The M&A LAWYER

January 2023 ▪ Volume 27 ▪ Issue 1

STRANGER THINGS: M&A IN 2022 AND WHAT TO EXPECT IN 2023

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We entered 2022 filled with positivity and excitement for the new year: the worst of the COVID-19 pandemic seemed to be behind us; most travel and other COVID-related restrictions had been lifted; and the global economy was going strong following a record-setting year for M&A in 2021. However, the mood quickly shifted, first with Russia's invasion of Ukraine in February 2022, which sent a shockwave through global markets, setting off economic sanctions against Russia's economy and assets. Global M&A took a hard hit with European deal making facing the biggest impact of these geopolitical developments, with over $150 billion in proposed European M&A transactions withdrawn in just the first month following Russia's invasion. U.S.-China relations have also deteriorated, reducing M&A transactions between North America and China to the lowest level of activity since 2013.

The M&A market faced other strong headwinds in 2022, including soaring inflation, rising interest rates, and a general downturn in the global economy. The U.S. Federal Reserve ("Fed") has made aggressive policy changes in an effort to curb inflation, including increasing the federal funds benchmark five times over the course of 2022. While economic indicators suggest that inflation may have stabilized, the U.S. economy contracted during the first two quarters of 2022 and rising interest rates increased the cost of capital for buyers to finance acquisitions. During the third quarter of 2022, global M&A activity experienced one of the slowest quarters since the onset of the pandemic in 2020, affecting almost all segments and industries within the global markets. The number of mid-market deals (deals between $1 billion and $5 billion in value) fell 43% in 2022 alone. Other major events of 2022 include Twitter suing Elon Musk to enforce Musk's $44 billion offer to acquire the company, the "death" of special purpose acquisition companies ("SPAC"), and increased antitrust and foreign investment scrutiny of M&A transactions from U.S. and global regulators.

With the looming threat of a potential recession in 2023, the slowdown in the M&A markets is expected to continue at least for a little

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longer. However, there is a silver lining for M&A dealmakers as we embark on the new year: with valuations down, 2023 could offer unique purchasing opportunities. We can expect to see more corporate carve-out transactions and more earn-outs (or other methods of deferring consideration and bridging valuation gaps). While 2022 has seen a shift in the global M&A landscape, M&A dealmakers have adapted and are ready to tackle the opportunities and challenges that the new year will bring.

We Crashed: Macroeconomic Trends and M&A Deal Flow

After a record-breaking year in 2021, global M&A activity slowed to historical averages as a result of economic uncertainty in the markets caused by soaring inflation, rising interest rates and the recent downturn in the U.S. economy. As of December 1, 2022, the Consumer Price Index for all Urban Consumers ("CPI") increased by 7.1% over the previous 12 months, with food and energy as the largest contributors to the increase. However, U.S. inflation has cooled since June's 9.1% year-over-year increase, with November recording the lowest reading since January 2022. Inflation in many countries, including Argentina and Turkey, has also hit a 40-year high. In an effort to combat inflation, the Fed has made several changes to U.S. monetary policy to bring inflation down to the Fed's long-term target of 2%. To date, the Fed has increased its federal funds benchmark five times, the first in March 2022 by 25 basis points, which marked the first time since 2018 that the Fed increased rates. The Fed followed with interest rate hikes in June, July, and September by an additional 75 basis points at each occurrence. On December 14, 2022, the Fed raised the benchmark again by an additional 50 basis points, taking the benchmark to a targeted range between 4.25% and 4.5%, marking the Fed's most aggressive policy moves since the early 1980s.

As a consequence, the U.S. economy stumbled during 2022, particularly during the first two quarters of the year. U.S. gross domestic product ("GDP") fell for two consecutive quarters: 1.6% and 0.6% during the first and second quarters of 2022, respectively. However, U.S. GDP increased by 2.9% on an annualized basis during the third quarter of 2022, reversing the negative trend during the first half of 2022. The U.S. economy grew faster in the third quarter than originally forecasted, bouncing back from two quarters of contraction, but the expansion was driven primarily by non-domestic factors, including an increase in exports overseas. As a result, many economists do not expect the recent growth to persist and forecast that a reces-

The M&A Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

One Year Subscription ● 10 Issues ● $ 1,128.00
(ISSN#: 1093-3255)

sion may be on the horizon for 2023. Former U.S. Treasury Secretary Larry Summers has hinted at an impending recession, noting that "there's never been a moment when we've had inflation above 4% and unemployment below 4%, and we didn't have a recession within two years."

Given the economic uncertainty and pessimism in the global markets, it is no surprise that M&A activity has declined, with deals taking longer to come together and a higher percentage of busted deals. In the first half of 2022, 10,602 deals were concluded with an aggregate value of $925.35 billion, according to data from S&P Global Market Intelligence. This was down from the record 12,421 deals with an aggregate value of $1.319 trillion announced in the first six months of 2021. During the third quarter of 2022, global M&A activity experienced one of the slowest quarters since the onset of the pandemic in 2020, affecting almost all segments within the global markets. By the end of Q3, 2022 had seen $2.7 trillion worth of M&A deals completed, down approximately one-third compared to 2021, and a 17% fall in the number of transactions. Only the first and second quarters of 2020—$704 billion and $444 billion, respectively—had lower deal volumes than the third quarter of 2022, which saw $722 million total value of deals completed.

Mid-market deals have taken the hardest hit and the number of such deals had fallen 43% by the end of last year. Additionally, interest rate hikes have increased the cost of capital for buyers to finance acquisitions. The yield on the S&P U.S. Investment Grade Corporate Bond Index was 5.11% on December 12, 2022, meaning debt issued on that day cost far more than it did at the start of the year, when the index was yielding 2.2%. This in turn makes borrowing to invest in M&A more expensive. Nevertheless, despite the relative downturn, 2022 has seen a return to historical levels in the M&A market. Global M&A deal volume suggests that 2022's deal volume numbers are comparable to pre-pandemic deal volume levels, even with the noticeable drop in deal activity during the third quarter of 2022.

House of the Dragon: Geopolitical Tensions and the War in Ukraine

It is difficult to overstate the significance of this year's geopolitical developments. In February 2022, Russia invaded Ukraine, provoking the largest European war and political crisis since the Second World War. The conflict in Ukraine has caused extreme civilian harm, leaving millions without access to food, water and other essential supplies. Since Russia's invasion, there have reportedly been over 7,000 civilian casualties, approximately 500 of them children, and over 6.5 million people have been internally displaced. The United States, the European Union, Japan, and other countries have responded with a raft of sanctions targeting critical areas of the Russian economy: restricting Russian exports of natural gas, oil and other commodities; freezing Russian assets held at foreign banks; prohibiting exports to Russia of sensitive technologies, as well as other goods that could be put to military use; prohibiting transactions with Russian banks, including the Russian central bank; and numerous other measures. The war and resulting sanctions regimes have had a worldwide economic impact. Disruption of food and fossil fuel exports from Russia and Ukraine have contributed to global inflation, as has the effective closure of overland transportation routes for Chinese exports to Europe. Companies have attempted to adapt to these challenges through shifts to alternative energy sources and shipping routes, but such adaptations have proven unable to fully mitigate increases in production and supply costs. More generally, economic fallout from the war has contributed to significant volatility in the stock markets.

While European deal making has experienced the most significant impact of these geopolitical developments—$150 billion in proposed European M&A transactions were withdrawn in the first month alone following the Russian invasion—the interconnectedness of the global economy has led to a more challenging M&A environment in all markets. Disruptions to global supply chains have made evaluating target companies more difficult, which, in conjunction with general geopolitical uncertainties, have led companies to postpone acquisitions. Additionally, the new sanction regimes have required heightened diligence requirements for cross-border deals. Acquirers must be careful to ensure that targets do not transact, and are not otherwise involved, with any sanctioned entities, and acquirers may need to predict the impact of future sanctions regimes that may yet be implemented as the war approaches a full year in duration. Finally, stock market volatility has led to significant valuation challenges for deals in which stock would constitute part of the consideration, further encouraging potential acquirers to postpone M&A activities.

This year also bore witness to an acceleration in economic decoupling between the United States and China. Although not as immediately impactful as the Russian invasion of Ukraine, over the long term, these trends may mark the beginning of a less globalized world economy. Commentators have identified several factors contributing to the current state of affairs: China and the United States have taken increasingly aggressive positions regarding the status of Taiwan; China's "zero-COVID" policies have greatly decreased the flow of people into and out of the country, and factory closures resulting from these policies have made China a less reliable manufacturing partner for American companies; as China relaxes its "zero-COVID" policies in response to social protests, it appears that China is experiencing a dangerous surge in COVID-related infections and deaths; and the United States has taken steps to limit Chinese imports of semiconductors while simultaneously encouraging the development of U.S. domestic production in this industry. In addition to the obvious impacts on global supply chains of these and related developments, data from Refinitiv as of the third quarter of 2022 show a 35% year-on-year decline in M&A activity involving China, reaching the lowest level since 2013. In the near term, cross-border deals involving China are likely to remain challenging, as political and regulatory risks impede Chinese investment abroad, and continued uncertainties over China's "zero-COVID" policies create significant risks for foreign investment in China. Moreover, the U.S. CFIUS has announced it is considering adopting "reverse merger" rules that would restrict U.S. buyers from acquiring certain Chinese assets.

The share of cross-border deals among closely affiliated countries has increased as a proportion of total M&A activity. While cross-border transactions have decreased across the board by 24% in 2022 as compared to cross-border activity levels from 2015 to 2019, the number of cross-border deals among closely affiliated countries has increased to comprise 51% of total global M&A activity in 2022 compared to an average of 42% during the 2015 to 2019 M&A cycle. As described above, investments from China into the U.S. have fallen from $27 billion at the high point in the first half of 2016 to $1.9 billion during the first half of 2022. However, North American investment in Europe has increased from $60 billion to $149 billion over the same period. The nature of cross-border deals is changing to reflect geopolitical tensions on the world stage, which we can expect to continue into 2023.

Better Call Saul: Increased Scrutiny from U.S. and Global Regulators

Both domestically and internationally, regulators have signaled a readiness to scrutinize M&A transactions more closely, adopting more aggressive policies with respect to antitrust and foreign direct investment ("FDI") regulations. In the United States, the Biden administration has made the promotion of competition a key aspect of its economic policy platform. Most notably, in July 2021, President Biden issued an "Executive Order on Promoting Competition in the American Economy." In this order, Biden encouraged the Federal Trade Commission ("FTC") and the U.S. Department of Justice ("DOJ") to take a much more aggressive approach to antitrust enforcement, with a particular focus on the labor, agricultural and healthcare markets, as well as the tech sector—a mandate that these agencies have adopted with vigor.

The DOJ and FTC promptly began a review of the

Vertical and Horizontal Merger Guidelines with an eye toward significantly narrowing the scope of mergers that will escape regulatory oversight. In January 2022, these agencies launched a public request for information regarding how best to update the Merger Guidelines in light of these goals. The FDIC soon followed suit, launching an analogous review of the rules governing bank mergers. Even before the new Merger Guidelines are finalized, however, both agencies have signaled a much greater willingness than under the past two administrations to bring litigation against proposed mergers. These deals include Lockheed Martin's proposed $4.4 billion acquisition of Aerojet Rocketdyne (abandoned by Lockheed Martin in February 2022), Nvidia's proposed $40 billion acquisition of ARM (abandoned by Nvidia in February 2022), United Healthcare's $13 billion acquisition of Change Healthcare (legal challenge defeated in court in September 2022), U.S. Sugar's $315 million acquisition of Imperial Sugar (legal challenge defeated in court in September 2022), the $25 billion merger of Kroger and Albertsons Companies (the FTC made a second request on December 3, 2022) and Microsoft's $69 billion acquisition of Activision Blizzard (the FTC filed suit on December 8, 2022). These agencies' success in court to date has been mixed, with judges frequently ruling in favor of the merging companies. But the DOJ and FTC do not need to rely on judicial rulings to effect the Biden administration's agenda—more stringent approval processes for major M&A transactions, a greater willingness to bring litigation against the transacting parties and more aggressive agency positions in settlement negotiations have significantly raised regulatory costs, such that some companies simply elect to abandon prospective M&A transactions that could face intense scrutiny.

Abroad, we have seen a related dynamic whereby certain countries, including Australia, Canada, Japan, New Zealand and the United Kingdom, have become more proactive in enacting, enforcing and widening their FDI regimes. The pandemic has exposed vulnerabilities with respect to many countries' international supply chains and cross-border trade profiles, and the response of these countries has been to review a broader array of transactions that have traditionally fallen outside of FDI review. In addition to expanding the jurisdictions of FDI regulators, many countries have imposed additional mandatory notice requirements with respect to proposed transactions and have given regulators additional powers to block or otherwise impose conditions on transactions on the grounds of national security or other strategic interests.

Most notably, the United Kingdom passed the wide-reaching National Security and Investment Act that went into effect in the first quarter of 2022. This law expands the scope of FDI review beyond just M&A activity, giving regulators the power to scrutinize minority investments and the acquisitions of assets such as land and intellectual property. Failure to comply may entail consequences ranging from nullification of the transaction to fines and even criminal sanctions. Going forward, significant cross-border deals will require careful review of evolving international FDI regimes in order to properly evaluate regulatory risk and to structure transactions appropriately.

The Dropout: The Rise and Fall of the SPAC

Following the explosion of SPAC transactions in 2020 and 2021, this past year once again saw SPACs feature prominently on the radars of M&A and capital markets practitioners, albeit for reasons far less favorable for the future robustness of this market. The widespread use of SPACs as a mechanism for a private company to go public provided, at least in part, a way to expedite the process of effecting an initial public offering ("IPO"). The securities laws governing mergers were perceived as being somewhat more lenient than those governing the IPO process, leading many practitioners to conclude that a SPAC merger (or "de-SPAC") is a faster and more affordable means of going public than a traditional IPO.

While the exact causes of the SPAC boom continue to generate considerable debate, the magnitude of this increase is beyond question. SPACs raised $81 billion in 2020—almost twice the amount raised in the previous 10 years combined—and then another $161 billion in 2021, including $97 billion in the first three months alone. Beginning in the second half of 2021, however, market participants and scholars increasingly observed that investments in SPACs tended to generate poor returns, materially underperforming not just the market writ large but also those companies that went public through a traditional IPO over the same time period. As interest rates rose, it became less economic for SPAC investors to park their $10 per share in a SPAC trust account pending finding a de-SPAC target. Increased regulatory scrutiny followed, which in combination with rising interest rates and economic tightening quickly drove the once-thriving SPAC market into near irrelevancy. As of August 2022, 143 SPAC IPOs were withdrawn, the highest number on record, and another 46 de-SPAC transactions were terminated. SPAC proceeds declined from $10 billion in the first quarter of 2022, to $2 billion in the second quarter, to less than $1 billion in the last two quarters combined.

