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Japan

PRIVATE EQUITY

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in Japan.

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JAPAN
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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

From November 30, 2021 to November 30, 2023, there were 2,644 M&A transactions in which the targets were Japanese companies (excluding intragroup transactions and transactions that do not result in a change of control). Financial sponsors were buyers in approximately 11% of such transactions, and were sellers in approximately 5% of them (Source: RECOF). We have seen recovery over the last 24 months from the rapid decrease in cross-border transactions in 2020 due to the COVID-19 pandemic, and the Japanese M&A market has continued to be active and private equity buyers have also continued their investments.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

As sellers, financial sponsors tend to avoid any post-closing exposures and to limit post-closing covenants and indemnification terms. Limitations on indemnification include short survival periods for representations and warranties (sometimes such survivals are less than a year after the closing) and incorporating de minimis, deductible or basket and cap thresholds or amounts with respect to indemnification payments. Cap amounts negotiated by financial sponsors are often lower than those negotiated by trade sellers. Financial sponsors are increasingly trying to structure their auction sale as nil recourse, encourage bidders to purchase W&I insurance policies, and sometimes initiate sell-buy flip process.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

The process for effecting the share transfer differs depending on whether the target is a listed or unlisted company, and, if it is an unlisted company, whether the target issues share certificates or not. An unlisted company will not issue share certificates unless it elects to issue them in its articles of incorporation. With respect to a target unlisted company that does not issue share certificates, the share transfer of shares in the target becomes effective pursuant to the agreement between a seller and a buyer without any mandatory actions under law, provided that the share transfer becomes perfected against the target and third parties only when the buyer is recorded as the shareholder in the target's shareholder registry. The shareholder registry can be updated by the joint request of the buyer and seller to the target, and such written request executed by the seller will be typically part of the closing deliverables for the share transfer. With respect to a target unlisted company that does issue share certificates, the transfer of shares in the target becomes effective only if and when the share certificates representing the transferred shares of the target are delivered from the seller to the buyer. In order to perfect the share transfer, the shareholder registry of the target must also be updated as in the case for an unlisted company that does not issue share certificates, but the request to update the shareholder registry of the target can be made by the sole request of the buyer in which the buyer presents to the target the share certificates delivered from the seller. Therefore, the share certificates representing the transferred shares must be part of the closing deliverables for the share transfer. In addition, a transfer of shares in an unlisted company (regardless of whether it issues share certificates) is usually subject to certain transfer restrictions set out in the company's articles of incorporation, and approval by a resolution of a meeting of the company's shareholders or board will be required. With respect to a listed company, all of its shares are managed under the book-entry transfer system. The share transfer only becomes effective when the transfer is recorded in the book entry account of the buyer. Such transfer will be registered at the buyer's account by the seller's request to the account management institution (e.g., securities company) where the seller's account is maintained. No transfer tax is applicable to any transfer of shares in a Japanese company.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

Financial sponsors usually cannot provide a guarantee to secure the obligations of the purchasing entity. Sellers are typically more concerned about closing uncertainties with respect to debt financing, and often request (particularly in auction processes) financial sponsors to submit binding commitment letters from the financial sponsors' banks prior to the execution of transaction documents. Also, sellers are often unwilling to accept any financing condition in transaction documents. Specifically for going-private transactions, where tender offers are regulated under the Financial Instruments and Exchange Act of Japan, a tender offeror who is a financial sponsor will be required to submit and make available to the public equity commitment letters from its fund entities and debt commitment letters from its banks to show that it has secured sufficient funds to settle the tender.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

A locked box pricing mechanism (in which the seller and the buyer agree on a fixed purchase price as of a historical locked box date with special indemnification by the seller for any subsequent value leakage from the target after the locked box date and accrual of interests on the purchase price from the locked box date until the closing) had been historically rare, but is increasing in transactions in which the targets are Japanese companies. However, any interest accrual (ticking fee) from the locked box date until the closing is rare. Having said that, still more often seen are transactions in which the target is a Japanese company and in which the purchase price is agreed as a fixed amount and is not subject to any closing adjustment, which, however, do not include provisions for leakage indemnification or interest accrual on the purchase price and are different from a locked box pricing mechanism. In such transactions, negative covenants of the seller would usually be provided in the transaction documents to protect the buyer from any decrease of enterprise value of the target; and such negative covenants would typically include prohibitions on the seller from paying any dividend or effecting any material "leakage" from the target.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

