plan must be posted in a prescribed format on a publicly available website; however, business secrets can be excluded (as agreed on a case-by-case basis with the applicable ministry).
- **Annual updates.** The acquiror is required to update the applicable ministry each year on whether the milestones set under the business restructuring plan are progressing according to schedule.
- **No immediate penalty for failure to achieve business plan targets.** If the targets stipulated in the business restructuring plan are not achieved, the acquiror will not be required to unwind the acquisition or pay a penalty. It is conceivable, however, that the applicable ministry may seek an explanation from the acquiror concerning why the targets were not fully achieved. Also, an acquiror that repeatedly fails to achieve business restructuring plan targets could tarnish its business reputation and face greater scrutiny from ministries in the future when seeking approval for another business restructuring plan (if not being outright banned).

Acquiror Must Provide the Applicable Ministry with a Report on the Adequacy of the Cash-Out Consideration. In connection with its submission of the business restructuring plan, the acquiror also is required to provide the applicable ministry with a report indicating that the consideration offered to the minority shareholders to cash-

out their shares is fair from a financial point of view. Although not specifically stated in the Enhanced Squeeze-Out Amendments, such report most likely should be derived from a valuation report or a fairness opinion delivered by an independent third party expert (but the actual third-party report or opinion does not need to be directly provided or addressed to the applicable ministry). The applicable ministry does not examine deeply to reach its own conclusion whether the squeeze-out consideration is adequate or not.

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As the Enhanced Squeeze-Out Amendments have been effective for only a few months, it is too early to tell whether the requirement to formulate a publicly available business restructuring plan will dissuade acquirors from utilizing this new squeeze-out method. Given the fact that the Enhanced Squeeze-Out Amendments were sponsored by the pro-business Ministry of Economy, Trade and Industry under legislation captioned to enhance Japan's "industrial competitiveness," it is conceivable that consolidations in industries that the Japanese government seeks to promote will receive fast-track and smooth ministry clearance.

Practice Points

Incentive for minority shareholders to exercise appraisal rights. The Enhanced Squeeze-Out Amendments do not take into account the frequent Japanese practice in friendly transactions for an acquiror to enter into a take-private acquisition agreement with the target company prior to launching the first-step tender offer, which agreement typically stipulates the proposed consideration to be offered to minority shareholders in the second-step squeeze-out transaction (and in particular, the exercise price for the conditional call option if the Enhanced Squeeze-Out Amendments are used). By agreeing upfront the consideration to be offered in the second-step squeeze-out transaction, it is not clear whether the consideration to be offered to the minority shareholders could ever be set at an amount lower than the first-step tender offer price. Accordingly, with the tender offer price often serving as a floor to the squeeze-out price and the acquiror making publicly available in close time proximity a business restructuring plan pursuant to which it commits to improve the financial performance of its business over the near to medium term with respect to enumerated key performance indicators, the Enhanced Squeeze-Out Amendments could create an incentive for target company minority shareholder to exercise their appraisal rights to seek a portion of the incremental value the acquiror expects to receive as a result of taking the target company private.

Business restructuring plan can be approved prior to launch of tender offer. To provide equal disclosure of the business restructuring plan, an acquiror can seek to have its plan approved by the applicable ministry and announced prior to the launch of the first-step tender offer. While this sequence could reduce the incentive for minority shareholders not to participate in the first-step tender offer and seek appraisal rights, it also may lead to an increase in the first step tender offer price in light of the information disclosed in the business restructuring plan.