The growing consensus regarding poor SPAC returns certainly contributed to their decline, but the SEC's recent proposed rulemaking also had a significant impact. On March 30, 2022, the SEC released a series of proposed rules that would close the regulatory gap between SPACs and traditional IPOs. Most notably, the SEC signaled that investment banks may undertake underwriter status for de-SPAC transactions, and indicated that a safe harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995 would not apply to de-SPACs. Furthermore, in response to academic research revealing a host of hidden costs borne by SPAC shareholders, the proposed rules would require extensive new disclosures by SPACs regarding conflicts of interest, a fairness determination for any de-SPAC transaction and an assessment of potential shareholder dilution. The plaintiffs' bar has independently attacked conflicts of interest inherent in the structure of SPACs, and in a decision this past January in *In re MultiPlan Corp. Stockholders Litigation*, the Delaware Chancery Court applied the entire fairness standard to a de-SPAC transaction, refusing to dismiss claims of breach of fiduciary duty against the SPAC directors and other parties associated with the de-SPAC.

Although there will likely be some residual SPAC activity as existing SPACs either find targets with which to merge or, failing to do so, wind up their operations, the future of this market is bleak. Given historically poor returns, rising interest rates, scrutiny by the plaintiffs' bar and SEC rules eliminating regulatory arbitrage with respect to traditional IPO processes, we have every expectation that the widespread use of SPACs to bring a company public is likely gone for the near term.

The White Lotus: *Twitter* Ultimately Leaves the Delaware M&A Litigation Landscape Unchanged

Easily 2022's most media-friendly lawsuit, *Twitter v. Musk* raised classic considerations for M&A deal participants. Most significantly, the case tested a purchaser's ability to get out of a deal. Musk accused Twitter of materially breaching its obligations under the merger agreement by refusing to provide him with information about allegedly fake accounts. Additionally, there were questions about whether the financing Musk had originally lined up to help fund the deal would come through as expected after Musk spent months disparaging Twitter and the overall market, including media stocks, declined. If permitted to abandon the deal, Musk would have been forced to pay a $1 billion reverse termination fee, but Twitter asserted that the Court should order specific performance and compel Musk to complete the transaction. However, after the Delaware Court of Chancery granted an expedited timeline for the case, Musk closed the deal to acquire Twitter on October 28, 2022, the final day before the trial would have moved forward, seemingly leaving questions regarding the availability and practicality of specific performance unresolved.

Better Things: Looking Ahead to 2023

Volatile equity markets, rising interest rates and economic uncertainty are expected to continue into 2023. The Fed's goal for 2023 is to get inflation as close as possible to the long-term target of 2% without plunging the economy into a recession. While a number of economic signs indicate that efforts to slow demand are working, the threat of a recession still looms. Nevertheless, 2023 may serve as a good buying opportunity for purchasers looking to acquire businesses or assets at depressed prices. Given the strong U.S. dollar, we may also see more acquisitions of European assets by U.S. buyers. Generally, we can expect to see an increase in distressed sellers and corporate carve-out transactions, which may be catalyzed in part by heightened levels of shareholder activism activity. For deals that are completed, expect more earn-outs (or other mechanisms for deferred consideration to bridge valuation gaps). In the end, although the impacts of inflation, rising interest rates and continued geopolitical conflicts are likely to persist, if M&A participants can remain agile and resilient as we embark on the new year, 2023 can offer a unique opportunity for businesses and deal participants alike.

CONGRESS ENACTS SUBSTANTIAL INCREASE IN U.S. MERGER NOTIFICATION FILING FEES FOR LARGE DEALS

By Michael H. Knight, Peter J. Love, Pamela L. Taylor and Craig A. Waldman

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The Consolidated Appropriations Act, 2023 ("CAA"), the omnibus spending bill that Congress passed to fund the government in 2023, introduces additional Hart-Scott-Rodino ("HSR") merger notification filing fee thresholds, increases filing fees for large transactions, and decreases fees for small transactions. Filing fees will increase for more than half of notifiable transactions. The government last updated the filings fees in 2001 when it introduced the existing three-tier fee structure.

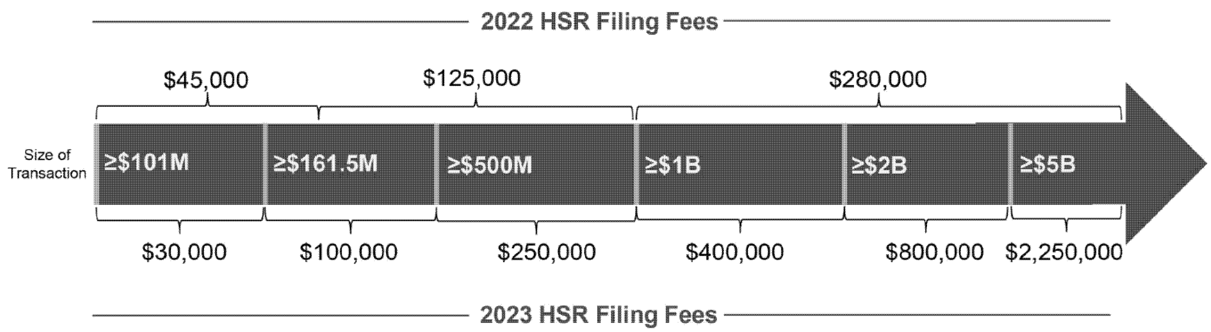
Figure 1 (see following page) illustrates changes from the existing filing fees to the new six-tier structure. Filing fees will be lower for transactions valued:

- Between $101 million and $161.5 million, decreasing from $45,000 to $30,000 for those deals; and
- Between $202 million and $500 million, decreasing from $125,000 to $100,000 for those deals.

For all other reportable deals, the filing fees will increase. For transactions valued at $1 billion or more (about 15% of notifiable M&A transactions), filing fee increases will be particularly steep:

- $400,000 for deals valued between $1 billion and $2 billion (a 43% increase);
- $800,000 for deals valued between $2 billion and $5 billion (a 186% increase); and
- $2.25 million for deals valued at $5 billion or more (a 704% increase).

Under HSR Act rules, the "size of transaction" may differ from headline deal value. The introduction of three additional filing fee tiers will require closer attention to valuation issues for more transactions to determine which filing fee applies for deals close to a threshold.



The new rules also adjust the filing fees annually based on the change in the Consumer Price Index. The new filing fees will take effect in 2023 after the Federal Trade Commission notice of the change in the fee schedule.

Disclosure of Subsidies from a "Foreign Entity of Concern"

The CAA also requires the Antitrust Division of the Department of Justice, FTC, Committee on Foreign Investment in the United States, and other federal agencies to develop new document or information requests for the HSR Form. Those requests must help the DOJ and FTC determine whether an acquisition involving a company that received a subsidy from a "foreign entity of concern," defined in 42 U.S.C.A. § 18741(a), including the governments of China, Iran, North Korea, and Russia, would violate the antitrust laws.

As highlighted recently, the European Union will require prenotification of certain large M&A transactions and public bids involving companies that receive subsidies from governments outside the EU starting in October 2023.[1]

The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

ENDNOTES:

[1] https://www.jonesday.com/en/insights/2022/12/eu-foreign-subsidies-regulation-filings-mandatory-starting-in-october-2023.

DOING DEALS IN JAPAN *REVISITED*: AN UPDATED INTRODUCTORY GUIDE FOR U.S. PRACTITIONERS

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The Japanese M&A market is in full swing. According to data from Mergermarket, (i) in 2021 there were a total of 109 inbound M&A transactions to Japan (a 47.3% increase from the previous year) amounting to a disclosed deal value of approximately $31.7 billion (a 230.7% increase from the previous year), and (ii) during the nine months ending on September 30, 2022, there were a total of 127 inbound M&A transactions (a 98.4% increase from the prior corresponding period) amounting to a disclosed deal value of approximately $26.5 billion (a 10.9% increase from the prior corresponding period). Similarly, Japan foreign direct investment inflows over 2021 increased by approximately 130% over the prior year according to data published by UNCTAD, with the United States being the single largest net investor into Japan.

There are many reasons for the attractiveness of the

Japanese market, including (i) Japan is the third-largest economy in the world, with a population of approximately 125 million (offering access to a large and broad-based market of sophisticated and affluent consumers), (ii) the Japanese yen has depreciated by approximately 30% against the U.S. dollar since the beginning of 2022 due to differences in monetary policies (resulting in lower purchase prices in U.S. dollar terms), (iii) the inflation rate in Japan is only 3.0% (one of the lowest among developed economies), (iv) wages in Japan have remained essentially flat for over a decade (allowing businesses to easily predict labor costs), and (v) the recent pivot from China due to political and industrial policy concerns has naturally placed Japan in the spotlight thanks to its stable political system, recognition of the rule of law, and its treaty relationships with numerous countries.

Japanese companies also continue to have an insatiable appetite for outbound M&A. According to data from Mergermarket, in 2021 there were a total of 443 outbound M&A transactions from Japan (a 19.4% increase from the previous year) amounting to a disclosed deal value of approximately $85.6 billion (a 193.7% increase from the previous year). Japanese companies are particularly attracted to the U.S. market. Over the 12 months ending on October 31, 2022, Japanese companies acquired 148 companies domiciled in the United States for a disclosed deal value of approximately of $19.50 billion (making Japanese companies the third largest purchaser of U.S. companies, behind Canadian and UK companies). As countries begin to slowly move away from pandemic travel restrictions, it is expected that Japanese outbound M&A will further increase as many earlier deals were either placed on hold or not pursued due to the proclivity of Japanese management to hold face-to-face meetings and to conduct on-site due diligence sessions before a deal can proceed.

With Japanese inbound and outbound M&A shifting into high gear, now is an opportune time for U.S. dealmakers to gain a basic understanding of Japanese M&A techniques in order to better advise U.S. and Japanese clients through comparative analysis and to anticipate (and manage) deal "blind spots." There are many stark differences in the methods to acquire a Japanese company and the ways to transact business in Japan when compared to U.S. laws and practices. This article does not purport to explain all the variances between U.S. and Japanese M&A techniques and practices, but aims to highlight the principal differences in (1) corporate governance, (2) M&A acquisition methods, and (3) the application and enforcement of contractual rights.[1]

Corporate Governance

Understanding the corporate governance structure of a Japanese company has multiple benefits. At a minimum, it enables purchasers of Japanese assets to better understand with whom they should negotiate and whether inherent conflicts of interest reside at the board level, the powers and limitations of the Japanese negotiating team, and the overall corporate decision-making process. In addition, Japanese companies entering the U.S. market may use their corporate governance systems as the framework for analyzing the U.S. deal team and the level at which negotiations should take place, and U.S. counsel's prior understanding of these systems may prevent unnecessary confusion and time delays in completing the deal.

A principal driver of Japanese corporate governance is the Corporate Governance Code, which was originally formulated by the Tokyo Stock Exchange and became effective in 2015. The Corporate Governance Code is a set of principles for companies listed on the Tokyo Stock Exchange aiming to ensure their sustainable growth, as well as to enhance their mid-to-long term corporate value. Listed companies are required to comply with the Corporate Governance Code or explain why they are not in compliance, so adherence is not mandatory. Every three years the Corporate Governance Code is amended. Increased representation of independent outside directors is one of the pillars of the 2021 amendments to the Corporate Governance Code.

Although Japan's corporate governance appears to becoming more closely aligned to the U.S. model in the publicly traded company context, in actuality there still exist fundamental differences. For example, the Revised Model Business Corporation Act and Delaware corporate law state that the business and affairs of every corporation should be managed under the direction of its board of directors.[2] Depending on a company's choice of its corporate governance structure, the Companies Act of Japan ("Companies Act") does not necessarily require a board of directors-centered supervisory structure (so corporate governance changes at the board level can be less poignant). [3] The Companies Act also allocates a portion of the supervisory function to the company's shareholders and statutory auditor (*kansa-yaku*).[4] Consequently, some of a board's traditional supervisory function and role as a check on executive abuse of power normally found in the U.S. corporate governance model is performed by other actors as well as board members in Japan. This difference in supervisory approach has influenced how the rights and responsibilities of directors and shareholders are apportioned under the Companies Act.

Shareholder Rights

While shareholders in a Delaware company may cast their votes upon the election of directors, an amendment to the company's certificate of incorporation, the dissolution of the company, or a fundamental corporate change (such as a merger or a sale of all or substantially all of the company's assets), the Companies Act provides shareholders (depending on their percentage ownership level) with a panoply of rights above those afforded to shareholders in a Delaware company, including the right to determine dividend payments, approve the sale of shares at a discounted price or involving a change in control, petition a court to dissolve the company, and establish the upper limit of the aggregate amount of compensation to be awarded to all directors.[5] Furthermore, the articles of incorporation of a Japanese company can be amended by only a shareholders' resolution (*i.e.*, the shareholders may propose an amendment to a company's articles without obtaining the board's approval).[6] Shareholders of Japanese companies, therefore, typically have greater and wider voting rights than shareholders in Delaware corporations.

Board of Directors

There are salient differences between U.S. and Japan boards of directors, such as (i) Japanese boards are relatively more insider-dominated, (ii) there are limitations on who is authorized to lawfully bind a Japanese company, and (iii) fewer powers can be delegated by a board of directors to a board committee. In addition, directors in Japan face greater exposure to personal liability because their business decisions can be second guessed by courts, unlike directors in the United States who can rely on a more robust business judgement rule to shield themselves from liability.

Insider-dominated boards. While a majority of the directors in U.S. public companies are usually independent directors and many U.S. private companies have independent board members, in Japan a majority of the board members still concurrently serve as senior executives of the company in almost all listed companies and most private companies. To address the lack of director independence at the listed company level, over the past 10 years the Japanese government has overhauled the director independence requirements under the Companies Act and the Tokyo Stock Exchange has amended its listing maintenance rules.[7] As a result of these efforts, the composition of board members in Japanese listed companies has significantly shifted towards independence over the past 10 years, but still remain controlled by insiders. A report published by the Tokyo Stock Exchange on August 3, 2022, revealed that of the companies listed on the Tokyo Stock Exchange Prime Market (the section of the Tokyo Stock Exchange reserved for the largest and most profitable companies), 92.1% had a board in which at least one-third of the members were independent directors (up from 6.4% in 2014), while only 12.1% of all Tokyo Stock Exchange Prime Market listed companies had a board comprised of a majority of independent directors (up from 1.4% in 2014).[8]

Apart from the composition of boards, practitioners should be aware that the expected role of independent directors in Japan may be different from that in the United States. For example, independent directors of Delaware companies are expected to act solely in the best interest of the company's shareholders in the absence of a constituency statute. On the other hand, independent directors of Japanese listed companies are explicitly tasked under the Corporate Governance Code to represent "the views of minority shareholders *and other stakeholders*" (emphasis added). For example, in connection with the sale of a company or a business division, the board of a Japanese corporate seller would not breach its fiduciary duties if it accepts a lower-price bid that firmly commits to maintain levels of employment and compensation at the target company and rejects a higher-price bid that does not have such HR commitments. This preference likely arises from Japanese directors' stakeholder-oriented understanding of their fiduciary duties.

Limited binding authority. The board of directors of a Japanese company must appoint one or more Representative Directors (*daihyō torishimari-yaku*) from among its directors to have the authority to represent the company (*i.e.*, execute contracts on behalf of the company). Historically, a Japanese company was required to appoint at least one individual who was a resident of Japan to serve as its Representative Director; however, this residency requirement was eliminated as of March 16, 2015, so now there are no director residency requirements. The name of each Representative Director is listed in the company's publicly-available commercial registry in order to provide notice of such binding authority to third parties.

