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BREXIT AND MERGER CONTROL

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The United Kingdom's June 23, 2016 vote to leave the European Union (EU)—known as Brexit—triggered a political and economic earthquake in Europe. After nine months of intense speculation and debate, Prime Minister Theresa May launched the formal Brexit process on March 29, 2017 by delivering a letter to the European Council invoking Article 50 of the Treaty on European Union (TEU), which sets out the procedure for a Member State to leave the EU.[1] Donald Tusk, the President of the European Council, promptly responded by issuing a statement[2] acknowledging receipt of the Article 50 letter and publishing draft guidelines for the negotiation to be led by the European Commission.[3]

Among the many difficult issues to be addressed in the Brexit negotiations, competition policy does not feature prominently. The UK's Article 50 letter doesn't mention competition policy at all, and the European Council's draft guidelines state merely that any future agreement between the EU and the UK must "ensure a level playing field in terms of competition and state aid, and must encompass safeguards against unfair competitive advantages." Nonetheless, Brexit is likely to have significant consequences for businesses engaged in acquisitions or joint ventures triggering antitrust review in Europe.

In particular, Brexit will bring an immediate end in the UK to the EU's "one-stop-shop" under the European Union's Regulation 139/2004[4] on the control of concentrations among undertakings (the EUMR). Currently, an EU merger filing precludes the need for a filing in the UK. As from the Brexit effective date, mergers may trigger filings both in the EU and the UK. Thus, Brexit will likely lead immediately to more UK merger notifications, a significant increase in the UK Competition and Markets Authority's (CMA's) workload, and increased burdens for companies. Global M&A transactions often trigger multiple merger filings, and the addition of one more may not seem too serious. Duplicate filings in Brussels and London will likely have a disproportionate impact, however, owing among other things to the fact that both authorities will often need to examine the same European markets in parallel, both authorities employ front-loaded, information-heavy regimes and any required remedies may overlap or even conflict.

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This "Brexit tax" in merger control can't be avoided entirely, but with creativity and good will the CMA and the Commission can significantly reduce its impact. The Commission and the CMA need not await the results of other negotiations before exploring these possibilities. Indeed, in a speech on February 4, 2017 ("the Coscelli Speech"),[5] the CMA's Acting Chief Executive acknowledged that "arrangements for effective co-operation and information sharing . . . will be key to the effectiveness of any future UK regime" and stressed the importance of coordination "even before Exit." This article explores the merger control implications of Brexit and suggests ways to mitigate the burden on competition authorities and business.

Brexit Background

The basic mechanism for an EU Member State to leave the European Union is set out in Article 50 TEU,[6] but the language of this article is very general. The Article 50 process is triggered by a notice from the leaving Member State to the European Council. Article 50 TEU does not define the conditions or procedure for giving such a notice, which depend on Member State law. Once the Article 50 notice is given, the leaving Member State and the European Union have two years to negotiate an exit agreement, failing which the Member State's exit becomes effective two years after the notice date.

As noted, the UK finally delivered its Article 50 notice on March 29, 2017, so the two-year deadline will expire on March 29, 2019. The European Council plans to meet on April 29, 2017 to approve the final form of the Commission's draft guidelines. The negotiation process will thus begin in May 2017, with the goal of completing negotiations by about October 2018 to allow time for required approvals by March 2019.

In a speech on January 17, 2017 ("the May Speech"),[7] the Prime Minister rejected an "unlimited transitional status" and said she wants a final agreement by the end of the two-year period. May's position seems unrealistic, since negotiating even traditional free trade agreements commonly takes five years or more, and May is aiming for a "new, comprehensive, bold and ambitious free trade agreement." Indeed, the European Council's draft guidelines call for a "phased approach to negotiations," beginning with settling the UK's obligations deriving from commitments taken while it was still an EU Member State and the immediate effects of the UK's withdrawal. According to the Council, the process of negotiating the

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future relationship of the EU and the UK will not even begin until "sufficient progress" on these issues has been achieved.

