Change of mechanism

Yoshinori Ono and Masataka Sato of Nishimura & Asahi discuss a new regime for the regulation of exchange tender offers in Japan

On July 1 2011, the Act on Special Measures concerning Industrial Revitalisation and Innovation of Industrial Activities (Act on Special Measures) was amended to reduce restrictions on tender offer bids using shares as consideration (a process known as an exchange offer). In practice, exchange offers have not been used in Japan due to restrictions on share issuances at favourable prices and restrictions on contributions in kind under the Companies Act. Instead, typically an acquirer uses cash as consideration for a tender offer bid.

There are several benefits of an exchange offer to an acquirer, including that it is able to acquire a target company without using a large amount of cash, and the acquisition serves as an effective use of an acquirer's treasury shares. There are also benefits to the shareholders of the target company: they receive the profits of any rise in the tender offeror's share price due to the acquisition.

In Japan, a share exchange (*kabushiki koukan*) under the Companies Act can also be used to acquire a company by using shares of the acquirer. In this process, the two companies enter into a share exchange contract that is approved by shareholders' meetings of each company. Then, the target company's shareholders receive shares of the acquirer and the target company becomes a wholly-owned subsidiary of the acquirer. A share exchange may not, however, be used to acquire only a portion of the shares of a target company and may not be used by a Japanese corporation to acquire a foreign corporation. On the other hand, these types of acquisitions are possible using an exchange offer.

“A share exchange may not be used by a Japanese corporation to acquire a foreign corporation”

Relaxation of restrictions on an exchange offer

There are three key amendments to the Act on Special Measures which relax restrictions on exchange offers.

The first relates to the fact that under the Japanese Companies Act, an exchange offer is recognised as contribution in kind of a target company's shares. Therefore, as a general rule, the Companies Act requires an investigation into the value of a target company's subject shares by an inspector appointed by the court. In practice, no schedule for the investigation is fixed in advance when a contribution in kind is made. Therefore, if restrictions on contributions in kind are imposed on an exchange offer, it is inconvenient because the schedule for the tender offer bid cannot be fixed.

In addition, if the value of the property contributed in kind falls considerably below its

value when the resolution to exchange the shares is adopted, the share subscribers or the directors of the issuing company are liable for the shortfall (Article 212, paragraph 1, item 2 and Article 213 of the Companies Act).

With an exchange offer, if the value of a target's shares falls considerably during the period after the tender offeror's resolution is adopted and before the tender offer bid is settled, the subscribing shareholders and the directors of the tender offeror are likely to be obliged to pay the tender offeror for the shortfall. This shortfall liability was a factor hindering the use of the exchange offer.

In response to this, the Act on Special Measures provides that subscribing shareholders and directors of a tender offeror are not subject to shortfall liability if they use a certified exchange offer: an exchange offer conducted under a business plan that is certified under the Act (Article 21-2, paragraph 2).

Another issue under the Companies Act was that a special resolution of a shareholders' meeting is required to conduct an exchange offer if the company issues or disposes of its shares at a particularly favourable price to persons who acquire the shares. Therefore, if a tender offeror seeks to add a premium when determining the ratio for the share exchange in an exchange offer, a shareholders' meeting is required. For example, if the tender offeror seeks to allot three of its shares for one target company share where a target company's share price is ¥200 ($2.60) and a tender offeror's share price is ¥100, this would mean that the tender

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offeror's shares will be issued or disposed of at around ¥67 per share while the share price of the tender offeror's shares is ¥100. The tender offeror is therefore required to explain at its shareholders' meeting the reason why it should issue shares at favourable prices, and obtain a special resolution of the shareholders' meeting.

For a tender offeror to hold a shareholders' meeting in order to provide a premium would require a considerable amount of time and money, particularly if the tender offeror is a listed company. Thus, these favourable issuance restrictions hindered the use of exchange offer in Japan. In response to this, the Act on Special Measures exempts favourable issuance restrictions for a certified exchange offer if the amount obtained by multiplying the number of shares to be delivered by the exchange offer by the net assets per share does not exceed one-fifth of the amount of net assets of the tender offeror (Article 21-2, paragraph 3). This is known as the simple transaction test.