U.S. practitioners may incorrectly assume that persons holding a title that appears equivalent to a senior executive position have the authority to legally obligate a Japanese company. This binding authority, however, is ordinarily non-existent. Many Japanese companies often refer to their highest level employees as "executive officers" (*shikkō yakuin*), but unless a special delegation has been made to such persons, they ordinarily will not have the authority to enter into contracts on behalf of the company.[9] When transacting with a Japanese company, therefore, the deal team should be sensitive to the divergence between title and actual power, and U.S. practitioners should anticipate that Japanese clients may be skeptical if a vice president or line manager claims to have the authority to execute contracts on behalf of the company (and may seek a legal opinion to confirm such authority, as opposed to relying on a corporate secretary's certificate).

Limited delegation of board authority. Unlike Delaware corporate law, the Companies Act does not permit a Japanese board to fully delegate its power and authority to a committee (even if the committee consists entirely of directors). When facing matters that require board approval, a Japanese company is actually required to hold a full board meeting or, if its articles of incorporation permit, pass a board resolution by way of unanimous written consent of its directors. In spite of these limitations, the establishment of a special or voluntary committee assigned with specific tasks is becoming more common in Japan, as discussed below in "M&A Acquisition Methods." Also, listed companies from the mid-2010s began to establish a "voluntary" committee to deliberate the nomination of senior management and director candidates and the details of their compensation in accordance with the Corporate Governance Code. For example, 79.7% of the Tokyo Stock Exchange Prime Market listed companies currently have a voluntary nomination committee (up from 7.8% in 2015), and 81.6% have a voluntary compensation committee (up from 10.7% in 2015). Although the resolutions of these committees are non-binding, they are expected to be respected by the entire board to the fullest extent possible.

Business judgments subject to judicial oversight. The relationship between a company and its directors is governed in Japan by the principle of agency. As an agent for the company, a director has a fiduciary obligation to conduct the affairs of the company with the "duty of care of a prudent manager." A director's satisfaction of the duty of care of a prudent manager is usually evaluated under the equivalent of what is commonly termed the "business judgment rule," however, this rule may provide shallow comfort for directors in Japan. Under Japan's business judgment rule, established by the Supreme Court of Japan in the *Apamanshop Holdings* case, Japanese courts are expressly permitted to consider whether a reasonable basis exists for board decisions (unlike Delaware courts, which normally give wide latitude to the decisions of the board of directors, unless the plaintiff can satisfy a heavy burden of proof).[10] Consequently, directors in Japan can be routinely exposed to second guessing by courts. For example, on July 13, 2022, the Tokyo District Court ordered four former senior executive directors of Tokyo Electric Power Company to jointly and severally pay approximately $97 billion to the company because the judges ruled that these directors should have recognized the possibility of a huge tsunami hitting the power plant complex based on a 2002 government study (even though the directors argued that the 2002 government study was not credible in their expert opinion, and a month earlier Japan's Supreme Court held that the Japanese government was not required to pay Fukushima residents compensatory damages arising from the nuclear disaster because a tsunami of that magnitude was not foreseeable).

M&A Acquisition Methods

While Japanese acquisition techniques vary depending on whether the target is listed or privately held, certain background principles cut across both public and private M&A transactions.

Background Principles

Formation of acquisition vehicle. A company not organized under Japanese law cannot merge or enter into a statutory corporate combination with a Japanese company. Establishing a new Japanese company could have negative tax implications for a purchaser if assets must be transferred to the new Japanese subsidiary, and also may delay the deal's timetable and significantly raise transaction costs. In particular, unlike the ability to incorporate a Delaware company overnight, completing the registration of a newly-established Japanese company will normally take approximately one week after the necessary paperwork is submitted to the local registry (completing the paperwork for new entrants to Japan often takes approximately three weeks). Using shelf companies is not common in Japan due to the inability to confirm that there are no prior "hidden" or contingent liabilities. Furthermore, although the stated capital (*shihon kin*) of a Japanese company technically can be one Japanese yen, many operating companies have a stated capital of approximately one million Japanese yen or more due to the local bias toward conducting business with financially strong and prestigious companies, and the stated capital is frequently viewed as an indicator of financial health.[11] The concept of shares with a par value no longer exists under the Companies Act.

Foreign direct investment regulations. Effective on June 7, 2020, Japan's foreign direct investment regulations underwent a major overhaul because the Japanese government believed that it lacked legislation to effectively screen foreign direct investment to the same extent as other developed countries. Consequently, the Japanese government revised its foreign direct investment regulations by (i) lowering the Japanese government approval threshold from 10% to a mere 1% for the acquisition of shares of listed companies that engage in a wide range of business activities deemed critical to Japan, (ii) requiring Japanese government approval for an overseas investor to exercise certain shareholder rights, and (iii) expanding the scope of persons who must obtain the approval of the Japanese government for an inbound investment (*i.e.*, persons considered a foreign investor was enlarged). However, Japanese government approval for a share acquisition of a listed Japanese company may not be required depending on a complex analysis of the number of shares being acquired, the type of foreign investor, whether the foreign investor agrees to curb its shareholder rights, the business activities of the target Japanese company, and the history of regulatory compliance by the foreign investor. On the other hand, a foreign investor acquiring as little as one share and as many as all of the shares of a privately owned Japanese company may need to obtain prior Japanese government approval depending on the business activities of the target Japanese company and whether the foreign investor agrees to curb its shareholder rights. A key distinction between U.S. and Japanese foreign direct investment regulations is that even after an acquisition, Japanese government prior approval may continue to be required each time the foreign investor seeks to exercise certain shareholder rights depending on ownership level and the government consents obtained by the foreign investor.[12]

Choice of acquisition methods and tax considerations. Similar to a U.S. target, a Japanese target can be acquired through an asset sale (referred to locally in English as a business transfer), stock purchase or merger. While an asset acquisition may be the initial option if the purchaser wishes to acquire only a portion of the target's business or to potentially avoid the assumption of certain liabilities of the target, stock acquisitions or mergers are the most common acquisition methods in Japan due to the seller being required to recognize the unrealized gain on the transferred assets and the purchaser not being able to inherit net operating losses and loss carryforwards from the seller.

In Japanese stock purchase transactions, the target shareholders frequently will be subject to Japanese national and local income tax if the purchase price for their shares is greater than the book value.[13] The target, on the other hand, is not required to recognize a capital gain on its assets or goodwill. In this respect, a stock purchase transaction offers tax advantages over a cash merger, and it is frequently used as the acquisition method for a cash deal.[14]

For mergers and other corporate combinations involving Japanese companies, the target will be required to recognize a capital gain on its assets and goodwill, unless the several requirements outlined in the table below are met. The requirement that the purchaser use its (or its direct parent's) shares as the sole consideration in order to obtain Japanese capital gains tax deferral is likely the main reason why mixed consideration (cash plus stock) is rarely used in Japan in the corporate combination context.

Capital gains or losses can be deferred at both the target and shareholder level in a qualifying merger or other qualifying form of corporate combination if the following requirements are satisfied:[15]

Requirements	**Qualifying Forms of Corporate Combinations**		
	100% Relationship[a]	<100% but >50% Relationship[b]	<50% Relationship
Consideration	Only purchaser shares or shares of purchaser's direct parent who owns (and is expected to continue to own) all of purchaser's shares[c]		
Employment	None	Approximately 80% of target's employees must be expected to continue to be employed (*Requirement applicable to the transferred business in a qualified corporate split or contribution-in-kind*)	
Business Continuity	None	Principal business of target must be expected to continue (*Requirement applicable to the transferred business in a qualified corporate split or contribution-in-kind*)	

Requirements	**Qualifying Forms of Corporate Combinations**		
Other	None	Principal assets and liabilities of the transferred business must be transferred to purchaser in a qualified corporate split or contribution-in-kind	● Mutual connection between the principal business of target and any business of purchaser (*Requirement applicable to the transferred business in a qualified corporate split or contribution-in-kind*) ● Target's controlling shareholders, who own directly or indirectly a majority of shares in target before the transaction, must continue to hold shares of purchaser (or the shares of its parent if used as the consideration) ● Principal assets and liabilities of the transferred business must be transferred to purchaser in a qualified corporate split or contribution-in-kind ● Either of the following: (i) sales amount, number of employees or other similar characteristics of target's principal business or a related business of purchaser is no more than approximately five times greater than the size of that of the other; or(ii) at least one senior manager of target and purchaser before the transaction will be appointed a senior manager of purchaser after the transaction (*and in the case of a qualified share exchange or share transfer, none of target's senior management resign upon the closing or shortly thereafter*)

a: Target or purchaser must own directly or indirectly all of the shares issued by the other party, or all of the shares of both the target and purchaser must be directly or indirectly owned by the same individual or company. Such capital relationship must be expected to continue.

b: Target or purchaser must own directly or indirectly less than 100% but more than 50% of the shares of the other party; or less than 100% but more than 50% of the shares of both the target and purchaser must be directly or indirectly owned by the same individual or company. Such capital relationship must be expected to continue.

c: At the target level in a qualified merger or share exchange, this consideration requirement no longer applies if the purchaser (the surviving company in the case of qualified merger or the parent company in the case of qualified share exchange) holds two-thirds or more shares of the target (the merged company in the case of qualified merger or the subsidiary in the case of qualified share exchange). On the other hand, the target shareholders are subject to capital gains tax if they receive any assets other than the shares of the purchaser or its parent.

While the availability of a tax-free U.S. corporate acquisition often depends on the results of a "continuity of interest" analysis, Japanese tax law appears to require the continuity of corporate organization at the target level as well as the target shareholders' continuity of investment. Generally speaking, therefore, an inverse relationship exists between the number of factors that must be satisfied and ownership percentage—as the target or purchaser's ownership percentage increases in the other party, the number of factors that must be satisfied to effect a tax-free qualified merger or other qualifying form of corporate combination decreases. It also goes without saying that the factors in the table above are vague and open to interpretation, so counsel should be instructed at an early stage if tax-free status is desired.

Japan still maintains a medieval-like stamp tax scheme of requiring the placement of a physical stamp (that can cost up to several thousand dollars) on certain documents in order to generate revenues for the government. While share purchase agreements are not listed as a document subject to the stamp tax, asset purchase agreements, merger agreements and real estate transfer agreements are subject to this levy. Though ripe for future amendment, currently a stamp tax does not arise if the last person signing the agreement is physically located outside of Japan at the time of such signing, or if all of the parties to the agreement sign electronically/there are no wet signatures (as the tax applies only to tangible agreements).

Public M&A Transactions

The two principal areas of difference when comparing U.S. and Japanese public M&A techniques are tender offer regulations and permissible defensive measures. On the other hand, steps to protect the interests of minority shareholders in management buyouts and acquisitions by controlling shareholders are becoming more closely aligned.

Tender offer regulations. While U.S. and Japanese tender offer regulations share many common elements, there are fundamental differences.[16] For example, generally speaking, Japanese tender offer rules are automatically triggered when a purchaser increases its beneficial ownership[17] in a Japanese reporting company above one-third through one or more "off-market transactions" or above 5% through transactions conducted "outside the market" with more than 10 persons during a rolling 60-day period.[18]

In addition, if a purchaser acquires more than 5% of the voting rights in a Japanese reporting company in one or a series of "off-market transactions" during a rolling three-month period, then generally speaking the purchaser may not acquire additional shares in any manner whatsoever that would increase by more than 10% its aggregate voting ownership level in the target over a three-month period (which ownership increase includes the transaction that brought the purchaser over the foregoing 5% ownership threshold) if as a result thereof its ownership level in the target would exceed one-third.[19]

Structuring the terms of a Japanese tender offer also can be more restrictive in comparison to options available under U.S. tender offer rules. For example, a purchaser can condition its tender offer only upon events specified by statute, such as the receipt of governmental approvals (but not the ability to obtain financing or the absence of a material adverse change), and a purchaser cannot withdraw its offer unless an event specified by Japanese securities laws occurs.[20] Furthermore, after the commencement of a tender offer (which occurs after the publication of the tender offer commencement notice), a purchaser may not decrease the tender offer price, decrease the number of shares or the minimum number of shares to be purchased, shorten the tender offer period, change the consideration of the tender offer, or change the withdrawal conditions listed in the tender offer documents. Also, if a purchaser intends to become an owner of no less than two-thirds of the voting rights in a Japanese reporting company, then it cannot launch a partial tender offer.

Other principal differences include:

- pre-commencement tender offer communications by the parties are not required to be filed with Japanese regulators;
- the purchaser is required to provide the Japanese regulator with evidence that it has ample funds to complete the offer at the proposed tender offer price (such as a bank statement that denotes it has sufficient funds);
- the equivalent of the "best price rule" under Japanese tender offer rules requires that the consideration offered to tendering shareholders through the tender offer be the same in form and amount, but such criteria normally does not require an examination of the arrangements entered into between the purchaser and the target's shareholders outside the tender offer, absent extreme circumstances (dispensing with the specific U.S. substantive standards applicable to employment compensation, severance, and other employee benefit arrangements with security holders of the target, and reducing the uncertainty that may exist with respect to commercial arrangements entered into between the purchaser and certain target shareholders at the time of the tender offer); and
- the initial and any subsequent tender offer period cannot in the aggregate extend beyond 60 business days from the commencement date.[21]

Defensive measures. Unsolicited transactions are becoming more prevalent in Japan, but the number of hostile acquisitions of Japanese companies pales in comparison to the United States.[22] The most recent annual survey conducted by Sumitomo Mitsui Trust Bank reports that as at the end of July 2022, 266 listed Japanese companies (*i.e.*, 6.9% of all the listed companies) have adopted anti-takeover mechanisms (down from the peak of 570 in July 2008), principally in the form of "advance warning" (*jizen keikoku*) public notices that detail (i) the procedures that a purchaser should follow in order for the board (or shareholders) to consider an acquisition proposal, and (ii) the potential defensive measures the company may take. The use of U.S.-style "poison pills" in Japan remains rare.[23]

A series of cases decided in 2005 promoted the use of "advance warning" by Japanese listed companies. In the *Nippon Broadcasting* case, the Tokyo High Court articulated that, in the context of disputes over corporate control, unless the target succeeds in proving that the purchaser is an "abusive acquiror," then the court should grant injunctive relief to stop the target from effecting anti-takeover mechanisms.[24] The Tokyo District Court, which had suggested in the *Nireco* case that the court will make a rebuttable presumption that a purchaser who violates the procedural provisions stipulated in the target's "advance warning" notice is an "abusive acquiror," held the following month in the *Japan Engineering Consultants* case that the target's board may require a hostile purchaser to present a business plan and allow the board sufficient time to examine its proposal in order for the target's shareholders to have adequate time to decide whether the hostile purchaser or the current directors should manage the target.[25] If the purchaser declines to comply with these reasonable requests, then the court held that the board, to the extent permitted by law, may take reasonable anti-takeover measures against the purchaser.[26]

A recently introduced form of anti-takeover measure is gaining traction in Japan. Since 2020, a number of Japanese companies have adopted "emergency anti-takeover measures." This scheme is similar to the U.S. practice of a "morning-after" poison pill (*i.e.*, a poison pill that is adopted by the target after a takeover bid is made), with the following major differences: (i) the measure is applicable only to the specified purchaser, (ii) the purchaser receives "conditional" share purchase warrants and other shareholders receive the company's new shares, (iii) the purchaser's warrants are exercisable only if the purchaser withdraws its ongoing takeover proposal and commits not to make any other unsolicited bids for the target in the future, and (iv) the purchaser is allowed to exercise its warrants only up to a pre-determined threshold (typically, 20% or the purchaser's pre-bid ownership level). The measure is designed to allow the purchaser to escape from suffering any economic losses so long as it withdraws its takeover bid and stays at the pre-bid ownership level, thereby forcing the purchaser to refrain from gaining control over the target.