The typical methods of risk allocation between the buyer and the seller in transactions in which the targets are Japanese companies do not differ from the general practices elsewhere, which include provisions relating to representations and warranties, pre and post-closing covenants, closing conditions, indemnification, and closing adjustment of the purchase price. Even when a financial sponsor is a seller of a target company, representations and warranties provided by the seller would usually include some representations and warranties about the target although the scope of such representations and warranties would be more limited compared to the scope a trade seller would provide. With respect to closing conditions, the absence of material adverse effect and a financing condition would usually be among the most heavily negotiated between the seller and buyer. Post-closing indemnification by the seller in favour of the buyer (for breaches by the seller of its representations and warranties and other covenants and agreements as set forth in the transaction documents) is a common means of risk allocation between the seller and the buyer. In going-private transactions in which there are multiple shareholders of the target company, such indemnification is often provided by the sellers who are controlling shareholders of the target company under tender agreements executed between such controlling shareholders and the tender offeror.

7. How prevalent is the use of W&I insurance in your transactions?

We have seen more and more cases where W&I insurance policies are purchased for M&A transactions in which the targets are Japanese companies. Especially, an increasing number of Japanese auction sellers are requesting bidders to rely on the W&I insurance in place of their recourses against the sellers. However, its impact on the transaction schedule can still be an issue. The underwriting process for the W&I insurance, including the due diligence and review of transaction documents by the insurance companies, is sometimes difficult to complete for transactions with tight timelines because the underwriting process will add additional time and costs and additional burdens on the resources of the transaction team members until the execution of the transaction documents in particular because major international underwriters would only accept transaction documents and due diligence reports written in, or translated to, English for their review. Recently, however, insurance companies become more and more actively providing W&I insurance in Japan based on Japanese language documents or English summaries of Japanese documents (rather than full translations), and the situation has been changing increasingly.

8. How active have financial sponsors been in acquiring publicly listed companies?

From November 30, 2021 to November 30, 2023, there were 132 public M&A transactions in which the targets were Japanese listed companies (excluding intragroup transactions and transactions that do not result in a change of control), and approximately 24% of these transactions involved financial sponsors as buyers (Source: RECOF). Among the inbound M&A transactions into Japan, the American private equity firms have built strong track records and continue to be primary players in large cap transactions and are active even post-COVID.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

Investments by foreign financial sponsors will typically be subject to pre-transaction notification or post-transaction reporting requirements under the Foreign Exchange and Foreign Trade Act (including its ancillary regulations, "FEFTA"). In 2019, 2020, 2021 and 2023, there have been a series of amendments to the FEFTA and the pre-transaction notification requirements have been expanded. By these amendments, many new businesses were added to the list of regulated sectors that require pre-transaction reporting, and the scope of activities that are categorized as foreign direct investment ("FDI") were also expanded. Under the FEFTA, among others, a pre-transaction notification and screening by the government is required for any acquisition by a foreign investor of (a) 1% or more shares or voting rights of a Japanese listed company, or (b) any number of shares or voting rights of a Japanese non-listed company from a person who is not a foreign investor, if the target is engaged in certain regulated sectors such as the defense industry, social infrastructure, agriculture, semiconductors (including their manufacturing equipment, devices, and materials), power generation (including renewable energy projects), software and information and communications. In such cases, a waiting period of 30 days will apply, which can be extended up to five months but may be shortened if the investment does not relate to national security. However, passive investors who are not foreign governments, sovereign wealth funds or state-owned enterprises (so long as they do not have a record of past violation of the FEFTA), can be exempted from the pre-notification requirement if they comply with certain conditions to ensure that they remain passive investors and make a post-facto report following its investment. Such conditions include a requirement to not cause their closely related persons to become a board member of the target, to not propose to the shareholders' meeting any transfer of business in any designated business sector, and to not to access any non-public technology information of the target relating to any designated business sector. In addition, a foreign investor is required to make a prior notification before it exercises its voting rights at the shareholders' meeting of a Japanese company to approve (a) appointment of the foreign investor or its closely related person as a board member of the target or (b) if the agenda is proposed by such foreign investor, approve a transfer of business in any designated business sector. However, this requirement will not apply if the target is a listed company and the holding ratio of the foreign investor is less than 1%. In addition, if the foreign investor acquired 50% or more of the total voting rights of the target after making the prior notification, it does not need to make another prior notification before it exercises its voting rights to approve the appointment of a board member of the target. While the only case in which the government issued a cease and desist order under the FEFTA was the proposed follow-on investment by The Children's Investment Fund, a British investment fund, in Electric Power Development Co., Ltd., the largest wholesaler of electricity in Japan, we have seen more detailed reviews on pre-transaction notification for FDIs and use of mitigation conditions by authorities, in particular in connection with the restricted businesses concerning national security. We have also seen transactions which were voluntarily cancelled partly due to the uncertainty of clearance under the FEFTA.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

