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MERGERS AND ACQUISITIONS | NOVEMBER, 2009

Takeover Bids under Japanese Law: Basic and Practical Considerations (Part 1 of 2)

This article was first published in the *M&A Review, November 2009, Vol.23, No.6.*

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1. Introduction

We had an opportunity to address the legal issues involved in the "squeeze out" of minority shareholders in the March 2009 issue of this journal and that article has received quite a few responses from readers. Therefore, in order to answer some of the questions raised by those responses, we are going to comment from a business practice oriented point of view, in two articles on certain basic and important issues relating to a tender offer (TOB), a preliminary step for a squeeze out.

Due to the introduction of a mandatory tender offer system pursuant to the amendment of the Securities Transaction Act (now the Financial Instruments and Exchange Act) in 1990, when a legal entity attempts an acquisition, in most cases it is inevitable that a tender offer will be launched. Accordingly, sufficient knowledge regarding tender offers is indispensable for those who are to be involved in the business practice of mergers and acquisitions.

Because mergers recently occur with various objectives in different ways, such as friendly acquisitions intended to enhance synergies by way of business combination, hostile mergers undertaken without obtaining the consent of management of the target company, and management buyouts aimed at reducing administrative costs associated with minority shareholders or settlement of conflicts of interest between the majority shareholders and minority shareholders, a variety of issues arise in relation to the practice of tender offers. In addition, because of frequent changes of law, particularly an amendment in 2008, the legislation regulating tender offers has itself been undergoing a remarkable change. These changes in the environment surrounding tender offers have made tender offer related practice quite complicated and technical and, therefore, it has become fairly difficult to quickly and precisely understand the whole system of tender offer practice and relevant important issues.

Based on the above, in order to assist the readers' understanding of the tender offer process, we will try to set forth guidelines for certain issues that are often essential in tender offer practice and, to the extent necessary to understand such guidelines, in this article we will briefly but systematically illustrate the basic legal system governing tender offers (including the scope of regulation of tender offers, requirements for the tender offer procedure and related legal entities) reflecting recent amendments to the relevant laws. In this article (Part 1), we will mainly comment on the scope of mandatory tender offers and in the next article (Part 2) we will explain the procedures and schedule for a tender offer.

As you may know, a tender offer can be made by legal entities other than the existing issuers (Articles 27-2 to 27-22 of the Financial Instruments and Exchange Law ("FIEL")) and, also, by the issuers themselves (Articles 27-22-2 to 27-22-4 of FIEL). In these articles, we will deal with tender offers made by entities other than the issuers and will not comment tender offers made by the issuers themselves.

In these articles, in order for the readers to specifically consider certain important issues in the practice relating to the schedule for a tender offer that will be covered in the next article (Part 2), we will begin our explanation using the following fictional case, which is based on our experience in the practice of tender offers.

[Case]

A stock corporation P (Company P) started negotiation on the transfer of shares of a listed company T (Company T) in the middle of April with A (Company A), which owns Company T's shares (60% of the voting stock), and felt that Company A was in a forward-looking attitude. Each of Company T's fiscal year end and the record date for voting rights in the annual shareholders meeting is March 31. During negotiations, Company A described its desire to sell all of Company T's shares that it owns as soon as possible and, at the latest, before the annual shareholders meeting of Company T. Company P basically understood Company A's desire.

2. Result of Violation of Regulations on Tender Offers

[Issue in Practice 1]

When a tender offer is mandatory, the tender offeror is required to disclose the tender offer period, number of share certificates to be purchased, price of shares and other relevant facts. If the tender offeror fails to disclose such items or makes a false disclosure, such a tender offeror may not only be subject to both serious criminal liability (up to 10 years' imprisonment), but also may be ordered to pay a civil penalty.