Judicial decisions are divided over the permissible use of emergency anti-takeover measures. In the *Japan Asia Group* case, the Tokyo High Court suspended the emergency anti-takeover measure primarily because it did not receive the approval of the target's shareholders.[27] Soon after the *Japan Asia Group* case, however, different panels of the Tokyo High Court affirmed the trigger of emergency anti-takeover measures against investment fund purchasers. In the *Fuji Kosan* case, the trigger of the emergency measure received the approval of Fuji Kosan shareholders owning approximately 66% of its outstanding voting rights,[28] while in the *Tokyo Kikai Seisakusho* case the trigger was conditioned on the approval of a "majority of the minority" and received the approval of approximately 79% of the company's outstanding voting rights (excluding, for purposes of vote tallying, the shares voted by the hostile purchaser and the target's directors) at a "voluntary" shareholders' meeting (*kabunushi ishi kakunin sōkai*).[29] In the *Mitsuboshi* case, by contrast, the Osaka High Court suspended the trigger of an emergency anti-takeover measure against an investment fund purchaser's attempt to replace the target's incumbent management through a proxy contest even though the trigger of the measure was approved by the target's shareholders.[30] The court held that in the target's emergency anti-takeover measure, the purchaser was practically prevented from withdrawing its proposal (which withdrawal would have allowed it to escape from suffering the measure's economic losses), so the measure was inconsistent with the target's alleged purpose of procuring sufficient time and information to enable its shareholders to assess the purchaser's proposal.[31]

Staggered boards also rarely appear as a Japanese anti-takeover tactic because this mechanism normally is not helpful. While Delaware corporate law allows shareholders to remove directors sitting on a staggered board only for cause, Japanese corporate law allows the majority shareholders (or two-thirds majority, if the target's articles of incorporation so provides) to remove any director with or without cause at any time. Accordingly, a purchaser who acquires more than a majority of the outstanding voting interests in a Japanese target can gain control over the target's board. A raiding purchaser, however, may not be able to swiftly remove incumbent directors because the Companies Act requires a company to actually hold a shareholders' meeting to adopt shareholder resolutions, unless all shareholders unanimously agree in writing to the matters being resolved (which unanimity requirement cannot be altered by the target's articles of incorporation).[32]

Management buyouts and other conflict of interest transactions. In June 2019, Japan's Ministry of Economy, Trade and Industry published its "Fair M&A Guidelines," an influential paper that significantly updates its prior guidance on how a management buyout and a controlling shareholder going private transaction should be conducted. The new guidelines provide steps to help ensure that a management buyout and other potential conflict of interest transactions are conducted fairly and are not abusive to minority shareholders (and resemble the measures espoused in *Kahn v. M&F Worldwide Corp.*). The Fair M&A Guidelines are not binding, but are considered by many dealmakers as mandatory best practices for both conflicted and many ordinary public transactions. According to the Fair M&A Guidelines, implementation by the target of all or most of the following measures should be used to ensure a fair process towards minority shareholders (thereby obviating the need for court intervention): (i) establishing a special committee composed of independent outside directors, independent outside statutory auditors and/or independent outside professionals to either make a recommendation towards the transaction or to directly negotiate the transaction, (ii) obtaining an external expert's opinion as to the fairness of the transaction from a financial point of view, (iii) undertaking a market check (including a go-shop), (iv) imposing a "majority of the minority" approval requirement, (v) implementing full disclosure of the acquisition process to create transparency, and (vi) excluding compulsory pressure tactics towards the minority shareholders (such as assuring that an appraisal remedy will be available and disclosing upfront that the second step squeeze-out price will be no lower than the first step tender offer price). Among the foregoing measures, the existence of an independent special committee is regarded as especially important, since the independent committee is expected to directly represent the interests of both the target and its minority shareholders (though most do not retain separate legal and financial advisors even though such retention is recommended by the Fair M&A Guidelines, but we expect this approach to reverse and more independent special committees will retain independent advisors). Obtaining fairness opinions are still uncommon in Japan M&A transactions (except in a going-private transaction of a listed subsidiary).

Private M&A Transactions

The practices adopted by Japanese parties to undertake a local private business combination differ significantly from U.S. norms. It wouldn't be unprecedented in Japan for a large domestic transaction to be documented in a 30-page or shorter acquisition agreement. Although listing all of the differences between a U.S.-style versus a Japanese style private acquisition agreement would extend beyond the scope of this article, the following are some of the notable differences:[33]

- Similar to U.S. practices, representations and warranties covering the basic business operations of the target are common in domestic private transactions, as well as specially-tailored representations and warranties addressing matters uncovered during the due diligence process. However, detailed or comprehensive representations and warranties are normally not included for matters concerning employee benefits, environmental liabilities, specific items from the financial statements (*e.g.*, accounts payable, inventory, backlog, etc.), accounting practices, tax, or real property. Nevertheless, the inclusion of a "full-disclosure" representation and warranty remains a current market practice, especially since management interviews are an important source of information in the due diligence process.

- The use of escrow agreements to hold-back a portion of the purchase price to settle indemnification claims and other post-closing obligations of the sellers only recently has been a plausible option in the local M&A scene due to the introduction of financially stable escrow agents offering the traditional services of an escrow agent at a reasonable price; however, the use of escrow arrangements is still very infrequent. Recently, the use of representation and warranty insurance has gained traction in Japan because local insurers now accept Japanese language acquisition agreements and due diligence reports, and insurers can issue the policy in Japanese (previously, all had to be in English because the underwriting team was based overseas). Purchase price holdbacks and earn-outs are possible alternatives in the private acquisition context, but neither is currently widely used in Japan.

- While indemnification provisions with baskets and caps are common features in Japanese private acquisition agreements, it is uncommon for agreements to contain (1) double materiality scraps, (2) pro-"sandbagging" clauses (to the contrary, anti-"sandbagging" clauses are often initially inserted even though the default rule in Japan appears to be anti-"sandbagging" when the agreement is silent on this issue), (3) a tax gross-up for indemnification payments (or claim off-sets for tax benefits resulting from the indemnification claim or insurance proceeds received), or (4) detailed procedures on how claims made by third-parties should be handled and controlled.

- Private acquisition agreements normally do not contain a separate section detailing how taxes of the target incurred prior to the closing should be handled, and if such tax matters are addressed, reliance is often placed on a short indemnification clause holding the seller responsible for pre-closing tax obligations.

- The inclusion of a detailed definition for "material adverse effect" is uncommon and, if provided, the use of numerous exceptions to the definition is even less common.

- A fixed date is often inserted for the closing date, rather than a formula of a number of business days after the satisfaction of the conditions precedent, but a backstop date is often included in case the fixed closing date cannot be achieved. Japanese private acquisition agreements also normally contain comparatively more conditions precedent than U.S. private acquisition agreements, most notably by conditioning the sale on the absence of events having a material adverse effect (using an undefined term) and frequently a financing-out (though this condition is becoming less common).

- Reverse termination fees are appearing in transactions where regulatory clearance is critical for the deal (but the reverse termination right is normally not available to the purchaser if it cannot obtain financing).

Japanese legal principles and cultural patterns may play a role in the differences between U.S. and Japanese contract drafting conventions. In particular, Japanese law does not have the U.S. equivalent of the parole evidence rule. As a result, the parties to a dispute normally can submit all applicable evidence to a court, even if a contract contains an integration clause that states the contract represents the entire understanding of the parties and supersedes all prior communications regarding the subject matter of the agreement.[34] Parties to an agreement in Japan, therefore, may naturally tend to feel that it is not important to memorialize all of the deal terms in a definitive set of transaction documents since external communications typically can be submitted to explain and supplement the provisions of a contract.

Japanese parties also may prefer to defer upfront detailed discussions over controversial and sensitive deal points because the parties frequently place great importance on preserving initial goodwill, and each side normally expects that post-closing differences will be reasonably resolved without undertaking formal dispute resolution proceedings (regardless of what rights and privileges appear in the deal documentation). To support such sentiments, Japanese commercial agreements frequently contain a covenant that the parties will decide through mutual consultation and good faith negotiations any matter that is not expressly provided in the agreement. Consequently, Japanese parties may feel that it is unnecessary for deal documentation to contain lengthy provisions delineating the various intricacies of the commercial arrangement and numerous deal-breaking scenarios because such sensitive matters can be subsequently worked out upon an analysis of the actual facts and the totality of the circumstances.

Squeezing Out Minority Shareholders

Methods. Similar to prevailing U.S. practices, a controlling shareholder of a Japanese company technically can utilize a cash-out merger to squeeze-out the minority shareholders of the target. However, until October 2017 a cash-out merger caused the target to incur a capital gains tax on its assets and goodwill, so Japanese companies developed unique methods of squeezing out minority shareholders (some of which are now so obscure, they are not addressed in this article).[35] Despite the dissipation of tax inefficiencies, the following continue to be common methods to squeeze-out minority shareholders depending on the ownership level of target shares by the purchaser: (i) the demand for sale of shares method and (ii) a reverse stock split:[36]

Demand for Sale of Shares Method (for purchasers *owning 90% or more of the voting rights)*. A cash squeeze-out of the minority shareholders by a supermajority controlling shareholder has been available to purchasers since 2015, and can be effected according to the following scheme:

- Once a purchaser achieves the status of being a "Special Controlling Shareholder" (as defined below) it is granted by operation of law with a conditional call option over all of the outstanding shares and other equity securities (*e.g.*, stock options and warrants) of the target not owned by the Special Controlling Shareholder, other than any treasury shares held by the target. The basic features of the conditional call option include: (i) it is created immediately upon a purchaser qualifying as a Special Controlling Shareholder, and no documentation needs to be prepared to issue the conditional call option to the Special Controlling Shareholder (since the conditional call option is created automatically by operation of law), (ii) it covers all of the outstanding shares and other equity securities of the target (not a portion or a class of securities, and it must be exercised in full), and (iii) there is no expiration date for the exercise of the conditional call option by the Special Controlling Shareholder. A "Special Controlling Shareholder" is defined as a person or entity that gains control of 90% or more (or a higher ownership threshold if stipulated in the target's articles of incorporation) of the total voting rights in the target, either alone or together with its wholly-owned subsidiary.

- To exercise the conditional call option, the Special Controlling Shareholder must (i) notify the target's board of directors in writing of its intention to exercise the conditional call option and provide the relevant details concerning its exercise (in particular, the proposed closing date for the share purchase and the purchase price for the shares and other equity securities held by the minority shareholders—which consideration must be in the form of cash), and (ii) request that the board of directors of the target accept the exercise of the call option by the Special Controlling Shareholder pursuant to such terms (which is why the call option is considered "conditional"). No direct communications between the Special Controlling Shareholder and the minority shareholders are required for the Special Controlling Shareholder to exercise its conditional call option, and the Special Controlling Shareholder cannot assign to a subsidiary (wholly-owned or otherwise) its rights under the conditional call option.

- The target's board of directors is required to act on behalf of the minority shareholders to protect their interests and to inform them of the details of the conditional call option exercise by the Special Controlling Shareholder. If the target's board of directors approves the call option exercise by the Special Controlling Shareholder, then the board must notify the minority shareholders in writing at least 20 calendar days prior to the proposed closing date for the share purchase.

Reverse Stock Split (for purchasers owning two-thirds or more of the voting rights). Upon approval by shareholders owning at least two-thirds of the voting rights (which includes the shares owned by the purchaser), the target can effect a reverse stock split pursuant to which (i) the consolidation ratio is set to a level that is sufficiently high to leave the minority shareholders with fractional share ownership after the split, and then (ii) the target pays cash to the minority shareholders instead of issuing fractional shares. A drawback of a reverse stock split is that it may not automatically apply to holders of stock options and other derivative securities, so an examination of these instruments will be necessary to determine if a reverse stock split can be applied to these holders.[37]

It is a frequent Japanese practice in friendly transactions for a purchaser to enter into a take-private acquisition agreement with the target prior to launching the first-step tender offer, which agreement typically stipulates the proposed consideration to be offered to the minority shareholders in the second-step squeeze-out transaction. By agreeing upfront the consideration to be offered in the second-step squeeze-out transaction (or the points to consider), it is not clear whether the consideration to be offered to the minority shareholders in a demand for sale of shares method or a reverse stock split ever could be fixed at an amount less than the first-step tender offer price. This is because the material details of the take-private acquisition agreement must be publicly disclosed and it would be an improper tender offer tactic to disclose that the minority shareholders will be squeezed out for a purchase price lower than the first-step tender offer price. However, in light of the holding in *Jupiter Telecommunications* (discussed below), transaction parties can minimize the risk that a purchaser would need to pay the minority shareholders a price greater than the first-step tender offer price.

Remedies. In a demand for sale of shares method, minority shareholders who object to a decision by the target's board of directors to accept the terms proposed by the Special Controlling Shareholder for the exercise of the call option can (i) exercise their appraisal rights and seek a court's determination of the fair value of their shares, (ii) seek an injunction to prevent the closing of the call option exercise, or (iii) file a lawsuit alleging a breach of fiduciary duties by the target's directors arising from its improper approval of the exercise of the call option. Minority shareholders who object to the reverse stock split have essentially the same foregoing remedies (except for technical differences in the appraisal remedy).

The Japan's Supreme Court holding in *Jupiter Telecommunications* has essentially closed the door on appraisal arbitrage in Japan. In this case, the Supreme Court held that if the tender offer is made in accordance with a process "generally accepted to be fair" and the bidder offers the same acquisition price that was paid following the first-step tender offer in the second-step cash squeeze-out transaction, then the court, in principle, should approve that same price as the fair value for the cashed-out minority shares.[38] The Supreme Court's holding marked a dramatic change in court precedents, where courts made their own valuation of fair price and frequently awarded dissenting shareholders an amount higher than the tender offer price that preceded the squeeze-out process. The *Jupiter Telecommunications* holding has dissuaded shareholders from initiating appraisal proceedings as a game tactic since the payment they will receive is likely to be the same as the tender offer price (so long as the transaction follows a fair process).[39]

Application and Enforcement of Contractual Rights

The inability to terminate certain contracts and the proclivity to resolve disputes outside of court are distinguishing factors of how contractual rights are honored and enforced in Japan.

Terminating Contracts

The principle of "freedom of contract" generally governs the interpretation of termination clauses under Japanese law, so the parties to an agreement generally have the right to end their contractual relationship in accordance with the terms of the arrangement. However, in the employment context or if a commercial agreement is characterized as a "continuous contract," then the ability to unilaterally terminate such arrangement in Japan is restricted.

The foregoing could have a critical impact on the valuation of a target if the purchaser mistakenly assumes that after the acquisition it can readily reduce the target's workforce and terminate all unfavorable "continuous contracts" simply by complying with an agreement's termination provisions.