Usually, buyers manage the risk by setting forth merger clearance as a condition precedent to either party's obligations in the transaction documents. Sellers mitigate the risk through a cooperation provision obligating the sellers and buyers to use their best or reasonable efforts to obtain antitrust approval. While it may not be unique to Japan, we rarely see "hell or high water" provisions in the executed transaction documents (although we see them in the seller's initial draft), and specific provisions otherwise providing for buyers' obligations to undertake certain divestures or to litigate are also rare. We see reverse break-up fee provisions in some large cap transactions, but they are not prevalent in small- to mid-cap transactions.

11. Have you seen an increase in (A) the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside; and (B) 'continuation fund' transactions where a financial sponsor divests one or more portfolio companies to funds managed by the same sponsor?

We have seen mezzanine financing as part of acquisition financing by private equity firms where mezzanine investors provide funds in the form of preferred shares or debt financing accompanied with warrants. There are also some financial sponsors making private investments in public equities (PIPEs) in the form of preferred shares, convertible bonds or warrants. While continuation fund transactions involving private equity firms are not that prevalent in Japan yet, a Japanese domestic private equity firm recently made an announcement of what it claims to be the first continuation fund transaction in Japan.

12. How are management incentive schemes typically structured?

Cash compensation awards are still common in sponsor-backed buyout deals; in some cases sponsors arrange for the management team to hold an equity stake in the company. The structure of these equity-based incentive schemes vary, but are typically structured as a rollover of existing equity into new equity or a granting of stock options either in the post-buyout portfolio company or its parent company. Transaction bonuses and golden parachute payments are not that common in Japan. However, in transactions in which the management members are also the sellers, buyers sometimes compensate the management members by providing severance payments to them.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

There are no specific tax rules applicable to management rollovers (e.g., tax-free rollovers) or parachute payments (e.g., prohibition of deduction for such payments and imposition of excise taxes on such payments) in Japan. With respect to stock options, certain "qualified" options that meet specific criteria will be classified as "qualified stock options" that will be subject to tax at capital gains rates (about 20%) when the underlying shares are sold. In contrast, holders of non-qualified stock options are first taxed based on the economic gain reflected in the difference in the value of the shares underlying such options compared to the exercise price of the options at the time of exercise of the options; and such gain is taxed as salary income (which would usually subject such holder to a higher progressive tax rate as compared to tax at the capital gains rates). Such holders are taxed a second time at the time of sale of the shares underlying such options; and the applicable tax is a capital gains rate tax on any increase in the value of the shares since the exercise of the options.

14. Are senior managers subject to non-competes and if so what is the general duration?

Senior managers who are employees are usually subject to non-compete obligations under their employment contracts or the work rules applicable to them. Even where there is no express provision in the employment contracts or the work rules applicable to them, it is construed that employees will be subject to implicit non-compete obligations, although their scope is ambiguous. Senior managers who are directors do not often enter into any written employment contract with the company, but will still be subject to statutory non-compete obligations under the Companies Act of Japan, which prohibit them from engaging in transactions that belong to or are within the scope of the business of the company unless board approval is obtained. Whether any post-employment non-compete obligations apply to such senior managers will in principle depend on whether there is any express agreement between the company and the senior managers in respect to such obligations. Typically, such agreement may be provided in the employment contracts, or work rules or internal regulations relating to directors. Also, with respect to a portfolio company of a financial sponsor, executive services agreements setting forth non-compete obligations are often executed between the financial sponsor and the key management members (see response to Question 15 below). The Japanese courts typically hold post-employment non-compete obligations valid for a period of one to two years, and in some instances even longer if there are rational reasons to uphold long term non-compete obligations. Non-compete obligations that are determined to be overly broad and restrictive by the court will be rendered unenforceable. In determining the enforceability of particular non-compete obligations, the courts also typically consider and weigh factors such as the position and responsibility of the former senior managers, whether the former senior managers were adequately compensated, and the scope and breadth of the non-compete obligations.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