2-1 Recent Case of Violation

It was reported in the news media that the Securities and Exchange Surveillance Commission issued a recommendation to the Financial Services Agency ("FSA") on October 16, 2009 that a capital firm established in the British Virgin Islands, which was alleged to have purchased a large quantity of certain equity warrants of a company listed on JASDAQ through off-market trading at the price of \30,000,000 without giving a public notice for commencing a tender offer, be subject to a civil penalty of \7,500,000 on a charge of violation of the FIEL (failing to give a public notice for commencing a tender offer). Although we are not able to verify the details of the facts of the case, it seems likely that the parties involved in the above case did not know the scope of the regulations on tender offers. However, as we explain later, with respect to civil penalties, whether the parties involved are aware of the relevant violation (the intent of the parties) is not relevant and insufficient knowledge will not be excused. Here, before we begin the explanation of what a tender offer is, we will outline the sanctions for violation of the regulations on tender offers.

2-2 Result of Violation of Regulations on Tender Offers

First, if a person or entity submits a tender offer notification with false statements of important matters or fails to submit a tender offer notification, as seen in the recent case described above, such person or entity that is in breach of the regulations on mandatory tender offers may be subject to criminal punishment (Article 197 etc. of FIEL)[1]. In other words, such an act could be considered a crime.

[1] Criminal penalties for violation of regulations on tender offers are divided into four types responding to the type of violation. The most serious penalty, where a false statement is made in respect of important matters in a public notice for commencing a tender offer, in a tender offer notification, etc., is (i) for a person who is in violation, ten years or less imprisonment, a fine of 10 million yen or less, or both (Article 197(1) of FIEL) and (ii) for a legal entity where such person is employed, a fine of 700 million yen or less as a dual liability(Article 207(1)(i)). The second serious penalty is, (i) for a person, 5 years or less imprisonment, a fine of 5 million yen or less, or both and (ii) for a legal entity, a fine of 500 million yen or less as a dual liability.

In addition, certain conduct that is in violation of the regulations on the tender offers, such as making a false statement in a tender offer notification, will be subject to a civil penalty (Article 172-5 and 172-6 of FIEL).[2] With respect to such civil penalty, because (i) as discussed above, whether the relevant personnel is aware of his or her violation or not does not affect implementation of the sanction and (ii) the text of the law provides that "the Prime Minister (FSA) shall order Issuer to pay -- an administrative monetary penalty", FSA's interpretation is that the administrative agency does not have discretion in rendering its orders to pay an administrative monetary penalty.[3] Thus it should be noted that, according to the above FSA's interpretation, payment of an administrative monetary civil penalty would be automatically ordered regardless of whether the relevant personnel is aware of his or her violation.

Iaddition, as civil liability, a person who is in violation of the regulation on tender offer may be liable compensation for damages sustained by a person who sells the share certificates, etc. in response to the tender offer (Article 27-16 to 20 of FIEL).

3. Definition of Tender Offer and Scope of Regulation of Tender Offer

[Issue in Practice 2]

The object of the tender offer, "Share Certificates, etc.", includes not only share certificates but also share options, bonds with share options and investment securities such as those related to J-REITs.

[Issue in Practice 3]

It is understood that the "Purchase, etc." which requires a tender offer does not include the issuance of additional shares and, accordingly, a third party allotment involving the issuance of additional shares would not subject to the regulations on tender offers. However, due to the amendment of the Securities Listing Regulations, etc. of the Tokyo Stock Exchange enacted in August 2009, it should be noted that (i) when a company plans to perform a third party allotment of shares in which (a) the number of shares to be issued would be equal to more than 25% of the number of issued and outstanding shares, or (b) a change of a controlling shareholder is expected, either of the following procedures is required: (x) receipt of the opinion of a person, who has a certain degree of independence from management, regarding the necessity and suitability of such allotment, or (y) confirmation of the intent of the shareholders on such allotment, i.e., a resolution in the shareholders' meeting regarding such allotment, and (ii) a company will be, in principle, delisted if the number of share to be issued in a third party allotment is more than 300% of the number of issued and outstanding shares.