The Council's draft guidelines foresee the need for transitional arrangements to "provide bridges towards . . . the future relationship," but notes that any such transitional arrangements must be limited in time and subject to effective enforcement mechanisms. Similarly, the Coscelli Speech recognizes the need for "clear transitional arrangements" in antitrust. Coscelli mentions in particular that transitional arrangements will be needed to cover investigations ongoing when Brexit becomes effective.

Coscelli's comments do not suggest that the EUMR one-stop-shop could continue to apply to transactions entered into post-Brexit. The draft Council guidelines note that any temporary extension of EU rules (to allow continued access to the EU's single market, for instance) would need to be accompanied by continued application of existing Union regulatory, budgetary, supervisory, and enforcement mechanisms. Since the UK has ruled out the continued jurisdiction of the EU courts, we must assume that post-Brexit transactions may be subject to notification both in the EU and the UK. Any transitional arrangements in the merger review area will likely concern such important but technical issues as the UK notifiability of transactions under EU review but not yet cleared on March 29, 2019.

Merger Control Background

Before discussing Brexit's impact for business in the area of merger control, it is worth summarizing the main similarities and differences between the Commission's and CMA's merger review processes.

In many ways, the Commission's and the CMA's approaches to merger control are similar. Both are sophisticated authorities using similar notification forms and using similar methods to analyse notified transactions. While the Commission blocks or remedies mergers that would lead to a "significant impediment to effective competition," and the CMA looks for a "substantial lessening of competition," the theories of harm and underlying economic analyses are essentially identical on their face. Both apply similar tests for establishing the relevant market (which the Commission refers to as its "small but significant and non-transitory increase in price" test (SSNIP), and the CMA as its "hypothetical monopolist" test). Both are more concerned with horizontal than with vertical or conglomerate mergers, and both look at possible unilateral, coordinated and conglomerate effects. Both use a two-phase process in which more problematic mergers are subjected to in-depth assessment (commonly referred to as "Phase 2").

On the other hand, the CMA's internal procedures differ in significant ways from the Commission's, for instance in the use of "Inquiry Groups" drawn from an independent panel to oversee Phase 2 investigations. Considering that the CMA has so far focused on smaller value transactions often having a local or regional focus and that its independent panel structure may make ensuring consistency more difficult, divergences may emerge when the Commission and the CMA are reviewing large, global transactions in parallel.

So far, the key difference between the EU and UK systems lies in which mergers are caught in the first place. The UK system captures "relevant merger situations" where the target has turnover above £70 million, or the parties' combined "share of supply" is 25% or more in the UK. In those situations, parties can decide whether or not to notify the CMA, although where the test is met parties are well-advised to inform the CMA, if only by an informal letter explaining why they do not intend to notify formally. The CMA can, wherever a relevant merger situation occurs, call in a merger for review.

By contrast, if a deal meets the EU notification thresholds—which are currently entirely turnover-based—an EU notification is mandatory. In that case, moreover, the parties cannot close a deal until clearance has been obtained. In the United Kingdom, it is legal to close a deal qualifying as a relevant merger situation without approval, unless the CMA requires the parties to hold their businesses separate until a decision has been reached.

The differences in thresholds lead to differences in the types of mergers reviewed by each authority. For example, the Commission reviews a large number of "full function joint ventures." Where a joint venture is set up by large multinational firms, the deal will be reviewed by the Commission if the parents meet the turnover tests even if the joint venture is small and has little or no market presence in the European Union. Cases of this nature are not caught under the UK rules.

These differences have a knock-on effect in the nature of the authorities' dockets and the outcomes of their cases. The CMA's long-term average of cases that are subjected to an in-depth investigation is around thirty percent, compared to about four percent for the Commission. This reflects the fact that "no issues" cases are often not notified under the CMA's voluntary system, so the CMA's case load has a larger number of difficult cases. Similarly, a larger proportion of CMA decisions require remedies or commitments to resolve competition concerns than is the case in Brussels. Because the CMA's cases are more difficult on average, the CMA has a number of different processes from the Commission:

- The CMA can fast-track cases straight to the in-depth Phase 2 review, where it is clear that the deal could not be cleared in Phase 1. The Commission cannot do this under the EUMR.