Employment arrangements. Unlike many jurisdictions in the United States, an employer in Japan cannot terminate an employee without good cause. Even if an employment contract stipulates that an employer may terminate the employment relationship for any reason or no reason, such provision normally will be held unenforceable as an unlawful attempt to bypass Japanese labor laws. The threshold for "good cause" in Japan is extremely high in comparison to most U.S. standards. Article 16 of Japan's Labor Contracts Act stipulates that the termination of an employee in Japan is invalid unless there is "objective good reason" for the termination and it is "acceptable in light of socially accepted standards." The foregoing standard is not defined or explained by Japanese statutes, which has given Japanese courts great latitude to determine when this standard is satisfied.

Japanese courts, taking into consideration the lifetime employment system established in the Japanese business community, require employers to meet extremely high burdens of proof to support the existence of "objective good reason," even if the employment agreement or the company's work rules permit a lower threshold. To demonstrate an "objective good reason," an employer normally would need to show that (i) the employee committed a severe breach of the company's work rules or other rules relating to employment, (ii) the employee lacks competence or the necessary business skills, or (iii) the survival of the subject company's business requires that headcount be reduced.[40] Even if the employer succeeds in showing an "objective good reason," the court will not permit the termination unless it is persuaded that the termination is "acceptable in light of socially accepted standards."[41] In each instance, direct and substantial evidence must be submitted to convince a judge to accept the dismissal, and it is often especially difficult to convince a Japanese court that poor performance alone should warrant employment termination. Accordingly, a company in Japan will normally negotiate a severance package with the affected employees, which calls for the employer to pay several months' wages (or more) as a separation payment in exchange for the employee's voluntary resignation. A company's Representative Director(s) and most likely its directors who hold executive authority do not benefit from the pro-employee provisions of Japanese labor laws.

Due to the significant restraints on terminating employees, employers in Japan often enter into fixed-term employment contracts. Japanese law generally permits fixed-term employment contracts of up to three years in length (the cap can be extended to five years for certain highly-skilled employees and persons aged 60 or older). The fixed-term employment contract will generally terminate at the end of the stated term, but can be renewed by the parties. Whether or not the employment contract is renewable, and the criteria for renewal, must be stated in the agreement. While a fixed-term employment agreement may prove useful to an employer in Japan who is uncertain about its future employment needs, if a fixed-term agreement is renewed repeatedly, the relationship with the employee may be deemed to be similar to a regular employment relationship and it will be more difficult for the employer not to renew the employment contract.[42]

Distribution, franchise and supply agreements. A "continuous contract" is generally understood in Japan as a contract under which a party is required to perform a duty continuously by virtue of the nature of the duty (*i.e.*, the duration of the agreement does not directly dictate whether an agreement is considered continuous, but the underlying type of obligation and whether such obligation by its nature should be performed continuously are the determining factors). Many Japanese lower court precedents treat distribution agreements, franchise agreements and supply contracts as "continuous contracts" due to the ongoing and long-term requirement of one party to supply and the other party to purchase the subject matter of the particular contract. If a commercial agreement is characterized as a "continuous contract," a Japanese court is likely to require a "justifiable and unavoidable reason" in order to allow the unilateral termination of such agreement.[43] Japanese courts place a high burden on a party seeking to terminate a "continuous contract" (even if the agreement permits unilateral termination) because the non-terminating party typically will make business decisions relying on the expected long duration of the agreement (and Japanese courts believe that such reasonable expectations should be protected). Accordingly, a one-sided cancellation right is normally voided. If a "continuous contract" is terminated without a justifiable and unavoidable reason, then the terminating party may be required to pay damages to the non-terminating party (the type and calculation of which is determined by Japanese courts on a case-by-case basis, but is rarely *de minimus*), or the termination can be enjoined until the passage of a sufficient wind-down period (as determined by the court).

Enforcing Contractual Rights

In comparison to the United States, civil litigation is not frequently used as a method to settle disputes in Japan. A U.S. purchaser entering the Japanese market that hastily uses or threatens the use of litigation to settle disputes may find its reputation tarnished and blacklisted from the local deal community.

There are a number of cultural, structural and procedural reasons that support the lack of civil litigation in the commercial context in Japan, including:

- The Japanese hold a cultural preference for informal mechanisms to resolve disputes as opposed to formal litigation, as illustrated by the above with respect to the proclivity to include covenants in commercial agreements that the parties should consult and undergo good faith negotiations to resolve matters not contained in the agreement.
- Japan has relatively few lawyers per capita in comparison to the United States. For every 250 Americans there is one lawyer, while in Japan there is one lawyer for every 2,837 Japanese.[44] The dearth of lawyers in Japan inherently limits the amount of litigation that can be brought and may even discourage parties from initiating litigation due to the perceived lack of adequate resources (especially in rural areas of Japan).
- Commercial parties may view Japanese judges with skepticism (jury trials do not exist in civil trials in Japan) because (1) most judges begin their judicial careers immediately after graduating from Japan's Legal Training and Research Institute, so commercial parties may be reluctant to have matters decided by a judge who has little (or no) business experience, and (2) some judges apply their own concept of fairness when deciding matters without particular reliance on the facts at hand or court precedents (other than decisions by the Supreme Court of Japan) and since it is difficult for plaintiffs to "forum shop" under the Japanese judicial system, commercial parties may prefer to settle matters pursuant to their own framework of justice.
- There is little "discovery" prior to the commencement of a trial (so pre-trial maneuvering through costly depositions or document demands do not generally exist). In addition, damages are normally prescribed by statute and Japanese courts are not allowed to grant punitive damages (so adversaries may be more inclined to settle their disputes before trial since damage awards can be more accurately estimated, thereby allowing the parties to better gauge their exposure when crafting settlements terms).

The lack of civil litigation in Japan is not due to arbitration or mediation serving as the preferred dispute resolution method. In comparison to civil litigation, commercial arbitration and mediation are actually even less frequently used in Japan as a way to settle either domestic or international disputes. During the fiscal year ended March 31, 2022, the Japan Commercial Arbitration Association (the Japanese counterpart of the American Arbitration Association) accepted only 14 new arbitration cases, and only one new mediation case.

Conclusion

Many Japanese companies pride themselves on their native business practices and scorn outside influences. However, the attitude of "this simply isn't the way we do it in Japan" may soon change. The increased pace of foreign direct investment into Japan should not only benefit the local economy, but also could impact how business is conducted in Japan. A common consequence of foreign direct investment is the transfer of technology and business practices by the overseas parent company to its Japan operations, and allowing the Japan operations to exploit the parent company's global network and resources. Even though Japan is one of the most advanced economies in the world, Japanese companies nonetheless also can benefit by adopting certain best practices developed elsewhere. Increased local competition arising from greater foreign direct investment could provide the requisite spark for Japanese businesses to discard outdated practices and implement significant changes. Should this occur and as a result Japanese companies increase their profitability, then a multiplier effect for change may follow because Japanese companies would become even more attractive candidates for foreign direct investment.

ENDNOTES:

[1]For earlier versions of this article, *see* Stephen D. Bohrer and Akio Hoshi, "Doing Deals in Japan: An Introductory Guide for U.S. Practitioners," *The M&A Lawyer*, 2010, 14(9), at 14-26, and "Doing Deals in Japan: An Updated Introductory Guide for U.S. Practitioners," *The M&A Lawyer*, 2017, 21(4), at 19-36.

[2]*See* Section 8.01(b) of the Revised Model Business Corporation Act and Section 141(a) of the Delaware General Corporation Law.

[3]Depending on the size of the company (measured by the amount of its stated capital and total liabilities) and whether the company's shares are publicly traded or subject to a statutory right of first refusal exercisable by the company (which would be typical for a privately-held company), there are 24 permissible corporate governance structures available under the Companies Act. Listed companies are, however, required to choose among three corporate governance models: (i) a company with a board of statutory auditors (*kansa-yaku-kai secchi kaisha*), which has been adopted by approximately 60% of the listed companies in Japan as of July 2022, (ii) a company with an audit and supervisory committee (*kansa-tō-iinkai secchi kaisha*), which has been available only since May 2015 and has been adopted by approximately 37% of the listed companies in Japan as of July 2022, and (iii) a company with three statutory committees (*shimei-iinkai tō secchi kaisha*), which has been available since April 2003 and most closely resembles the American corporate board model, but been adopted by only approximately 2.3% of the listed companies in Japan as of July 2022. For ease of comprehension, in this article we focus on the Japanese corporate governance structure of *kansa-yaku-kai secchi kaisha* given its overwhelming adoption.

[4]Generally speaking, a statutory auditor is tasked with the responsibility of (i) monitoring the performance of directors to confirm that they are in compliance with applicable laws, regulations and the company's articles of incorporation, and properly executing their duties owed to the company, and (ii) overseeing and reviewing the audit of the company's financial statements by its external accounting firm (a privately-held company, if it does not appoint an external accounting firm, can limit the responsibility of its statutory auditor to an audit of the company's financial statements). In comparison to the U.S. corporate governance model, the function of a statutory auditor is similar to that of an independent director who also serves on the company's audit committee. The critical difference is that a statutory auditor does not have a vote in the meetings of the board of directors.

[5]Unlike the "Say-on-Pay" votes in the United States, shareholder resolutions on executive compensation in Japan are legally binding. Traditionally, the board of directors (or top management under a delegation from the board) decided how to allocate compensation among directors within an aggregate amount approved by shareholders. However, in accordance with the Corporate Governance Code, as of July 2022 nearly 60% of listed companies refer compensation allocation to a voluntarily established compensation committee, whose majority members are independent directors.

[6]Unlike U.S. corporations, Japanese companies only have articles of incorporation, which is often a relatively short document in length. The provisions that would typically appear in a U.S. company's bylaws can be found in a Japanese company's board regulations or are statutorily prescribed under the Companies Act.

[7]An "independent director" is defined as an "outside director" who is not likely to have a conflict of interest with the company's public shareholders. The Tokyo Stock Exchange sets out detailed "independence tests" similar to the NYSE's independence tests in the form of guidelines. However, unlike the NYSE's independence tests, the Tokyo Stock Exchange's tests have no bright-line monetary thresholds (such as the amount of compensation or transaction value), so the existence

of a conflict of interest is judged by the company taking into account all of the circumstances. An "outside director" is any person who serves as a director, other than (i) a present or former executive or employee of the subject company and its subsidiaries (unless 10 years have passed since his/her resignation, in which case, such person can qualify as an "outside director"), (ii) a controlling shareholder or a present director, executive officer or employee of the subject company's parent, (iii) a present executive or employee of a sister company to the subject company, or (iv) a spouse or relative within a second degree of kinship to a director, executive officer or key employee of the subject company.

[8]Effective April 4, 2022, the Tokyo Stock Exchange reorganized its market segments into the Prime Market, the Standard Market and the Growth Market. The ratio in 2014 is based on the companies listed on the former Section 1 of the Tokyo Stock Exchange, which is the closest equivalent to the Prime Market.

[9]In the case of a *shimei-iinkai tō secchi kaisha*, the authority of its executive officers is essentially equivalent to that held by executive officers in U.S. corporations, and they directly owe fiduciary duties to the company. They are called *shikkō-yaku* (not *shikkō yakuin*) in Japanese and are distinguished from employees. Even in a *shimei-iinkai tō secchi kaisha*, however, corporate binding authority is normally reserved to the Representative Officer(s).

[10]Saikō Saibansho [Sup. Ct.] July 15, 2010, Hei 21 (ju) no. 183, 2091 Hanrei jihō [Hanji] 90 (Japan).

[11]Under the Companies Act, at least one-half of the sum paid to a company in connection with a new share issuance must be allocated to the company's stated capital account, with the balance allocated to the company's capital surplus account (*shihon jōyo kin*). A registration tax equal to the greater of 0.7% of the stated capital amount or 150,000 yen (for a newly established company) and 30,000 yen (when an existing company allots new shares) is payable, so companies with a large stated capital account will have paid a relatively higher registration tax in comparison to less "prestigious" companies that have a smaller stated capital amount. The allocation between a company's stated capital account and capital surplus account does not have an impact on the amount available for dividend payments, and Japanese companies are not required to pay the equivalent of a Delaware annual franchise tax.

[12]For a comprehensive discussion of Japan's foreign direct investment regulations, *see* Stephen D. Bohrer and Hiroko Jimbo, "Amendments to Japan's Foreign Direct Investment Law: Heightened Review of Inbound Investments," *The M&A Lawyer*, 2020, 24(6), at 1-16.

[13]Effective April 1, 2021, the target shareholders may sell their shares without recognizing capital gains for tax purposes if (i) their shares are sold through a procedure known as a statutory share delivery (*kabushiki kōfu*) and (ii) 80% or more of the consideration consists of the purchaser's shares. A statutory share delivery is a form of share-for-share exchange under the Companies Act and available only for companies organized under Japanese law. Under a statutory share delivery, the ownership of the target's shares is transferred to the purchaser in exchange for the delivery of the purchaser's shares (or other consideration, such as cash) by agreement of the target's individual shareholders, and the transfer becomes effective through procedures prescribed under the Companies Act. A statutory share delivery is available only when the target company becomes a new subsidiary of the purchaser on a majority voting interest basis as a result of the transaction and cancelled if the number of shares the purchaser could acquire by the effective date does not reach the minimum set out by the purchaser.

[14]We are aware of only a few transactions where non-Japanese purchasers chose a tender offer as an acquisition method in a stock deal, but those transactions were made prior to the introduction of a triangular merger to Japanese corporate law (which became effective in 2007 to allow the surviving company in a merger to deliver shares of its parent company to the shareholders of the merged company instead of its own shares). However, unlike in the United States, a reverse triangular merger is not feasible in Japan because the Companies Act does not allow merging parties to convert or otherwise affect the shares held by the shareholders of the surviving company by operation of the merger and certain tax inefficiencies that were not addressed until 2019. A non-Japanese purchaser, nevertheless, may consider a stock tender offer as an acquisition method if the home jurisdiction of the purchaser prohibits the purchaser from performing a triangular merger under Japanese law or the purchaser wishes to make a hostile takeover bid with stock as the consideration.

[15]A corporate split (*kaisha bunkatsu*), share exchange (*kabushiki kōkan*), and share transfer (*kabushiki-iten*) are forms of business combinations prescribed under the Companies Act. Under a (i) corporate split, the assets and liabilities of a contributor's business are assumed by either a newly established company (in exchange for its shares) or an existing company (in exchange for its shares, cash and/or other property) by operation of law, (ii) share exchange, the

target is converted into a wholly-owned subsidiary of the acquiring company by operation of law and remains a separate legal entity (in this respect, it is identical to a reverse triangular merger under Delaware corporate law), and (iii) share transfer, all outstanding shares of the subject company (or companies) are transferred to a newly incorporated company, and such newco issues shares on a proportional basis to the shareholders of the subject company (or companies). Tax considerations and the ultimate ownership structure frequently drive the selection of the form of business combination. For more information about corporate splits, *see* Stephen D. Bohrer and Tatsuya Tanigawa, "Everything You Always Wanted to Know About Corporate Splits in Japan (But Were Afraid to Ask)," *The M&A Lawyer*, 2016, 20(7), at 17-27.