3-1 Definition of Tender Offer and Scope of Regulation of Tender Offer

A tender offer means "an act of soliciting offers for purchase, etc. or sales, etc. of share certificates, etc. from many and unspecified persons through public notice and making purchases, etc. of share certificates, etc. outside of the financial instrument exchange market." (Article 27-2(6) of FIEL) The purpose of regulation of tender offer under FIEL is, as described below, to contribute to "protection of investors" (Article 1 of FIEL) by requiring tender offer procedures for certain purchases, etc. of securities, in which a purchaser is to disclose the period, number and price, etc. of the subject securities, and providing equal opportunity to sell share certificates, etc. to investors. According to the text of Article 27-2(1), in principle, the following purchases "shall be made by means of a tender offer":

(a) of "shares, etc." issued by a certain type of issuers (an object)

(b) by "a person other than the issuer" (a subject)

(c) "purchase, etc." (an action)

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[2] The amount of the civil penalty imposed on conduct which is in violation of regulations on tender offers is 25% of the aggregate purchase price of the shares. (Article 172-5 and 172-6 of FIEL)

[3] "The Report of the Legislation Working Group – on civil penalty system" as of December 18, 2007 by the first committee of the financial system council, Page 19

(d) which falls under any of the categories listed in (i) to (vi) of Article 27-2(1)

The "shares, etc." in (a) means "Shares, bonds with share options and other securities[4] designated by cabinet order." (Article 27-2(1)) As a "cabinet order", Article 6(1) of the relevant enforcement order includes bond with share options and investment securities (including investment securities based on a J-REIT) in addition to shares and bonds with a share option. The certain type of issuers in (a) are issuers required to submit an annual securities reports and issuers of regulated securities (securities listed in the market for institutional investors or traded in the over-the-counter transactions). (Article 27-2(1))

In order to distinguish (x) a tender offer launched by a person other than the issuer provided in Articles 27-2 to 27-22 of FIEL and (y) a tender offer launched by the issuer provided in Articles 27-22-2 to 27-22-4, in (b) the subject of the purchase is "a person other than the issuer". In this article, as we described in "**1 Introduction**", we will discuss the former, i.e. tender offers launched by a person other than the issuer.

The "purchase etc." in (c) means "purchases and other type of transfers for value including other similar transactions as designated by cabinet order." (Article 27-2(1)) Article 6(3) of such cabinet order lists a pre-contract to sell or purchase made by one party, acquisition of an option in relation to sale and purchase of shares and so on. It is understood that a "purchase" means an acquisition of the issued securities[5] and, therefore, an issuance of additional shares is not deemed a "purchase."[6,7]

In principle[8], an action which satisfies all of conditions in (a) to (c) and falls under the categories listed in either of the items of Article 27-2(1) of FIEL requires a tender offer. Such categories will be described in 3-2 below.

Here, we examine the Case to determine whether it satisfies (a) to (c). As to an object, since a Company T is required to submit annual securities reports as a listed company (Article 24(1)(i)), its shares are "shares"[9] of an issuer required to submit an annual

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[4] It should be noted that, with respect to the "securities" in this clause, even when the securities indicating the relevant right have not been issued, the rights to be indicated in the relevant securities would be deemed as such securities (so-called deemed securities, Article 2(2) of FIEL). For example, in a shareholding company which does not issue a share certificate, the right with respect to a share is deemed a "share certificate".

[5] "Research on Economy System of Our Country from Competition Policy Related Point of View in 2001/Research on TOB" March 2002, Commercial Law Center Inc., Page 29

[6] "ANALYSIS TOB" by Anderson, Mori and Tomotsune, Page 46 provides as follows: "issuance of new shares is deemed "acquisition of newly issued share certificates" (Article 27-2(1)(iv), however, since "acquisition of newly issued share certificates" and "purchase" are referred to in parallel in the same clause, it is assumed that "acquisition of newly issued share certificates" is not included in "purchase".