Thirdly, as a general rule, the Companies Act prohibits subsidiaries from acquiring shares of their parent entity (Article 135, paragraph 1 of the Companies Act). As a result, the subsidiary of a tender offeror that is implementing an exchange offer may not acquire shares of the parent in order to deliver them as consideration (such a structure is known as a subsidiary structure) under the Companies Act. In response, the Act on Special Measures provides an exemption to this restriction (Article 21-2, paragraph 2).

The subsidiary structure is significant because

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of the growing trend of Japanese companies establishing their head offices outside Japan. The subsidiary structure enables such Japanese corporations to acquire foreign corporations with more flexibility. It should be noted, though, that although the Act on Special Measures exempts restrictions against a subsidiary acquiring a parent entity's shares under the Companies Act, similar restrictions under foreign laws may still apply.

Procedures for an exchange offer

There are generally three phases to the carrying out of an exchange offer under the Act on Special Measures. First, a business plan including an exchange offer is submitted to and approved by regulatory authorities; then, a board of directors' resolution is made to implement an exchange offer and issue shares and finally the tender offer bid is conducted and the target company shares are acquired in exchange for delivery of acquirer's shares to the target company shareholders.

Business plans

The Act on Special Measures provides for approval of various types of business plans, but approval of one of the following four types of plan is required for the exemptions under the Act: a business restructuring plan (Article 5, paragraph 1); a management resources revitalisation plan (Article 7, paragraph 1); a management resources integration plan (Article 9, paragraph 1); or a resources productivity innovation plan (Article 11, paragraph 1).

A business restructuring plan is a plan to enhance the productivity of an entire enterprise by selection and concentration of investment of management resources in the core business of a target company.

A management resources revitalisation plan is a business plan where the company succeeds to businesses held by other entities, and is intended to enhance the productivity of those businesses while effectively making use of the management resources of the other entities. This plan assumes that entities within the group will be reorganised or that there will be an acquisition of business divisions by strategic investors or funds.

A management resources integration plan is a business plan which aims for the significant enhancement of productivity through innovative practices that integrate managerial resources in different business fields.

A resources productivity innovation plan is a business plan where a target company enhances the productivity of its own resources. In contrast with the other types of business plans listed here, a resources productivity innovation plan includes measures to improve energy and other resource use, and thereby enhances the profit by reducing costs.

The Act on Special Measures sets out the items to be described in each type of business plan. Generally, the business background, purpose and direction, an outline of the business subject to the business plan, the reason for selection of the plan, the targets to be achieved, time of implementation and matters concerning employees must be included in each type of business plan. These plans are then approved based on the requirements in the Act. In addition to the requirements of the possibility and the appropriateness of the business plan, the Act requires the establishment of targets for management indices such as return on equity or return on assets, and detailed figures on enhanced finances.

In practice, it is generally best to consult with the regulatory authorities approximately two months before the date for which approval is scheduled. If the tender offeror is a listed company, it is best to consult with the authorities two months before the tender offer bid is scheduled to be disclosed to the public.

After it is contacted, the regulatory authority will typically conduct a detailed review of the plan to confirm compliance with requirements in the Act on Special Measures. After this review, the official application for approval of the business plan is submitted. Once a plan is officially submitted, it takes approximately one month to be approved.

In order to use an exchange offer, specific matters, including the number of shares to be used as consideration, must

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be stated in the plan approval application. Documents must also be attached which state the exchange ratio of the shares of the target company to the shares of the tender offeror and describe why the consideration is reasonable.

At the time of application for approval, it is not necessary to have finalised the specific terms and conditions of the exchange offer, such as the exchange ratio and the number of own shares to be disposed of. These matters must be determined before approval of the business plan, however.