[16]Japanese tender offer rules are applicable to a company that is subject to the periodic reporting requirement under the Financial Instruments and Exchange Act of Japan (which is substantially identical to the periodic reporting requirement under the U.S. Securities Exchange Act of 1934 ("U.S. Exchange Act")). As an initial step, a prudent purchaser should examine whether Japanese mandatory tender offer rules will apply before acquiring shares in a Japanese reporting company.

[17]Ownership level is calculated on a diluted voting power basis and includes the voting interests held by "specially-related persons" (*tokubetsu kankeisha*) of the purchaser (similar to the "group" concept under Section 13(d) of the U.S. Exchange Act).

[18]A transaction conducted "outside the market" means a purchase and sale that does not clear through a stock exchange (*i.e.*, a transaction privately negotiated directly between the purchaser and the seller of the shares) or a proprietary trading system meeting statutory requirements. An "off-market transaction" means a purchase and sale that (i) does not clear through a stock exchange or (ii) clears through a non-auction trading system run by a stock exchange, such as the Tokyo Stock Exchange Trading Network System (commonly referred to as "ToSTNeT"), unless the transaction falls under a statutory exception.

[19]The intention behind this extremely complicated rule is to require a purchaser who has acquired more than 5% of the outstanding voting rights of a Japanese reporting company in "off-market transactions" to wait three months before commencing further target share acquisitions. The Japanese government enacted this "speed bump" requirement in 2006 in response to a public outcry against the rapid accumulation by M&A Consulting (also known as the Murakami Fund) of shares in Hanshin Electronic Railway in "off-market transactions." Except for the 10-day cooling off period under Rules 13d-1(e)(2) and 13d-1(f)(2) of the U.S. Exchange Act, U.S. tender offer rules do not have a similar stop-and-wait rule.

[20]Pursuant to Article 14, Paragraph 1 of the Enforcement Order of the Financial Instruments and Exchange Act, a purchaser can withdraw its offer if the target or its subsidiary determines to undertake certain actions or experiences certain events, including: (i) a statutory corporate combination, (ii) a corporate dissolution, (iii) the filing of a petition for bankruptcy, (iv) a decrease in its stated capital, (v) the sale or discontinuance of all or part of its business, (vi) the delisting of its shares, (vii) a stock split, (viii) the allotment of shares or share purchase warrants with or without consideration, (ix) a sale or other disposal of material assets, (x) the incurrence of a significant amount of indebtedness, (xi) the issuance of an injunctive order to stop its principal business, (xii) the revocation of a principal business license, (xiii) the discontinuity of business with a major customer or supplier, (xiv) the loss of a material asset due to a *force majeure* event, or (xv) the occurrence of any other event or circumstance that is equivalent to the matters above and specified by the purchaser (a so-called "catch-all" provision). Most of the foregoing events and actions are subject to numerical thresholds. Japan's Financial Services Agency has very narrowly interpreted the "catch-all" provision. On August 2, 2012, the agency published an official statement indicating that the following events would be captured by the "catch-all" provision: (a) the target pays dividends after the commencement of the tender offer, (b) the target's disclosure documents include false statements or material omissions, or (c) a material contract of the target is terminated due to events that occur after the commencement of the tender offer. Noticeably absent is the ability of a purchaser to withdraw its offer upon the occurrence of any event or circumstance that would cause a reasonable purchaser to withdraw its offer. As a result, a purchaser launching a tender offer in Japan is generally required to assume the consequences of unforeseeable events during the pendency of a tender offer.

[21]Because the receipt of third party approvals is not a permissible tender offer condition in Japan, if there is an expectation that it will take more than 60 business days to obtain antitrust clearance, foreign direct investment approval or other material third party consents, then legal counsel should be consulted on what information concerning the offer can and should be publicly disclosed without resulting in the commencement of the tender offer.

[22]While hostile takeover attempts in Japan were

historically made by activist funds and were mostly unsuccessful, some recent successful hostile takeovers were initiated by large reputable Japanese companies. For example, in March 2021 Nippon Steel Corporation increased its ownership stake in Tokyo Rope Mfg. Co. Ltd. from 9.95% to 19.9% through an unsolicited tender offer, and in December 2021 SBI Holdings, Inc. successfully completed its unsolicited tender offer for all of the shares in Shinsei Bank, Limited (in which the Japanese government was a major shareholder).

[23]The *Bull-dog Sauce* case (Saikō Saibansho [Sup. Ct.] August 7, 2007, Hei 19 (kyo) no. 30, 61 Saikō Saibansho minji hanreishū [Minshū] 2215 (Japan)) is sometimes referred to as the case where a poison pill was intentionally triggered by the target. Bull-dog's pill, however, was far from the typical "poison pill" when compared to those adopted in the United States. Under the Bull-dog pill (which was approved by approximately 83.4% of the outstanding voting rights in Bull-dog), all shareholders (including Steel Partners) would receive three share purchase warrants per share. However, Steel Partners was required to exchange its warrants for cash, while other shareholders were required to exchange their warrants for Bull-dog's newly-issued shares. As a result, Steel Partners' share ownership level in Bull-dog reportedly decreased from 10.52% to 2.86%, but it received a cash payment of approximately $26.1 million. In essence, Bull-dog's exercise of its pill was a partial cash-out of an existing shareholder. For fiscal 2006, Bull-dog reported a net profit of only approximately $6 million, making the large cash payment to Steel Partners rather remarkable under the circumstances. The *Nihon Keizai Shinbun* newspaper reported on July 3, 2007, that an investment banker referred to the Bull-dog poison pill as the "honey pill."

[24]In the *Nippon Broadcasting* case, the court enjoined the issuance of new share purchase warrants to a friendly third party. *See* Tōkyō Kōtō Saibansho [Tokyo High Ct.] March 23, 2005, Hei 17 (ra) no. 429, 58 Kōtō saibansho minji hanreishū [Kōminshū] 39 (Japan).

[25]*See* Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] June 1, 2005, Hei 17 (yo) no. 20050, 1186 Hanrei taimuzu [Hanta] 274 (Japan), and Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] July 29, 2005, Hei 17 (yo) no. 20080, 1909 Hanrei jihō [Hanji] 87 (Japan).

[26]As recently as 2021, this holding was reaffirmed by the Nagoya High Court in the *Nippo* case. The court, however, put considerable emphasis on the fact that the target's "advance warning" scheme was approved twice in a row by shareholders in its annual meeting. *See* Nagoya Kōtō Saibansho [Nagoya High Ct.] April 22, 2021, Rei 3 (ra) no. 138, 446 Shiryōban shōji hōmu [Shiryōban shōji] 138 (Japan).

[27]*See* Tōkyō Kōtō Saibansho [Tokyo High Ct.] April 23, 2021, Rei 3 (ra) no. 798, 446 Shiryōban shōji hōmu [Shiryōban shōji] 154 (Japan).

[28]*See* Tōkyō Kōtō Saibansho [Tokyo High Ct.] August 10, 2021, Rei 3 (ra) no. 1593, 1630 Kin'yū shōji hanrei [Kinhan] 16 (Japan).

[29]*See* Tōkyō Kōtō Saibansho [Tokyo High Ct.] November 9, 2021, Rei 3 (ra) no. 2391, 1641 Kin'yū shōji hanrei [Kinhan] 10 (Japan), affirmed by Saikō Saibansho [Sup. Ct.] November 18, 2021, Rei 3 (ku) no. 1046, Rei 3 (kyo) no. 15, 1641 Kin'yū shōji hanrei [Kinhan] 48 (Japan).

[30]*See* Ōsaka Kōtō Saibansho [Osaka High Ct.] July 21, 2022, Rei 4 (ra) no. 750, 461 Shiryōban shōji hōmu [Shiryōban shōji] 153 (Japan), affirmed by Saikō Saibansho [Sup. Ct.] July 28, 2022, Rei 4 (kyo) no. 12, 461 Shiryōban shōji hōmu [Shiryōban shōji] 147 (Japan).

[31]In the *Mitsuboshi* case, the purchaser was required, among others, to commit (i) not to make any future takeover proposal with respect to the company, (ii) not to sell a substantial amount of the shares of the target it held to a third party without obtaining the target's approval, (iii) not to make any shareholder proposal at the target's shareholders meetings and not require the target to convene an extraordinary shareholders meeting at least until the end of the next annual shareholders meeting, and (iv) not to oppose any proposals by the target's board at shareholder meetings. The court held that these commitments were excessive restrictions on the purchaser's intrinsic shareholder rights.

[32]Under the Companies Act, if a director is removed from office without "justifiable grounds" (which is a difficult standard to satisfy and would not be met simply due to a change in ownership), then the director is entitled to receive the salary that would have been paid to him/her until the annual general meeting held in conjunction with the expiration of his/her term. A hostile purchaser, therefore, should consider director compensation payments in its calculation of takeover costs.

[33]The Japan Federation of Bar Associations has not published a model acquisition agreement and there is no equivalent in Japan of the American Bar Association's "Deal Points Study," so the matters addressed in this section reflect the observations of the authors with respect to small-to-mid cap domestic private M&A transactions.

[34]We note that in the cross-border context, Japa-

nese courts may respect an integration clause if the parties knew or should have reasonably known the significance of the provision. *See, e.g.*, Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] Dec. 13, 1995, Shō 63 (wa) no. 16921, 938 Hanrei taimuzu [Hanta] 160 (Japan) (although the agreement was governed by Japanese law, the plaintiff was advised by a New York-licensed lawyer and the defendant's general counsel and corporate secretary was a New York-licensed lawyer, so the parties should have been fully capable of understanding the meaning of the integration clause), and Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] Dec. 25, 2006, Hei 18 (wa) no. 1710, 1964 Hanrei jihō [Hanji] 106 (Japan) (court referred to the integration clause in a definitive license agreement as a reason to deny the introduction of a most favored nations clause allegedly agreed prior to the execution of the license agreement). For a detailed analysis of Japanese courts' interpretation of integration clauses, *see* Akio Hoshi, *Interpretation of Corporate Acquisition Contracts in Japan: A Legal Transplant through Contract Drafting*, 16 Asian J. Comp. L. 106, 121-22 (2021).

[35]Effective October 1, 2017, a target will incur a capital gains tax on *certain* of its assets in connection with a cash-out merger, unless after the transaction (i) approximately 80% of the target's employees are expected to continue to be employed and (ii) the principal business of the target is expected to continue (as denoted in note (c) to the table setting forth the requirements for a qualifying merger or other qualifying form of corporate combination). The same requirements were made applicable to the other procedures to squeeze-out minority shareholders, including the demand for sale of shares method and a reverse stock split, to eliminate tax treatment differentials between these methods. When a minority squeeze-out transaction is regarded as a non-qualifying form, the tax applies only to assets whose book value is JPY 10 million or more, and therefore, it does not apply to so-called self-created goodwill (*jika sōsetsu noren*) because its book value is normally zero. Despite the government's efforts to create a level-playing field among the various squeeze-out methods for tax purposes, a cash-out merger still has a tax disadvantage because the succession of tax loss carryforward from the merged company is likely to be restricted in the case of a forward cash-out merger, and the use of tax loss carryforward in the target is likely to be restricted in the case of a reverse cash-out merger.

[36]As long as the purchaser intends to maintain the target as a separate entity, squeezing out minority shareholders by way of a cash-delivery-share-exchange (*genkin kōfu kabushiki kōkan*) is also an effective method to squeeze-out minority shareholders in light of the October 1, 2017 Japanese taxation reforms discussed in *supra* note 35. However, this procedure is rarely used perhaps due to market inertia as it has no material advantages over the reverse stock split method (which has been widely tested by Japanese courts and considered an acceptable method to squeeze-out minority shareholders) and can even be relatively more burdensome if the purchaser directly acquires the target's shares (as opposed to acquiring through a special acquisition vehicle). Therefore, a cash-delivery-share-exchange is not discussed in this article.

[37]*See supra* note 35 for the further requirements that a demand for sale of shares method and a reverse stock split need to satisfy in order to avoid disadvantageous tax treatment.

[38]*See* Saikō Saibansho [Sup. Ct.] July 1, 2016, Hei 28 (kyo) no. 4 to 20, 70 Saikō Saibansho minji hanreishū [Minshū] 1445 (Japan). There are currently no mandated steps that should be undertaken to demonstrate that the tender offer process is "generally accepted to be fair." In the *Jupiter Telecommunications* case, the Supreme Court did note as favorable facts that (i) the target set up an independent committee and obtained its opinion on the transaction, (ii) the target retained its own legal counsel and financial advisor, and (iii) the bidder announced in the tender offer process that the squeeze-out price would be the same price as in the first-step tender offer. Since the 2016 Supreme Court holding in the *Jupiter Telecommunications* case, the Fair M&A Guidelines were published (as discussed in the body of this article), and adherence to such guidelines ordinarily should provide irrefutable support about the fairness of a tender offer's process.

[39]The Companies Act was amended in 2014 to permit a target to make a tentative payment to dissenting shareholders for an amount the target considers to be fair. By paying this amount (which often will equal the price paid in the first step tender offer), Japan's current statutory 3% interest obligation on unpaid share consideration will accrue only on the ultimate amount that a court awards in excess of the consideration already paid to the dissenting shareholder. In light of the *Jupiter Telecommunications* holding, there most likely will be little incentive for shareholders in Japan to object to a transaction simply to collect a high interest payment award.

[40]For the third factor, Japanese courts typically consider: (i) whether the reduction of headcount is needed in light of the company's financial performance, (ii) whether the company has made a reasonable good-faith effort to avoid the termination through other means, such as trying to change the employee's work-

position or second the employee to other companies, (iii) whether the selection of the terminated employees was made based on fair and reasonable standards, and (iv) whether the company has undertaken good-faith discussions with the affected employees and labor unions.

[41]When assessing whether a termination meets "socially accepted standards," a Japanese court would consider various factors, including: (i) the significance of the reason for the termination, (ii) the process leading to the termination, (iii) the terminated employee's performance, (iv) the severity of the employee's poor conduct, (v) the remorse shown by the terminated employee, (vi) the existence of measures taken by the employer to avoid the termination, and (vii) the lack of alternative measures available to the employer (*e.g.*, easier work or more suitable work for the affected employee).

[42]In 2012, Japan's Labor Contracts Act was amended to provide a new Article 18, which requires a company to covert an employee to indefinite term status (i.e., not subject to a fixed-term contract) upon the employee's request and so long as the employee has worked for more than five years on two or more fixed term agreements and there has been no break in employment of six months or longer.

