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An introduction to Japan's recent guidelines for MBOs and controlling shareholder acquisitions

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On 28 June 2019, as part of the continuing push to reform corporate governance under the Abe administration, Japan's Ministry of Economy, Trade and Industry (**METI**) introduced the new "Guidelines for Fair M&A – Enhancing Corporate Value and Securing Shareholders' Interests" (the **Guidelines**). The Guidelines are intended to address past abuses in (i) management buyouts (**MBOs**) of listed companies, whereby the existing management will purchase shares from public shareholders and remain invested in all or part of the capital of the target company going forward, and (ii) acquisitions by a controlling shareholder of all of the shares held by public shareholders in a controlled subsidiary.[1]

Since the introduction of the Guidelines, Japan has seen a number of high profile deals involving management or controlling shareholders, including the recent takeover efforts relating to Unizo, the merger of Yahoo Japan and Line, and most recently Maeda Corp's tender offer for Maeda Road Construction, making the Guidelines more relevant than ever for participants in the Japan public M&A market. This comes at a time of great change for the Japan market, which is experiencing historically unprecedented levels of shareholder activism and hostile takeovers. We set out below a brief summary of the Guidelines, with the aim of helping our international clients navigate these developing trends.

Introduction

The Guidelines set forth certain exemplary procedures (the **Fairness Ensuring Measures**) that are aimed at ensuring the legitimate interests of public shareholders.[2] The Guidelines are only "soft" law in that they do not have any legal enforceability.[3] However, the directors of a Japanese corporation owe a duty of care of a prudent manager and a duty of loyalty to the corporation, and the Guidelines indicate that where the Fairness Ensuring Measures are effectively implemented, there is a high probability that a court would respect the agreed terms and conditions as achieving a "fair price" for purposes of the Companies Act[4] and that the directors should not be in

[1] "**Controlling shareholder**" is defined by reference to the Securities Listing Regulations of the Tokyo Stock Exchange, where it is defined to mean, generally, (i) a parent company (which could include a shareholder holding less than a majority of the voting rights in a company) or (ii) a person who holds, directly or indirectly, the majority of the voting rights in a company. (Guidelines, fn. 4).

[2] Guidelines, §2.2.2.

[3] *See* Guidelines, §1.3.

[4] Under the Japanese Companies Act, shareholders dissenting to a corporate reorganization (such as various mergers under Japanese law) may be entitled to exercise appraisal rights and demand that their shares be purchased at a "fair price." (Guidelines, fn. 16).

breach of their duty of care and duty of loyalty.[5]

Therefore, in addition to buyers looking to establish that they have paid a "fair price" for the shares, it could be anticipated that the boards of directors of Japanese targets facing an MBO or a controlling shareholder acquisition will be pressured to adopt the Fairness Ensuring Measures in order to meet their fiduciary duty requirements and avoid a lawsuit alleging personal liability.

The Fairness Ensuring Measures

The Guidelines recognize that the implementation of the Fairness Ensuring Measures is not a prerequisite to realizing fair terms and conditions, and that not all of the Fairness Ensuring Measures must be implemented to ensure fair terms and conditions.[6] Furthermore, the Guidelines envision that various combinations of the Fairness Ensuring Measures could be adopted in diverse situations,[7] and that the focus should be the effective functioning of the Fairness Ensuring Measures rather than the number of formal procedures put in place.[8] As such, parties should seek to tailor the Fairness Ensuring Measures to the individual circumstances of a transaction.

However, it should be noted that the Guidelines place a particular emphasis on the formation of a Special Committee (as defined below) among the Fairness Ensuring Measures.[9]

The Fairness Ensuring Measures set out in the Guidelines as a model are as follows:

Independent special committee

The Guidelines recommend the formation of a special committee of independent persons (the **Special Committee**) to evaluate the terms and conditions of a transaction and the fairness of the procedures for such transaction from the perspective of the enhancement of corporate value and the interests of the public shareholders.[10]

The members of the Special Committee should be independent from the buyer and independent from the transaction in question (i.e. members should not have a significant interest in the success or failure of the transaction).[11] It is recommended that the members be composed of (i) outside directors, (ii) outside auditors or (iii) outside experts, and it is preferred that the members be composed of outside directors in light of the fact that they were elected by the shareholders and owe fiduciary duties to the company[12] under the law, as well as having knowledge about the business of the target.[13] In particular, it is recommended that the chair of the Special Committee be an outside director.