[7] Accordingly, our understanding should be that a third party allotment by way of issuance of new shares does not fall under the category of the "purchase". As to a third party allotment of the shares, since the controlling right of the company could be affected depending on the number of the shares to be allotted or the way the shares are allotted, there exists an argument that a certain type of a third party allotment should be subject to the so-called "1/3 rule". "The Report of TOB Working Group – TOB system" by the first committee of the financial system council, Page 4 provides as follows: "in respect of a third party allotment of shares, under the Companies Act, certain remedies such as an injunction are prepared against offering at a lower price or issuance of new shares in a manner extremely unjustifiable and the relevant issues would be solved under the Companies Act." "At this moment, it is considered that a third party allotment is not required to be subject to the on-third rule." On the other hand, it should be noted that the Securities Listing Regulations and the relevant rules of the Tokyo Stock Exchange effective as of August 24, 2009 (a) newly specify the items subject to timely disclosure in the case of a third party allotment and (b) newly provide that when a company plans to perform a third party allotment of shares in which (i) the number of shares to be issued would be equal to or more than 25% of the number of issued and outstanding shares, or (ii) a change of a controlling shareholder is expected, either of the following procedure is required; (x) receipt of the opinion of a person, who has a certain degree of independence from management, regarding necessity and suitability of such allotment, or (y) confirmation of the intent of shareholders on such allotment, i.e. a resolution in the shareholders' meeting on such allotment, and (c) a company will be, in principle, delisted if the number of share to be issued in the third party allotment is more than 300% of the number of issued and outstanding shares. Osaka Stock Exchange and Nagoya Stock Exchange are also reviewing the possibility of setting forth similar provisions with respect to a third party allotment.

[8] Even where conduct satisfies the requirements referred to in all of (a) to (d), the actions that are exempted pursuant to Article 27-2(1) proviso are not subject to a mandatory tender offer, such as acquisition of shares as a result of exercise of subscription warrants.

[9] As Company T is a listed company, currently it is not a company that issues share certificates as a result of introduction of electronic share certificate system under the settlement rationalization law effective as of January 5, 2010. In such case, the right indicated by the share certificate is deemed to be the "share". (please see note 4)

securities reports, satisfying (a). In respect of the subject, the legal entity who is to make the purchase is a Company P which is "other than the issuer (company T), satisfying (b). In addition, Company P will pay a certain consideration for shares of Company T to Company A. Such transaction will be considered as a "purchase and other type of transfer for value", satisfying (c). Therefore, if the transaction falls under any of the categories in (d), in principle, Company P will be required to launch a tender offer.

3-2 Scope of Categories

[Issue in Practice 4]

Due to introduction of the rule for a rapid purchase (Article 27-2(1)(iv)), if a person acquires (a) 32% of the issued shares through transactions outside the financial instrument exchange market and (b), within three months from (a), 2% of the same through transactions inside the financial instrument exchange market, such an acquisition of shares requires a tender offer, though such an acquisition is not subject to the 1/3 rule (Article 27-2(1)(ii)).

The categories provided in each of provisions of Article 27-2(1) are as follows:

(a) a purchase conducted **outside of** a financial instrument exchange market (**excluding** a purchase from **an extremely small number of persons**) and, after such purchase, the number of shares owned by a person who conducted such purchase exceeds 5% of the issued shares (hereinafter, in this article, the "5% Rule"). A purchase from "an extremely small number of persons" means to purchase form ten or fewer persons during the 60 days before the date of the purchase causing the number of shares owned to exceed 5% of the issued shares (i.e. including the date of such purchase, within 61 days) (Article 6-2(3) of Enforcement Order)

(b) a purchase conducted **outside of** a financial instrument exchange market from **an extremely small number of persons**, upon which the ratio obtained by dividing the number of owned shares by the issued and outstanding shares exceeds one third (Article 27-2(1)(ii), hereinafter, in this article, the "1/3 Rule").

(c) a purchase through a specified sale and purchase (so-called, off-market trading) upon which the ratio obtained by dividing the number of owned shares by the issued and outstanding shares exceeds one third (Article 27-2(1)(iii), hereinafter, in this article, the "Specified Sale and Purchase Rule").

(d) a rapid purchase in which a transaction inside the financial instrument exchange market and a transaction outside the financial instrument exchange market are combined (Article 27-2(1)(iv), hereinafter, in this article, the "Rapid Purchase Rule"); i.e., a case where, (i) within three months, (ii) more than 10% of the shares are acquired as a whole through purchases (regardless of whether such purchases are inside or outside of the financial instrument exchange market) or acquisition of issued shares, (iii) among such acquisition of shares, the shares acquired through the purchases inside the financial instrument exchange market or the specified sale and purchase (excluding a purchase through a tender offer) exceeds 5% of the issued and outstanding shares, and (iv) upon such acquisition of shares, the ratio obtained by dividing the number of owned shares by the issued and outstanding shares exceeds one third.