[43]Japan's Supreme Court has not provided any specific rule to determine what constitutes a "justifiable and unavoidable reason," but the factors that Japanese lower courts have considered when determining the existence of a "justifiable and unavoidable reason" include the following: (i) the non-terminating party committed a prior breach of the "continuous contract;" (ii) trust between parties has been destroyed; (iii) the non-terminating party faces severe financial difficulties that make it difficult to perform its obligations under the "continuous contract" (*i.e.*, as a result, the terminating party makes an anticipatory repudiation of the "continuous contract"); (iv) a material change in circumstances has occurred; (v) the length, term, and subject matter of the "continuous contract" in question (*i.e.*, whether the goods/services are unique or can be sourced from several other suppliers); (vi) the number of times the "continuous contract" has been renewed and the manner in which the renewals were granted (*i.e.*, renewed automatically or after negotiations); (vii) the reason(s) for terminating the "continuous contract;" (viii) the amount of damages the non-terminating party will suffer due to the termination of the "continuous contract;" (ix) the costs incurred by the non-terminating party in order to continuously fulfill its obligations under the "continuous contract" (*e.g.*, capital expenditures, employees hired, advertising expense, etc.); and (x) the amount of prior notice offered before the termination takes effect. However, in the case of international distribution agreements, having the laws of a country other than Japan as the governing law of a contract and requiring disputes be resolved outside of Japan could avoid the application of the "continuous contract" theory and dissuade a Japanese court from asserting jurisdiction based on public policy grounds (even if the obligations under the subject contract will be performed in Japan). *See* Tōkyō Chihō Saibansho [Tokyo Dist. Ct.] August 28, 2007, Hei 19 (yo) no. 20047, 1991 Hanrei jihō [Hanji] 89 (Japan).

[44]As of April 1, 2020, the United States had 331,449,281 inhabitants (according to a survey of the U.S. Census Bureau) and 1,327,010 lawyers as of January 1, 2022 (based on data published by the American Bar Association). As of October 1, 2022, Japan had 124,830,000 inhabitants (according to a survey of the Statistics Bureau of Japan's Ministry of Internal Affairs and Communications) and 43,993 lawyers as of October 1, 2022 (based on data published by the Japan Federation of Bar Associations and excluding judges and public prosecutors).

ADVANCING FORWARD: DELAWARE COURTS PROVIDE FURTHER GUIDANCE ON INCUMBENT BOARD ENFORCEMENT OF ADVANCE NOTICE BYLAWS

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In late 2021 and early 2022, two decisions from the Court of Chancery addressing advance notice bylaws reiterated, consistent with long-standing Delaware law, that clear and unambiguous advance notice bylaws will be enforced. These decisions also noted that application of such bylaws remains subject to equitable review to determine if the incumbent board acted manipulatively or otherwise inequitably in rejecting stockholder board nominees.[1] However, these decisions also articulated slightly different standards of review—with the court in the first decision holding that under the court's equitable review a stockholder could prove "compelling circumstances" justifying a finding of inequitable conduct, while the court in the second decision expressly applied enhanced scrutiny, placing the burden on the incumbent board to demonstrate it acted reasonably.[2]

The Court of Chancery's most recent decision on this topic further reiterates that clear and unambiguous bylaws will be enforced. Furthermore, the decision clarifies that enhanced scrutiny focusing on the reasonableness of incumbent board conduct is the standard of review that applies to the application of even validly enacted advance notice bylaws. Therefore, when assessing a board's application of an advance notice bylaw, the court will analyze whether the board has identified proper corporate objectives and has justified its actions as reasonable in relation to those objectives.

AIM ImmunoTech

In *Jorgl v. AIM ImmunoTech Inc.*,[3] the Court of Chancery rejected a request for preliminary, mandatory injunctive relief on behalf of a dissident stockholder and his proposed slate of board nominees by denying the plaintiff's motion for preliminary injunction in favor of the defendants, AIM ImmunoTech Inc. and the incumbent board.

The court's decision laid out the interesting factual circumstances of the plaintiff's director nominations, which occurred within the larger context of an ongoing attempt by a group, comprised of both stockholders and non-stockholders, to take over the company. As one part of this takeover attempt, the plaintiff, who had only acquired stock 10 days before his director nominations were submitted, put forth two non-stockholders for positions on the company's three-member board. The incumbent board was immediately suspicious, as one of the nominees was the same individual recently submitted as a director nominee by another stockholder. The board had rejected those nominations and suspected that a stockholder named Franz Tudor, who had allegedly been harassing the company for years, was secretly behind them. The short period and common nominee between the prior failed nominations and the plaintiff's current nominations prompted the board to investigate further. It discovered information leading it to conclude that Tudor and his allies were also behind the plaintiff's effort. Based on this undisclosed information, the board unanimously rejected the nomination notice, leading to litigation.

The court first analyzed the board's decision to reject the nomination notice by considering whether it complied with the company's advance notice bylaw. The court noted that Section 1.4(c) of the bylaws required disclosure by the nominating stockholder of "a description of all arrangements or understandings between such stockholder and each proposed nominee and any other person or persons (including their names) pursuant to which the nomination(s) are to be made."[4] The court reiterated that "[c]lear and unambiguous advance notice bylaw conditions act[] in some respects as conditions precedent to companies being contractually obligated to take certain actions."[5]

The court concluded that the plain meaning of "arrangements or understandings," as demonstrated by reference to dictionary definitions, required the stockholder "to disclose any advance plan, measure taken, or agreement—whether explicit, implicit, or tacit—with any person towards the shared goal of the nomination."[6] The court rejected the plaintiff's argument that "arrangements or understandings" required a *quid pro quo*.

Next, the court considered whether the nomination notice satisfied the unambiguous requirements of the bylaw. The court analyzed the record evidence that, behind the scenes of the plaintiff's nomination, both stockholders and non-stockholders, led by Tudor, were working together to devise legal strategy and to formulate a plan for a proxy contest in order to ultimately take control of the board. The court rejected the plaintiff's argument that the information in the notice was truthful and to the best of his knowledge at the time. Clearly doubting the veracity of the plaintiff's statements about his own knowledge, the court held that the disclosure about "arrangements or understandings" was at least misleading. The court also highlighted that, even if the plaintiff's knowledge of the extent of the roles of others in the nominations was limited, one of the proposed board nominees clearly knew the full information and was involved in preparation of the nomination notice, yet stayed silent. For all these reasons, the court held that the plaintiff failed to show that the nomination notice undisputedly met the bylaw's requirements.

The court then moved on to an equitable review of the incumbent directors' decision to reject the nomination notice, because "the Board's technical entitlement to reject the Notice does not necessarily mean that equity will allow it to stand."[7] The court noted that the parties agreed that some form of enhanced scrutiny was appropriate, but disagreed on the standard's label and requirements. The plaintiff argued that the defendants were required to show a "compelling justification" for their actions as set forth in *Blasius Industries, Inc. v. Atlas Corp*.[8] The defendants, on the other hand, argued that—"whether labeled as *Unocal*[9] or *Blasius*"—enhanced scrutiny review that looks to the reasonableness of the board's actions should be applied. Concluding that the "exacting review" of *Blasius* was not appropriate, the court noted that "[s]till, this court must 'reserve space for equity to address the inequitable application of even validly-enacted advance notice bylaws.' "[10] The court stated that "enhanced scrutiny requires a context-specific application of the directors' duties of loyalty, good faith, and care" and that to satisfy the standard "[t]he board must 'identify the proper corporate objectives served by their actions and justify their actions as reasonable in relation to those objectives.' "[11]

In applying enhanced scrutiny review, the court first addressed whether the corporate objectives served by the advance notice bylaw were reasonable. The court began by noting that "[a]dvance notice bylaws are 'commonplace' tools for public companies to ensure 'orderly meetings and election contests."[12] Notably, the plaintiff did not question the board's intentions in adopting the advance notice bylaw and it had been adopted on a "clear day.' " Instead, the plaintiff challenged the provision's potential breadth, arguing that if "arrangements and understandings" is not limited to circumstances where there is an exchange of promises, the standard is unworkable. The court rejected this position after concluding that the plain language of the company's bylaw was not so sweeping, that it was not unreasonable, that there were legitimate reasons why the board would want to know whether a nomination was part of a broader scheme to control the company and that the information would be important to stockholders in deciding which director candidates to support.

Finally, the court considered whether the board's rejection of the nomination notice was a reasonable response in relation to these corporate purposes. The defendants argued that they acted reasonably after the board surmised that the nomination notice was part of a broader scheme involving undisclosed arrangements and understandings. The plaintiff, for his part, contended that the board sought merely to entrench itself at the expense of his rights as a stockholder to nominate directors. The court sided with the defendants after considering issues undermining the plaintiff's position, such as the context in which the board received and considered the plaintiff's notice, as well as the legitimate grounds the board had to question the plaintiff's motives, including his having bought stock only 10 days before nominating two non-stockholders, one of whom was a nominee on a previously rejected nomination notice. Ultimately the court concluded that these factors, in addition to lingering factual disputes, prevented granting the plaintiff's motion as a matter of law.

Takeaways

- This most recent decision by the Court of Chancery involving advance notice bylaws further reiterates that unambiguous bylaws should be enforced according to their terms.
- Nonetheless, Delaware courts will continue to conduct an equitable review of an incumbent board's decision to reject a nomination notice even if that notice failed to comply with unambiguous terms of the advance notice bylaw.
- Prior Court of Chancery decisions approached the standard of review for this equitable review slightly differently. While the courts generally agreed equitable review was appropriate, not all expressly applied enhanced scrutiny. The decision in *AIM* expressly applied enhanced scrutiny and clarified that, in the context of an advance notice bylaw, the burden is on the incumbent board to demonstrate it acted reasonably by identifying proper corporate objectives and justifying its actions as reasonable in relation to those objections.
- However, this decision, consistent with the court's other recent decisions on advance notice bylaws, further indicates that, as a practical matter, clear and unambiguous bylaws adopted on a "clear day" in order to achieve the legitimate goal of an orderly corporate electoral process are unlikely to fail equitable review in the absence of specific evidence of inequitable conduct.
- Furthermore, this decision demonstrates that advance notice bylaws remain an important and legitimate tool for incumbent boards to protect the corporation and its stockholders from undisclosed arrangements by individuals or groups seeking corporate control.[13]

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ENDNOTES:

[1]*See* Skadden Discusses Delaware Court Rulings on Advance Notice Bylaws and Incumbent Director Conduct, (https://www.skadden.com/-/media/files/publications/2022/06/skadden_discusses_delaware_court_rulings_on_advance_notice_bylaws_and_incumbent_director_conduct.pdf), The CLS Blue Sky Blog, June 29, 2022; *see also Rosenbaum v. CytoDyn Inc.*, 2021 WL 4775140 (Del. Ch. 2021); *Strategic Investment Opportunities LLC v. Lee Enterprises, Incorporated*, 2022 WL 453607 (Del. Ch. 2022).

[2]*Rosenbaum v. CytoDyn Inc.*, 2021 WL 4775140, at *15 (Del. Ch. 2021); *Strategic Investment Opportunities LLC v. Lee Enterprises, Incorporated*, 2022 WL 453607, at *14 (Del. Ch. 2022).

[3]*Jorgl v. AIM ImmunoTech Inc.*, 2022 WL 16543834 (Del. Ch. 2022).

[4]*Id.* at *11.

[5]*Id.* (citation omitted).

[6]*Id.* at *12.

[7]*Id.* at *14.

[8]*Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, Fed. Sec. L. Rep. (CCH) P 93965 (Del. Ch. 1988).

[9]*Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, Fed. Sec. L. Rep. (CCH) P 92046, Fed. Sec. L. Rep. (CCH) P 92077 (Del. 1985).

[10]*Jorgl v. AIM ImmunoTech Inc.*, 2022 WL 16543834, at *15 (Del. Ch. 2022) (citation omitted).

[11]*Id.* (citation omitted).

[12]*Id.* (citation omitted).

[13]Despite their acceptance by the Delaware courts, advance notice bylaws remain a continuing focus of litigation and dissident stockholders can be expected to continue challenging the adoption, amendment and/or scope of such bylaws when seeking to make director nominations. *See, e.g., Politan Capital Management LP v. Kiani*, 2022-0948-NAC (Del. Ch.).

IRS ISSUES GUIDANCE ON EXCISE TAX ON STOCK REPURCHASES AND CORPORATE ALTERNATIVE MINIMUM TAX

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On Tuesday, December 27, 2002, the Treasury Department and IRS issued notices providing initial guidance on the stock repurchase excise tax (the "Excise Tax," and such notice, the "Excise Tax Notice"),[1] which is generally applicable to public U.S. corporations, and the corporate alternative minimum tax (the "CAMT," and such notice, the "CAMT Notice"),[2] both of which were imposed by the Inflation Reduction Act of 2022 (H.R. 5376) (the "IRA") and are effective January 1, 2023. The notices describe the regulations that the IRS and Treasury plan to issue regarding these taxes and a limited set of key issues they raise. Importantly, taxpayers are generally permitted to rely on these notices before the regulations come into effect.[3]

Consistent with the IRA, the Excise Tax Notice confirms that the Excise Tax captures a much broader set of transactions than typical stock redemptions (*e.g.,* split-offs, certain acquisitive reorganizations, preferred stock redemptions and so-called "bootstrap" acquisitions), but certain rules set forth in the Excise Tax Notice may generally mitigate the tax where stock is repurchased in exchange for non-recognition property. In addition, in certain respects, the Excise Tax Notice provides helpful guidance and relief (*e.g.*, stock redemptions in liquidation of a SPAC will generally not be subject to the tax).

The CAMT Notice provides for several adjustments to "adjusted financial statement income" ("AFSI"), which is the base for the imposition of the CAMT, in situations where a taxpayer may have income or loss for financial accounting purposes but not for regular corporate income tax purposes. These adjustments should shift the CAMT computational tax base toward the computational tax base of the regular corporate income tax, in many cases minimizing potential CAMT liability and its applicability.

1% Stock Repurchase Excise Tax

Key Takeaways

- Redemptions made in complete liquidation of corporations (including SPACs) generally are not subject to the Excise Tax.
- Generally, the cash component (but not the stock component) of consideration received in certain acquisitive reorganizations, recapitalizations, and split-offs is subject to the Excise Tax.
- Preferred stock redemptions are generally subject to the Excise Tax.
- The cash received from a target corporation in a so-called bootstrap acquisition is generally treated as a repurchase subject to the Excise Tax.
- Stock repurchases occurring pursuant to reorganization transactions where cash is paid in lieu of

fractional shares typically are excluded from the Excise Tax.

- The Excise Tax Notice provides conventions for determining the fair market value of repurchased stock (on which the Excise Tax is assessed), generally looking to public trading price indicators.

- Taxpayers may rely on the Excise Tax Notice until the issuance of forthcoming proposed regulations, although it is unclear when such regulations will be issued.

Analysis

In General. As noted in our Client Memo on the IRA,[4] the Excise Tax imposes a non-deductible 1% excise tax on repurchases after December 31, 2022 of any stock of any U.S. corporation that has any publicly traded shares (a "Covered Corporation").[5] The Excise Tax is imposed on the fair market value of the stock "repurchased" (or deemed repurchased) during the taxable year, *minus* the fair market value of any stock "issued" by such corporation during the taxable year (the "Netting Rule"), and *minus* the fair market value of "qualifying property" (generally, stock received in certain acquisitive reorganizations or split-offs that would otherwise be subject to the tax during the taxable year).[6] "Repurchase" is defined as a redemption[7] and any economically similar transaction, as well as the acquisition of a Covered Corporation's stock by certain of its affiliates from a third party. The statute is broadly drafted and so is the Excise Tax Notice; the Excise Tax covers a broader range of transactions than a typical open-market repurchase of shares, generally including the redemption of preferred stock, cash consideration received in certain acquisitive reorganizations and split-offs, and cash consideration received from a target in certain so-called "bootstrap" acquisitions.