[5] Guidelines, fn.1. Where directors of a Japanese corporation violate their fiduciary duties to the company, its shareholders would be entitled to bring a lawsuit against such directors both (i) for damages in an individual capacity and (ii) as a representative action on behalf of the company, after following necessary procedures under the Companies Act.

[6] Guidelines, §3.1.1.

[7] Guidelines, §3.1.2.

[8] Guidelines, §3.1.3.

[9] Guidelines, §3.2.3.

[10] The Guidelines indicate that one of the factors that should be examined is the contents of share valuation, including the reasonableness of the financial forecasts and assumptions. According to the Guidelines, if a discounted cash flow (**DCF**) valuation is used, it is necessary to review the reasonableness of the business plan, its preparation history and the rationale for the discount rate and if a comparable company valuation is used, the rationale for the selection of comparable companies. (Guidelines, §3.2.2; Guidelines, fn. 29).

[11] In particular, with respect to independence from the buyer in a controlling shareholder acquisition, given of the requirements for an outside director under Art. 2, item 15 of the Companies Act, a requirement that a person is not, and has not been for past 10 years, an officer in the controlling company should be considered. Furthermore, the following factor from the Tokyo Stock Exchange should be considered: whether an outside director or outside auditor has a special relationship with the buyer, for instance where one of their main clients is the buyer or they receive a large amount of fees from the buyer. (Guidelines, §3.2.4.2.A).

[12] The Guidelines note that, ordinarily, a member of the Special Committee, including an outside director, who follows the Guidelines in accordance with their duty of care should not be subject to liability. (Guidelines, fn. 26).

[13] Guidelines, §3.2.4.2.B.a.

While outside auditors, unlike outside directors, are not originally expected to be directly involved in the management decisions of a company, they are also recommended given that they were elected by the shareholders and owe fiduciary duties to the company. Outside experts could be selected as members of the Special Committee, but given that they are not elected by the shareholders and that their responsibilities to the company are unclear, it is recommended that any such outside experts should contractually assume a duty of care to the company.[14]

The Special Committee should be formed as soon as possible after receiving a takeover proposal evidencing an objectively concrete, feasible and sincere takeover intent.[15] The Special Committee should be substantially involved in negotiations between the target and the buyer, for example it should be determined in advance that the board of directors will not approve a transaction if the Special Committee finds that the terms and conditions of the transaction are not appropriate, and the Special Committee should be empowered to directly negotiate such terms and conditions or have sufficient oversight of the project team.[16] The Special Committee should be authorized to obtain its own advisors, although the Special Committee could use the advisors hired by the board of directors if they have a high level of expertise and it is determined that there is no problem with their independence.[17] The Special Committee should be given sufficient information to make its decision and members should be given appropriate remuneration.[18]

In principle, a board of directors that follows the decision of a Special Committee that has been properly established and functions effectively should have satisfied their duty of explanation.[19] Generally, if all disinterested directors have approved a transaction and none of the auditors have any objection, it should be seen as a sign that the Fairness Ensuring Measures have functioned effectively. However, if there are any dissenting directors or auditors, it would be important to make the identity and the reasoning of the dissenting persons clear to the shareholders, in addition to recording them in the minutes of the board meeting.[20]

Independent expert advisors

In relation to the Fairness Ensuring Measures and the fairness of the terms and conditions of the transaction, the target company should retain outside advisors. In particular:

1. **Legal advisors**: Legal advisors should be independent and advise the target regarding the establishment of the Fairness Ensuring Measures, including the establishment and selection of the Special Committee, determining the directors with special interests who should be excluded from the evaluation and negotiation process, and determining the independence of financial advisors and third party valuation advisors.[21]

[14] Guidelines, fn. 39.

[15] Guidelines, §3.2.4.1; Guidelines, fn. 33.

[16] Guidelines, §3.2.4.4.