(e) a purchase during the period of the tender offer launched by another person (Article 27-2(1)(v), hereinafter, in this article, the "Counter Tender Offer Rule"); i.e., a case where a person who own more than one third of the issued and outstanding shares conducts purchases etc. of more than 5% of the issued and outstanding shares during the period of a tender offer launched by another person.

(f) a purchase designated by a Cabinet Order as being equivalent to a purchase listed in the above items

(A) 5% Rule

It is understood that the purpose of the 5% rule is , ,when a person is to acquire a certain amount of shares from many people, to provide an opportunity for all of the shareholders to sell their shares and to ensure disclosure of sufficient information necessary to determine whether the relevant shareholders would accept such invitation to sell their shares.

In the above Case, since Company P is to acquire Company T's shares only from Company A, i.e. Company P would acquire shares from ten or fewer shareholders within a period of 61 days, such acquisition of shares would not be subject to the 5% Rule regardless of whether such acquisition occurs outside of the financial instrument exchange market.

(B) 1/3 Rule

The purpose of 1/3 Rule, in addition to the purposes of the above 5% Rule, is to prevent a portion of the shareholders from exclusively enjoying the control premium.

Regarding the above case, if Company P acquires all of Company T's shares which Company A owns outside of the financial instrument exchange market, Company P would own 60%, which exceeds one-third, of the issued and outstanding shares of Company T and, therefore, the 1/3 Rule would apply to Company P's acquisition of the relevant shares and a tender offer would be mandatory for Company P.

(C) Specified Sale and Purchase Rule

The Specified Sale and Purchase Rule has been effective since 2005, since ToSTNeT transaction etc., at the Tokyo Stock Exchange, which is conducted inside the financial instrument exchange market, is similar to a negotiated transaction and it is necessary to prevent abusive use of such transactions.

(D) Rapid Purchase Rule

The Rapid Purchase Rule has been introduced mainly to prevent a person from acquiring more than one-third of the issued and outstanding shares without implementing a tender offer by way of a series of transactions such as (i) purchase of 32% of the shares, etc. outside of the financial instrument exchange market and (ii) purchase of 2% of the shares, etc. in the market or by acquisition of newly issued shares in a third party allotment.

As in the above Case, if a person is to acquire 60% of the issued shares, it is almost infeasible to acquire most of the relevant shares outside of the market without being subject to the 1/3 Rule. Therefore, in this regard, it seems that the Rapid Purchase Rule would not matter in the above Case. However, if Company P plans to acquire 34% of Company T's shares among the shares Company A owns, there is a possibility that Company P purchases 32% of the shares from the outside of the market and 2% of the shares in the market to avoid application of the 1/3 Rule. In such a case, this Rapid Purchase Rule might be applicable. (In such a case, in order for Company P to avoid application of the Rapid Purchase Rule, Company P needs to wait for more than three months after its acquisition of 32% of the shares from the outside of the market before its acquisition of the remaining 2% of the shares.)

(E) Counter Tender Offer Rule

The Counter Tender Offer Rule has been introduced to deal with cases where, during the period in which a person makes the tender offer, another person continues to purchase the subject shares on a massive scale in the market

without implementing the tender offer, based on a view that, if there are competing purchases of the shares that may affect the control of the target company, such other purchases should also be subject to the tender offer regulation so that the relevant purchasers would be treated equally and the relevant investors would be furnished with sufficient information to determine which purchaser would be appropriate to control the target company.

3-3 Persons in a Special Relationship

[Issue in Practice 5]

The scope of the "Persons in Special Relationship", which has close relevance to the ration of shares owned by a purchaser, requires careful consideration. In a case where, although a controlling shareholder delegates the execution of its voting rights to a purchaser in respect of a subscription agreement between the shareholder and the purchaser, even though such purchaser does not own any shares prior to the purchase of the shares, FSA's understanding is that, in principle, such shareholder would not be considered a Person in a Special Relationship.