Preferred Stock Redemptions Are Subject to Excise Tax. The Excise Tax Notice confirms that a Covered Corporation's redemption of preferred stock, which includes the redemption of "participating" preferred stock, is subject to the Excise Tax where the redeemed property is stock for federal income tax purposes and the repurchase is a redemption within the meaning of section 317(b). For example, where a Covered Corporation has outstanding, publicly traded common stock and non-publicly traded, mandatorily redeemable preferred interests that are stock for federal income tax purposes, redeeming the preferred stock generally triggers the Excise Tax.[8]

Exceptions to the Stock Repurchase Excise Tax

- *Complete Liquidations.* The Excise Tax as drafted could encompass a wide range of transactions and corporate actions, including SPAC redemptions (which can occur pursuant to SPAC extension votes, prior to a business combination, or upon liquidation). However, the Excise Tax Notice clarifies that a redemption occurring pursuant to a complete liquidation of a Covered Corporation is not a "repurchase." This would generally include SPAC liquidations.[9] Other SPAC redemptions not in liquidation (*e.g.*, if certain shareholders elect to be redeemed in connection with a de-SPAC transaction, or pursuant to a redemption right triggered when a SPAC seeks an extension of its term) would still be subject to the Excise Tax, though the Netting Rule may apply to reduce or eliminate the Excise Tax that would otherwise apply to a SPAC redemption not in liquidation.

- *Qualifying Property in Acquisitive Reorganizations.* In an acquisitive reorganization (*i.e.*, an A reorganization (including triangular reorganizations), a C reorganization or an acquisitive D reorganization), a recapitalization (*i.e.*, an E reorganization) or a mere change in a Covered Corporation's identity, form, or place or organization (*i.e.*, an F reorganization), the use of acquirer's stock as consideration is excluded from the tax base to which the stock repurchase Excise Tax applies.[10] To the extent other consideration (*e.g.*, cash) is used, however, the tax base is not reduced by the extent of such nonqualified consideration.[11] The effect is that the Excise Tax applies to cash consideration received in these transactions.

- *Split-Offs*. Similarly, the Excise Tax Notice specifies that a Covered Corporation's use of controlled corporation stock in a split-off, in exchange for such Covered Corporation's own stock, is excluded from the tax base to which the Excise Tax applies.[12] If the split-off includes a distribution of other consideration that is not qualifying property (*i.e.*, property permitted to be received on a tax-free basis) like cash, however, the tax base is not reduced by such nonqualified consideration.[13] The effect is that the Excise Tax applies to cash consideration received in these transactions. Note that a distribution by a distributing corporation of stock of a controlled corporation in a tax-free transaction under section 355 that is not a split-off is not treated as a repurchase (and therefore is not subject to the Excise Tax) (*e.g.*, a pro rata spin-off).[14]

- *Bootstrap Acquisitions*. The Excise Tax Notice provides that, to the extent that the consideration in an acquisition is funded by the target corporation's own cash or borrowed cash, the target is treated as repurchasing its own stock in a transaction subject to the Excise Tax. For example, in a transaction where a parent corporation acquires a target using a merger subsidiary that borrows funds and merges with and into the target and the target's shareholders exchange all of their stock for cash, the target is treated as if it redeemed its stock in a repurchase to the extent that its own cash (including cash attributable to such debt-financing) funded the transaction and is subject to the Excise Tax.[15] An acquiror may consider whether to avoid using this fairly typical leveraged buyout structure and consider alternative means for pushing debt into a target, subject to financing and other non-tax considerations.

- *Dividends*. The Excise Tax Notice provides that a repurchase is not subject to the Excise Tax to the extent that it is treated as a dividend for federal income tax purposes[16]. Most ordinary course repurchases are, however, subject to a rebuttable presumption that they do not qualify for this exception.[17] Covered Corporations can rebut this presumption for a given repurchase from a given shareholder by establishing "sufficient evidence" that such shareholder treats the repurchase as a dividend on such shareholder's federal income tax return. "Sufficient evidence" requires, among other things, proper information reporting by the Covered Corporation, evidence of any applicable withholding, a certification from the shareholder and evidence of the Covered Corporation having sufficient earnings and profits.[18]

- *Determining Fair Market Value of Repurchased Shares*. The Excise Tax Notice specifies that the "fair market value" of the repurchased stock is the market price of the stock on the date that it is repurchased, regardless of whether the price at which the stock is repurchased equals such market price. If any stock of the same class and issue of the repurchased stock is traded on an established securities market, the guidance provides various acceptable methods for deriving market price.[19] Covered Corporations must consistently use a chosen method for all stock repurchases during its taxable year.[20]

Corporate Alternative Minimum Tax on Book Income

General CAMT Framework. The CAMT imposes tax on large corporations that are profitable from a book perspective but are subject to no or low federal income tax. The CAMT applies at a rate of 15% to an "applicable corporation," which generally is any corporation (other than an S corporation, a RIC or REIT) whose average annual ASFI exceeds $1 billion over the three taxable years ending with the current taxable year (the "Book Income Test").[21] AFSI is derived from the net income or loss reported on an applicable corporation's "applicable financial statement" ("AFS") covering such taxable year. An AFS generally is an annual report or other SEC-required financial statements. Significantly, the CAMT Notice does not provide a way for an applicable corporation to cease to be an applicable corporation.[22]

Aligning AFSI With Regular Corporate Income Tax. Generally, CAMT liability is determined using a different computational tax base (generally, GAAP) than the regular corporate income tax. Because CAMT liability is tied to the financial accounting rules (*e.g.*, GAAP), where such rules diverge from the regular corporate income tax rules there can be dramatic variations in the applicable tax bases. In particular, where a transaction results in income from a financial accounting perspective but that income is not recognized for purposes of the regular corporate income tax, the CAMT could result in significantly higher tax liability due to the larger CAMT tax base. The CAMT Notice generally brings the CAMT tax base more in line with that of the regular corporate income tax (thereby mitigating the potential for corporations to qualify as applicable corporations and mitigating the potential of significant CAMT liability if they do so qualify) by providing for adjustments to AFSI in certain instances where a corporation books a transaction as producing income or loss for financial accounting purposes but does not recognize income or loss for regular corporate income tax purposes. Specifically:

- *Certain Reorganizations and Split-off Transactions*. Certain reorganizations and split-off transactions may result in financial accounting gain or loss (and corresponding basis adjustments in assets) but are treated as tax-deferred for regular corporate income tax purposes. The CAMT Notice provides that in those cases, AFSI will not include any gain or loss recognized for financial accounting purposes.[23]

- *Cancellation of Indebtedness*. Certain transactions (including certain reorganizations) give rise to income as a result of cancellation of indebtedness for financial accounting purposes, but do not result in income recognition for regular corporate income tax purposes because the cancellation of indebtedness income is excluded from the corporate income tax computational tax base. To shift the CAMT tax base toward that of the regular corporate income tax and to mitigate the harshness of a rule imposing tax on book income arising from the cancellation of indebtedness income for distressed companies, the CAMT Notice provides that AFSI will not include the amount of any excluded cancellation of indebtedness income.[24]

- *Correlative Basis and Attribute Adjustments*. In each of the above cases, the CAMT Notice requires the relevant taxpayer to, for purposes of calculating AFSI, make a correlative basis adjustment to the stepped-up (or stepped-down) basis such taxpayer would receive under the financial accounting rules. That is, for example, where a transaction produces income for financial accounting purposes but such income is excluded from AFSI under the CAMT Notice,[25] any step-up in the basis of the assets resulting from such income under the financial accounting rules is ignored and AFSI ignores any such step-up (and corresponding depreciation or amortization deductions) going forward.[26] Likewise, the CAMT Notice requires that any tax attributes that an applicable corporation reduces under the cancellation of indebtedness rules for corporate income tax purposes must have a corresponding decrease in such attributes (including basis) for financial accounting purposes, when calculating AFSI. These correlative adjustments preclude taxpayers from receiving a double benefit of AFSI exclusion and, for example, increased book depreciation that would reduce AFSI.[27]

Determining "Applicable Corporation" Status and Other. The CAMT Notice includes several clarifications regarding how to determine applicable corporation status (including in acquisitions and in spin-offs and split-offs) and provides a safe harbor method for determining applicable corporation status, under which a corporation is an applicable corporation only if its book income is at least $500,000,000 under a modified Book Income Test.[28] The CAMT Notice also addressed certain technical aspects of the depreciation deductions and tax credits that are beyond the scope of this article.

ENDNOTES:

[1]*See* Notice 2023-02.

[2]*See* Notice 2023-07.

[3]Notice 2023-02, § 1; Notice 2023-07, § 5.03. Reliance on the Excise Tax Notice and the CAMT Notice is permitted upon the publication of the notices in the Federal Register.

[4]*See* https://www.paulweiss.com/practices/transactional/tax/publications/inflation-reduction-act-imposes-corporate-minimum-tax-and-an-excise-tax-on-stock-repurchases?id=43645.

[5]The Excise Tax also applies to certain corporations that have expatriated and are subject to the "inversion rules" of section 7874. Unless otherwise provided, all section references are to the Code, as amended. Special rules govern the applicability of the Excise Tax to repurchases of stock of certain foreign corporations. *See generally* Notice 2023-02, § 2.04.

[6]Certain "issuances" are excepted where the effect of the issuance would be to reduce artificially a Covered Corporation's Excise Tax liability as permitted by the Netting Rule (*i.e.*, a Covered Corporation's issuance of stock with respect to its existing stock). *See* Notice 2023-02, § 3.08(4). In addition, the Excise Tax Notice does not permit carryforwards or carrybacks of unused reductions under the Netting Rule. *See* Notice 2023-02, § 3.03(3)(c). Each year stands on its own for these purposes.

[7]Specifically, redemptions within the meaning of section 317(b), which applies to a corporation acquiring its stock from a shareholder in exchange for property (but excluding exchanges for the corporation's own stock or rights to acquire the corporation's stock).

[8]*See* Notice 2023-02, §§ 3.04(2)(a) & 3.09, Ex. 1. The Excise Tax Notice provides that the fair market value of non-publicly traded stock is to be calculated in accordance with any reasonable valuation method under the principles of Treasury Regulation section 1.409A-1(b)(5)(iv)(B)(1). *See* Notice 2023-02, § 3.06(2)(b). In certain cases, it may be possible that a redemption would be treated as a "dividend" under the general rules of section 302. As discussed below, the notice contains a rebuttable presumption that the redemption is a repurchase, but it appears that a corporation could rebut that presumption in the case of a redemption of preferred stock using certain rules, to the extent they are applicable on any given facts.

[9]Specifically, section 331 but not section 332(a) must apply. Notice 2023-02, §§ 3.04(4)(b)(i) & 3.09, Ex. 16. Moreover, the Excise Tax applies in certain liquidations but generally requires an 80% corporate owner. As a result, the Excise Tax typically will not apply to a SPAC liquidation.

[10]Notice 2023-02, § 3.07(2)(a).

[11]Notice 2023-02, § 3.09, Ex. 6.

[12]Notice 2023-02, § 3.07(2)(d).

[13]*See* Notice 2023-02, § 3.09, Ex. 11.

[14]*See* Notice 2023-02, § 3.04(4)(b)(ii).

[15]*See* Notice 2023-02, § 3.09, Ex. 3.

[16]Notice 2023-02, § 2.05(2)(f).

[17]Specifically, repurchases to which section 302 or 356(a) apply. Notice 2023-02, § 3.07(6)(b).

[18]*See* Notice 2023-02, § 3.07(6)(b).

[19]Specifically, any of: (i) the daily volume-weighted average price as determined on the repurchase date; (ii) the closing price on the repurchase date; the average of the high and low prices on the repurchase date; and (iii) the trading price at the time of the repurchase. In addition, if the repurchase date is not a trading day, the market price is determined by reference to the immediately preceding trading day. Notice 2023-02, § 3.06(2)(a)(i).

[20]*See* Notice 2023-02, § 3.06(2)(a). The Excise Tax Notice also provides guidance for determining the market price of repurchased stock that is not traded on an established securities market or denominated in a non-U.S. currency. *See* Notice 2023-02, § 3.06(2)(b)-(c).

[21]There are special AFSI tests for corporations that are members of foreign-parented multinational groups (as defined in section 59(k)(2)(B)), corporations whose three-taxable-year periods include a taxable year that is less than 12 months and corporations in existence for less than three years.

[22]Once a corporation meets the Book Income Test, it remains an applicable corporation unless (a) Trea-

sury determines such treatment is no longer appropriate and (b) either (i) there is a change in ownership (of an undefined nature) or (ii) its AFSI falls below the relevant threshold for a requisite number of consecutive years, as determined by Treasury. *See* section 59(k)(1)(C). Accordingly, without guidance, once an applicable corporation is an applicable corporation, it appears it will remain an applicable corporation.

[23]Notice 2023-07, § 3.03(1)(a).

[24]Notice 2023-07, § 3.06(1)(a).

[25]Notice 2023-07, § 3.03(1)(a).

[26]Notice 2023-07, § 3.03(2).

[27]Notice 2023-07, § 3.06(2).

[28]Notice 2023-07, § 5.03(2).

FROM THE EDITOR

Here's to the New Year

The first issue of *The M&A Lawyer* in 2023 looks back to the prior year—we lead off with our annual year-in-review piece by Sullivan & Cromwell's Frank Aquila and Melissa Sawyer, who chronicle well the volatile, unsettled year that was: a year marked by war, inflation, and a general slowdown in M&A activity.

As for 2023, what to expect? Sawyer and Aquila take their shot at predicting: "With the looming threat of a potential recession in 2023, the slowdown in the M&A markets is expected to continue at least for a little longer. However, there is a silver lining for M&A dealmakers as we embark on the new year: with valuations down, 2023 could offer unique purchasing opportunities. We can expect to see more corporate carve-out transactions and more earn-outs (or other methods of deferring consideration and bridging valuation gaps)."

Expect the heightened tenor of antitrust activity seen in 2022 to continue—in December alone, the FTC made a second request to block the Kroger/Albertsons merger and filed suit to block Microsoft's acquisition of Activision Blizzard. As Sawyer and Aquila write, "these agencies' success in court to date has been mixed, with judges frequently ruling in favor of the merging companies. But the DOJ and FTC do not need to rely on judicial rulings to effect the Biden administration's agenda—more stringent approval processes for major M&A transactions, a greater willingness to bring litigation against the transacting parties and more aggressive agency positions in settlement negotiations have significantly raised regulatory costs, such that some companies simply elect to abandon prospective M&A transactions that could face intense scrutiny."

The Fed's goal for the year is to hammer inflation down to the 2% range, somehow without causing a recession—how this plays out in the equity and bond markets will in part drive M&A activity. Aquila and Sawyer noted that there are indications of a solid buyer's market, as company valuations, particularly in areas like tech, are down or even depressed, while a strong dollar means that European assets are relatively cheap.

"Generally, expect to see an increase in distressed sellers and corporate carve-out transactions, which may be catalyzed in part by heightened levels of shareholder activism activity," the authors write. Also expect more earn-outs or other mechanisms meant to bridge valuation gaps. While getting deals done in 2023 may take more alacrity and skill than in the boom months of 2021, the potential is still there for a strong year.

Chris O'Leary

Managing Editor

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