- The CMA has no "short form" notification procedure. At the EU level, parties to deals that seem to raise no concerns can use the less onerous "Short Form CO," an abbreviated version of the full Form CO used for notifying transactions under the EUMR.

- The CMA's Phase 1 review lasts 40 working days, compared to the Commission's 25. Any difference here, however, may be off-set by pre-notification discussions, which allow the Commission to extend the review process outside the statutory timetable.

Brexit Consequences for Merger Control

Turn to the future. Brexit is likely to impact merger control in four main ways: a significant increase in UK filings, a possible reduction in EU filings, the loss of a framework for cooperation between the Commission and the CMA, and greater burdens and legal uncertainty for businesses.

More UK Filings

Many transactions meeting the EUMR filing thresholds will also meet the UK thresholds post-Brexit, but not all. For instance, joint ventures that meet the EU turnover thresholds by virtue of the parents' turnover are not necessarily captured under the UK rules. In addition, some deals that meet the EU thresholds will not trigger the UK thresholds, because the target does not have more than £70m in UK turnover and the transaction does not involve the creation or increase of a 25% share of supply in the UK. Moreover, transactions raising no competition issues, like many private equity transactions, will probably not be notified under the UK's voluntary system even if the thresholds are met. In short, not all transactions notifiable under the EUMR will also be notified in the United Kingdom, but many likely will be. This duplication will lead to a significant increase in the CMA's workload. According to the Coscelli Speech, the CMA anticipates between 30 and 50 additional notifications, and a half dozen or so additional Phase 2 investigations, for an increase of 40%-50% in the CMA's workload.

Fewer EU Filings

Conversely, Brexit may lead to a reduction in the number of EU filings. Many companies derive a significant portion of their EU turnover in the UK, and some transactions that would currently be notifiable under the EUMR likely won't meet the turnover thresholds for mandatory filing when the UK is excluded. The number of EU filings eligible for voluntary referral to the Commission could also be reduced. Under the EUMR, parties acquiring control in transactions that would otherwise be notifiable in three or more Member States can request that the transaction be referred to the Commission for review. The UK's jurisdictional thresholds are broad, and it is not uncommon for the UK to count as one of the jurisdictions that can be used to trigger a referral request. Parties to transactions that would be subject to review in (only) three EU Member States, including the UK, would no longer be able to take advantage of the voluntary referral process. Overall, it seems likely that Brexit will result in a small but noticeable drop in the number of filings to Brussels. On the other hand, changes to the EUMR thresholds the Commission is currently considering[8] may have a greater effect on the number of EU filings than Brexit.

Lost Cooperation Framework

Under the EUMR's one-stop-shop, the Commission and the CMA do not currently have to coordinate parallel merger reviews. Thanks to the ECN, there is currently a strong institutional framework for cooperation among the Commission and national competition authorities (NCAs), but the CMA will be excluded from this framework at precisely the time when the need for coordination will increase, thanks to the large number of parallel merger investigations.

The Commission could and likely will enter into a bilateral Memorandum of Understanding with the CMA providing for cooperation in antitrust matters, as it has done with many other competition authorities. Because so many merger cases involve pan-European markets, however, efficient handling of parallel EU and UK merger investigations will require a far greater level of coordination than currently occurs under existing Commission agreements.

Burdens and Uncertainty for Businesses

The need for duplicate filings in the EU and the UK will directly and immediately increase the burden of merger control for business. Of course, many transactions trigger multiple merger control filings already, so one more may not be seen as a material change. Unfortunately, however, the extra burden for business may be greater than the addition of one more filing would otherwise suggest, for several reasons.