A person in Special Relationship means a person who has a certain relationship with those who conduct purchases of the shares. In determining whether a case falls under any of the categories described in Clause 3-2 in which the tender offer is mandatory, the percentage of shares, etc. owned by a purchaser is an important factor. In this regard, in addition to the shares, etc. owned by a purchaser itself, the shares, etc. owned by a "Person in Special Relationship" are also counted in calculating the percentage of shares owned by the purchaser. In addition, a "Person in Special Relationship" is an important concept which is relevant to the determination of (i) exemption from a mandatory tender offer (notes 8) and (ii) prohibition of purchases and constitutes an item to be listed in a tender offer notification.

There are two types of a Person in Special Relationship: (a) a person in a special and formal relationship and (b) a person in a special and substantial relationship.

(a) Person in Special and Formal Relationship (Article 27-2(7)(i) of FIEL)

A person in a special and formal relationship means a person who has a certain relationship in respect of ownership of shares, kinship or other matter provided in a cabinet order with a person who purchases the shares, etc. Specifically, if a purchaser is a person, persons in a special and formal relationship with the purchaser include (i) relatives of such purchaser (spouses and relatives in the first degree) and (ii) entities that have a certain equity relationship (special equity relationship) with the purchaser and the directors of such legal entities. If a purchaser is a legal entity, persons in a special and formal relationship with the purchaser include (i) directors of the legal entity and (ii) legal entities that has a special equity relationship with the purchaser and the directors of such legal entities. (Article 9(1) and (2) of Cabinet Order)

(b) Person in Special and Substantial Relationship (Article 27-2(7)(ii) of FIEL)

A person in special and substantial relationship means a person having agreed with the person conducting the purchase of the shares, etc. to jointly acquire or transfer the shares, etc. or jointly exercise voting rights or other rights as shareholders of the issuer of the shares, etc., or to transfer or accept transfer of the shares between them after the purchase of the shares.

In the above Case, since (i) Company P and Company A started their negotiation in the middle of April which is after the record date, March 31, (ii) Company A desires to sell Company T's shares prior to Company T's annual shareholders meeting (we will refer to an important issue regarding timing of earnings announcement in the next article (Part 2)) and (iii) the purchase should be conducted as soon as possible in order to properly control the relevant information; due to a tight timeline, it would be unfeasible to hold a special shareholders meeting to match the ownership of the shares with the voting rights of such shares. For the purchase of the shares after the record date, in order to match the ownership of the shares with the voting rights, it might be likely that Company A would agree with Company P to delegate its voting rights to Company P in an agreement in respect of the tender offer. When such agreement is made, the question is whether Company A fulfills the conditions of a person in

special and substantial relationship with the purchaser, i.e. “a person having agreed with the person conducting the purchase of the shares, etc. to jointly exercise voting rights”.

In this regard, to fulfill the requirement to “jointly exercise”, generally it would be necessary for both the purchaser and the relevant person in a special relationship to have a voting right at some point. Therefore, if the purchaser does not own any shares of the target company before the purchase (at the time of the record date, both parties do not simultaneously have voting rights), delegation of the voting right from the seller to the purchaser would not normally have the seller and purchaser “jointly exercise” the voting rights. Based on the above, if Company P does not own any shares issued by Company Ts prior to Company P’s purchase of shares from Company A, Company A would not satisfy the conditions for a person in a special and substantial relationship.

On the other hand, in a case where the purchaser owns some voting rights prior to the attempted purchase, both of the purchaser and the seller would have voting rights at the time of the record date. In such a case, the purchaser and the seller could “jointly exercise” the voting rights. Therefore, in determining whether the seller falls under the category of a person in a special relationship, the purpose of delegation of voting rights by the seller would matter in such a case.

If the seller delegates the voting rights to the purchaser, the purpose of such delegation would be to match the ownership of the shares with the person who could exercise the relevant voting rights due to the purchase of the shares after the record date.

In the above Case, since both parties are not likely to have come to an agreement to “jointly exercise” the voting rights, it is believed that Company A does not fall under the category of a person in a special and substantial relationship with Company P. (However, if the seller sells only a part of the shares it owns and the seller, unlike Company A in the Case, continues to be a shareholder of the target company after the sale of the shares in question, such situation should be separately reviewed.) Accordingly, Company P is not required to list Company A as a person in a special relationship in the tender offer notification.