A financial sponsor would typically enter into a management services agreement with the key management members of the financial sponsor's portfolio companies. The management services agreement would set forth, among others, the responsibilities and compensation of the key management members, causes for termination of such key management members or agreement, non-competition and non-solicitation obligations, and certain reporting requirements. A financial sponsor would also typically nominate one or more directors to serve in each portfolio company to facilitate the financial sponsor's oversight of the portfolio company's business operations. Such directors would attend the board meetings at which material business issues and agenda items would be discussed and approved. Furthermore, certain fundamental corporate actions and events relating to the portfolio company, including amendments of articles of incorporation and mergers and other corporate reorganizations, are subject to approval by a resolution of the general meeting of the shareholders, and a financial sponsor having control over a portfolio company would be able to either approve or reject such actions or events.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

It is common to form a pooling vehicle for employee ownership both in listed and unlisted companies. In an unlisted company, participating employees would be typically obliged to dispose of their ownership of shares in the company at a pre-determined price (often at the original acquisition price) if they leave the company. As such, the company can offer employees ownership in the company while at the same time ensuring that the shareholding of the company will not be overly dispersed or diluted. On the other hand, in a listed company, participating employees would be entitled to receive their vested shares in the company when they leave the company; they also have a choice of holding such shares or selling them on the market after the vesting of such shares (whether they remain or leave the company).

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

Across all sizes of transactions, loans from a syndicate of banks is the most popular source for debt financing. Corporate bonds are not usually used as instruments for senior financing because the issuance of corporate bonds secured by collateral requires the involvement of a trust bank under Japanese law, and the completion of such collateralization and involvement of a trust bank introduces complexities to the transaction. However, mezzanine financing is sometimes offered in the form of a subordinated bond or convertible bond (that does not require collateralization), or preferred stock, in addition to a subordinated loan. Furthermore, partly because Japanese banks are becoming more careful in providing acquisition financing after Marelli, a global automotive supplier and KKR portfolio company, filed for a court-led insolvency proceeding earlier 2022, some private equity firms are starting to more seriously consider the use of off-shore holdco financing from offshore debt financiers.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

There are no explicit rules prohibiting financial assistance by a target company in connection with the acquisition of shares of the target company. As such, it is possible for the target to guarantee the liabilities of the buyer under the transaction documents and create a security interest over the target's property and assets for the benefit of the lenders to the buyer. However, because the directors of the target owe fiduciary duties to its shareholders including the minority shareholders, it is common practice for the target to not make such guarantee or to create such security interest before the buyer acquires 100% of the outstanding shares of the target. In the case of a 100% acquisition of an unlisted company, the target can provide the guarantee or create the security interest as soon as the sale between the seller and the buyer is consummated. In contrast, in a going-private transaction of a listed company, such guarantee or creation of security interest will be possible only after both the tender offer and subsequent transaction to squeeze out minority shareholders have been completed.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

There is no publicly available standard form of acquisition financing governed by Japanese law. However, the model contracts for syndicated loans published by the Japan Syndication and Loan-trading Association are widely referred to in the drafting of acquisition financing documents. The provisions in financing documents specific to acquisition financing are drafted on a deal by deal basis, including with respect to representations and warranties, covenants, conditions precedent, and events of default, as well as the collateral package. Major banks that are familiar with acquisition financing tend to have and use their own forms of financing documents. When both the lender and the borrower are represented by experienced counsel, negotiations between the lender and the borrower tend to focus on deal-specific issues and the completion of the financing documents could be done efficiently and relatively quickly.

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

The scope of the collateral package, regarding which collateral will be required in addition to the shares of the target, is among the most heavily negotiated issues in financing documents. Among the deal specific provisions in a loan agreement, the representations and warranties, covenants, conditions precedent, and events of default are the most heavily negotiated provisions. With respect to the covenants, in addition to financial covenants, those covenants which would place restrictions on the business operations of the target company (such as any restriction on capital expenditure by the company) are the most heavily negotiated.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

Interests in private debt funds are increasing, and there are some funds which are primarily engaged in mezzanine financing in Japanese private equity transactions and distressed financing in PIPEs, but in general, the number of credit funds providing debt capital in Japanese private equity transactions is still limited.

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