[17] Guidelines, §3.2.4.5.

[18] Guidelines, §3.2.4.6; Guidelines, §3.2.4.7.

[19] Guidelines, §3.2.5. The Guidelines further provide that, while the Companies Act provides that "Directors with a Special Interest" are not allowed to vote on such matters where they possess a conflict, the involvement of not only "Directors with a Special Interest", but also other persons with an interest in the evaluation and negotiation should also be avoided as much as possible. However, if there is an effectively functioning Special Committee, it may not be necessary to exclude all persons who have previously been directors and officers of the buyer, and it may be sufficient to exclude only those persons who are currently serving as directors and officers of the buyer. Guidelines, §3.2.6.

[20] Guidelines, fn. 46.

[21] Guidelines, §3.3.1. Legal advisors whose practice has a high degree of dependence on the buyer may not be independent. Guidelines, fn. 50.

2. **Stock valuation report and/or fairness opinion**: It is desirable to obtain a stock valuation report and/or fairness opinion from an independent third party valuation advisor. The fairness opinion is a document whereby such advisor would state that the terms and conditions of the transaction are fair to the public shareholders of the target from a financial point of view.[22] The effectiveness of the fairness opinion is underpinned by the credibility of the third party valuation advisor. Therefore, the third party valuation advisor should (i) be independent and neutral, (ii) have a rigorous process for the issuance of the opinion, (iii) have advanced expertise and performance and (iv) have a positive reputation.[23] Where the third party valuation advisor has a material interest in the success or failure of the transaction, this should be disclosed to the public shareholders to enable them to make an appropriate judgment on their independence.[24]

Market check

A market check is achieved by ensuring the opportunity for other potential bidders to make a competing offer, and could be conducted "actively," whereby the target investigates and evaluates whether there are any other potential bidders, or "passively," whereby the transaction is executed in a manner that allows for competing offers to emerge.

An active market check includes auction processes prior to agreeing to or announcing a particular transaction, or active solicitation for a period of time after the initial agreement or announcement.[25] In the case of an active market check, reasonable deal protection clauses may be appropriate.[26] For a passive market check, contact with other potential bidders should not be unreasonably restricted (for instance, prohibiting the target from communicating with any competing bidder), but a reasonable breakup fee may be deemed appropriate.[27]

If there is a concrete, feasible and serious competing offer (which should be determined by the Special Committee),[28] such offer should be seriously examined and may not be arbitrarily refused. Generally, it is envisioned that an offer that provides the most consideration to the public shareholders should be the offer that most enhances corporate value, but if the board of directors and the Special Committee determine that, as an exception, a different offer most enhances corporate value, they should fully satisfy their duty of explanation with respect to the reasonableness of their judgments.[29]

[22] The board of directors and the Special Committee should evaluate the fairness of the terms and conditions of a transaction while taking into account not only the results of the valuation, but also the feasibility of the business plan, characteristic of the calculation method used, the level of premium in similar M&A transactions, the value that can be realized without the M&A transaction, the expected impact of the M&A in enhancing corporate value, and the presence or absence of alternative transactions. (Guidelines, §3.3.2.1.B.).

[23] Guidelines, §3.3.2.2.B. There are no special rules or regulations in Japan governing the issuance of fairness opinions, and it is unclear whether there is sufficient legal responsibility for the issuance of an inappropriate fairness opinion. Furthermore, the issuance of fairness opinions has not been common practice in Japan. As such, the fairness opinion can be considered to be guaranteed in part by the reputational risk assumed by the third party valuation advisor and therefore reputation can be considered an important factor. (Guidelines, fn. 56; Guidelines, fn. 58).

[24] Guidelines, §3.3.2.3. Where the third party valuation advisor is lending funds to the acquisition or otherwise lends funds to the buyer, it could have a conflict and the seriousness of such conflict could depend on multiple factors such as the importance of the loans to the third party valuation advisor, the role that it play in the syndication of the loans, etc. (Guidelines, fn. 59).

[25] Guidelines, fn. 61.

[26] Guidelines, fn. 61.

[27] Guidelines, fn. 63.

[28] Guidelines, fn. 67.