Decisions to conduct an exchange offer

As discussed above, a special resolution of a shareholders' meeting is required to conduct an exchange offer at the price that includes a premium. However, under the Act on Special Measures, no shareholders' special resolution is required and a board of directors' resolution is sufficient to approve the tender offer if the simple transaction test is satisfied.

The Act also permits an exchange offer to offer a combination of the shares and cash as consideration. If consideration in an exchange offer is a combination of shares and cash, only the shares used as consideration must be used when calculating the simple transaction test. The numerator used to calculate the simple transaction test does not include cash consideration.

It is therefore possible to satisfy the simple transaction test by increasing the ratio of cash consideration. Even if the simple transaction test is satisfied, however, a special resolution of a shareholders' meeting would be necessary if shareholder(s) of the tender offeror that hold sufficient shares to block the special resolution notify the tender offeror of their intention to object to the exchange offer within two weeks from the date of the public notice made by the tender offeror after the tender offeror's board of directors resolves to approve the issuance of shares (Article 21-2, paragraph 3 of the Act on Special Measures).

Tender offer bid

In order to conduct an exchange offer, the tender offeror needs to comply with the Financial Instruments and Exchange Act.

Under the tender offer bid system in Japan, a tender offer bid must be conducted within a period which is not less than 20 and not more than 60 days. All of the target company shares that are tendered must be purchased unless the tender offer notification indicates a minimum threshold of tendered shares or a maximum limit of tendered shares. However, if the tender offeror's shareholding ratio in the target company after the tender offer bid will be two-thirds or more, the tender offeror must acquire all of the shares of the target company tendered. In addition to the above, the Financial Instruments and Exchange Act requires that a tender offer must have uniform terms and conditions.

The Financial Instruments and Exchange Act does not require a minimum number of tendered shares for tender offers; but in order to qualify for the special exemptions under the Act on Special Measures, the tender offeror must turn the target company into a relevant business party which is similar to a subsidiary under the Companies Act (Article 2, item ii of the Ordinance for Enforcement of the Act on Special Measures).

Therefore, paragraph 11-(d) of the Basic Guidelines for the Act on Special Measures provides that if the tender offeror holds less than 40% of the voting rights of the target company before the exchange offer, then a minimum limit is required that is sufficient for the tender offeror to hold 40% or more of the voting rights of the target company after the tender offer bid.

The Act on Special Measures gives shareholders of the tender offeror who object to an exchange offer the right to sell their shares to the tender offeror for their protection from dilution (Article 21-2, paragraph 3 of the Act on Special Measures).

If the simple transaction test is met and the issuance of shares of the tender offeror is approved by the board of directors of the tender offeror, all shareholders of the tender offeror may exercise a right to sell their shares to the company.

If the share issuance is approved by a shareholders' meeting, then only shareholders who gave notice of their disapproval of the tender offer may exercise the right to sell their shares. The price for any such sale must be a fair price. This put-right must be exercised within a period from 20 days before the day the shares are issued up to the day immediately preceding the relevant issuance date.

Capital gains tax

A tender by the shareholders of the target company in an exchange offer is a contribution in kind to the tender offeror of the shares of the target company. As a contribution in kind of shares is also a transfer of shares, any capital gains are subject to tax. In contrast, the shareholders of the target company in a share exchange (*kabushiki kokan*) may defer capital gains taxes on the shares because of a special provision in the tax law.

In an exchange offer, however, capital gains taxes on shares held by the accepting shareholders may not be deferred (even though the mechanism of the exchange offer does not differ with a share exchange in that the shares of the tender offeror are acquired in exchange for the shares of the target company held by the shareholders of the target company).

If the accepting shareholders do not have funds to pay the applicable taxes, they will be forced to raise sufficient funds by selling their shares of the tender offeror. The foregoing is considered to be a factor that limits the use of the exchange offer, and thus a helpful tax system reform is desirable so that taxation on capital gains may be deferred in an exchange offer.