First, the high level of market integration in the EEA suggests that parallel review by the Commission and the CMA will involve a higher degree of overlap and duplication than parallel reviews by other jurisdictions. In many cases, the relevant geographic markets on which a transaction's impact is to be analysed will be EEA-wide, or at least regional. As a result, the Commission's and CMA's investigations, including for example extensive questionnaires, meetings with customers and competitors, and potentially site visits, will often involve the same entities and locations.

Second, within merging parties' organizations, the same limited group of people responsible for the European region will often be called upon to provide information for both the EU and UK investigations. While in many cases the same data will be usable in both notifications, any differences in the information required will increase the burden for European market research or other business teams. To the extent that the Commission's and CMA's lines of questioning diverge in the course of the investigations, this burden will further increase.

Third, to the extent the Commission and the CMA have different concerns about a transaction and require remedies to address those concerns, divergent or conflicting remedies will be more likely to create operational problems than remedies in different regions of the world. Although the Commission and the CMA currently take similar approaches when analysing mergers, their approaches may diverge over time. May reportedly[9] advocates a more industrial-policy oriented approach to merger control than the Commission or the CMA have traditionally supported. The Prime Minister's sentiment is not repeated in the Coscelli Speech or in the UK Government's January 2017 Green Paper on Building our Industrial Strategy,[10] however, and sudden policy changes seem unlikely. Nonetheless, duplicate merger reviews covering the same European markets create legal uncertainty and in some cases may lead to divergent outcomes.

Mitigating the Brexit Tax in Merger Control

For all these reasons, Brexit will likely increase the burden of merger review for business and increase legal uncertainty over time. The Commission and CMA could, however, take a number of concrete steps to mitigate these negative consequences, even before the Brexit effective date.

First and most broadly, the Commission and the CMA should create an ad hoc framework for cooperation in merger cases. This cooperation should be much broader than existing forms of cooperation between agencies, such as between the Commission and the U.S. antitrust agencies. The new cooperative framework could encompass all stages of the merger review process, from the notification to investigation to remedies.

With respect to the notification process, the Commission and the CMA could undertake a review of their existing notification forms to identify differences that might lead to unnecessary burdens for companies notifying in both jurisdictions and consider changes. Another approach to achieve similar benefits could be for the CMA to accept EU notifications (with some supplemental UK-specific information) for UK purposes, as the Swiss authority does with EU notifications.

It would also be helpful to align the Commission's and the CMA's pre-notification and Phase 1 timelines. As noted, the current UK process is 40 working days in Phase 1 in comparison to 25 working days in Brussels, but the EU notification process begins with an often-lengthy pre-notification period. If a UK filing must be delayed until the EU pre-notification process is completed (so that the same market information can be used in both notifications), the longer UK Phase 1 period would be unnecessary.

With respect to the investigation process, the Commission and the CMA could greatly reduce the burden for business by cooperating in the collection of evidence. For instance, they could prepare common questionnaires, cooperate in interviews with customers and competitors, and conduct site visits and state-of-play meetings jointly. Rights of defense would of course need to be protected, but merging parties would generally benefit from such cooperation. Similarly, if parties receiving an EU statement of objections wished to exercise their right to an oral hearing, the hearing could be coordinated with the CMA—or, perhaps more realistically, the CMA could consult closely with the Commission and adjust its review timelines to allow the EU and UK processes to move forward in parallel and align key decision points.

Where remedies are needed, the Commission and the CMA could agree to accept remedy proposals in the same format, if and to the extent the issues are the same, and to cooperate in the market testing of proposed remedies. Similarly, in remedy implementation the Commission and the CMA could agree to accept the same forms and otherwise avoid duplication. For example, in many cases only one monitoring or divestiture trustee should be required for both the EU and UK processes. A useful model might be the existing but informal arrangements between the U.S. agencies and the Canadian Competition Bureau, under which the Bureau sometimes relies on remedies negotiated by the U.S. agencies based on a side letter, without the need for a complete separate remedy process in Canada.