[29] Guidelines, §3.4.4.

A market check will generally not be effective for a controlling shareholder acquisition, absent special circumstances, since a third party making a competing offer must obtain the shares from the controlling shareholder as well.[30]

Majority-of-minority condition

A majority-of-minority condition means that the majority of the shares held by the public shareholders, who do not share a significant interest with the buyer, have approved the transaction.[31] For instance, a majority-of-minority condition could be set by, in a two-tier takeover, setting a certain number as the tender offer threshold in the first stage of the takeover bid, or, in a one-tier takeover, setting a condition for the cancellation of the effectiveness of the reorganization agreement if a certain number of votes are not obtained at the shareholders' meeting.[32] Although the majority-of-minority condition is deemed to be highly effective in securing the fairness of the terms and conditions of a transaction, it may not be appropriate in all circumstances due to concerns about inhibiting M&A, for example where the controlling shareholder already owns a large percentage of the target company.[33]

Information disclosure and enhanced transparency

In order for the shareholders to make an informed judgment about the merits of a transaction, it is recommended that the following information be disclosed (in addition to information already required to be disclosed under applicable rules and regulations):

1. **Information on Special Committees**: (i) independence and qualifications; (ii) scope of authority granted to the Special Committee; (iii) chronology of the Special Committee's deliberations and its involvement in negotiating with the buyer; (iv) the rationale and basis for the Special Committee's decision including appropriateness of the transaction, reasonableness of the transaction terms and fairness of procedures, and the contents of the Special Committee's report; and (v) the remuneration of members.[34]

2. **Information about the stock valuation report and fairness opinion**: (i) information regarding the valuation process based on specific valuation methodologies (including for DFC valuation, the forecast of free cash flows and whether they assume the implementation of the transaction, the chronology of the preparation of the financial forecasts, the type of and basis for the discount rate and perspectives on the period used for free cash flow forecast and terminal value);[35] (ii) information about the fairness opinion; and (iii) information on the significant interests of the third party valuation advisor.[36]

[30] Guidelines, §3.4.3.2.

[31] In this regard, under the current practice of tender offer bids in Japan, shareholders who have entered into an agreement to tender their shares to the buyer are generally excluded from the minority. However, shareholders who have entered into an agreement to tender their shares to the buyer may or may not share a significant interest with the buyer, and where they do not share such interests, reaching an agreement to tender the shares after serious negotiations with the shareholders who have an interest as sellers in the transactions may in fact support the fairness of the transaction terms. (Guidelines, fn. 71).

[32] Guidelines, fn. 72.

[33] Guidelines, §3.5.2. For instance, in such case a small number of shareholders may be able to block a transaction that would otherwise enhance corporate value. (Guidelines, fn. 74).

[34] Guidelines, §3.6.2.1.

[35] Such details are required to be disclosed under applicable Tokyo Stock Exchange rules for a cash tender, but not for a transaction where the consideration is in shares, and certain commentators indicated that this requirement could discourage such stock transactions. The Guidelines indicate that if any of this information will not be voluntarily disclosed, the Special Committee should specifically consider the reasonableness of the reasons for, and the extent of, not disclosing such information as well as the appropriateness of the value of the shares, and disclose the results of such deliberation. (Guidelines, fn. 81).

[36] Guidelines, §3.6.2.2.

3. **Other information**: (i) the process leading to the implementation of the transaction; (ii) the background and purpose for deciding to carry out the transaction; (iii) the specific details of interests held by the directors of the target in relation to the transaction; (iv) the details of discussions and negotiations with buyer; (v) whether alternative acquisition methods or competing proposals were considered; and (vi) the names and reasons of any directors and auditors opposing the transaction.[37]

Elimination of coercion

Finally, to eliminate coercion of public shareholders, it is recommended that (i) parties refrain from adopting a scheme to remove dissenting shareholders' appraisal rights or their rights to otherwise petition the court to determine the price of the shares and (ii) where a majority of the shares are acquired in a tender offer, the minority shareholders be squeezed out as soon as possible.[38]

[37] Guidelines, §3.6.2.3.

[38] Guidelines, §3.7.

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