Procedural cooperation and convergence between the Commission and the CMA are clearly desirable post-Brexit, but it remains to be seen how far the CMA will be prepared to accept the Commission as the "lead authority" on European competition matters. The CMA may be less willing to allow another agency to take a leading role than the Swiss and Canadian authorities have been (even though pre-Brexit it would not have had jurisdiction over cases caught by the EUMR). If that turns out to be the case, a looser structure in which the Commission and the CMA could agree on a case-by-case basis which authority is best placed to take the leading role may be preferable.

In summary, Brexit will likely lead to duplicate EU and UK notifications in many transactions that meet the EUMR thresholds. The additional notification requirements will lead to increased costs and complexity for business. With creativity and good will, however, the Commission and the CMA could do much to mitigate these burdens. In many cases, the Commission and the CMA could potentially make significant improvements through bilateral agreements without the need for new legislation. Although the structure and contents of the broader Brexit negotiations are likely to be unclear for some time, the Commission and the CMA would be well advised to consider potential steps and to set up working groups to discuss these initiatives in parallel with the broader negotiations.

ENDNOTES:

[1] https://www.gov.uk/government/publications/prime-ministers-letter-to-donald-tusk-triggering-article-50.

[2] http://www.consilium.europa.eu/en/press/press-releases/2017/03/29-euco-50-statement-uk-notification/.

[3] https://www.neweurope.eu/article/tusk-muscat-present-eu-councils-draft-guidelines-following-uks-article-50-notification-berxit/.

[4] http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32004R0139.

[5] https://www.gov.uk/government/speeches/andrea-coscelli-on-the-cmas-role-as-the-uk-exits-the-european-union.

[6] http://www.lisbon-treaty.org/wcm/the-lisbon-treaty/treaty-on-European-union-and-comments/title-6-final-provisions/137-article-50.html.

[7] https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech.

[8] http://ec.europa.eu/competition/consultations/2016_merger_control/index_en.html.

[9] http://uk.reuters.com/article/uk-britain-eu-industry-idUKKCN10C3CX.

[10] https://www.gov.uk/government/consultations/building-our-industrial-strategy.

REAFFIRMATION STOCKHOLDER VOTE WILL CLEANSE NON-CONFLICTED CONTROLLER TRANSACTIONS AND EVEN TRANSACTIONS APPROVED BY BOARDS ALLEGEDLY NOT INDEPENDENT AND DISINTERESTED: *MERGE HEALTHCARE*

By Abigail Pickering Bomba, Warren S. de Wied, Steven Epstein, Arthur Fleischer, Jr., David J. Greenwald, Scott B. Luftglass, Philip Richter, Robert C. Schwenkel, Peter L. Simmons, and Gail Weinstein

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Merge Healthcare Inc. Stockholders Litigation[1] is the most recent decision reflecting an expansive interpretation by the Court of Chancery of the Delaware Supreme Court's seminal 2015 *Corwin* decision. The opinion confirms again the power of *Corwin* in "cleansing" a transaction based on stockholder approval in a fully informed vote. When *Corwin* applies, a transaction will be reviewed, post-closing, under the business judgment rule (regardless of the standard of review that was applicable pre-closing) and, as a result, challenges will be dismissed at an early stage of litigation.

Key Points

- ***Corwin* cleansing of non-conflicted controller transactions**. The court reaffirmed that fully informed stockholder approval cleanses a transaction even if the target company has a controller, so long as the controller's interests are aligned with the other stockholders' interests.

- ***Corwin* cleansing of transactions approved by allegedly non-independent directors**. The decision is the fourth post-*Corwin* Court of Chancery decision indicating that fully informed stockholder approval cleanses a transaction even if the directors who approved the transaction are alleged to have not been independent and disinterested.

- **Which transactions are excluded from *Corwin* cleansing**. Based on *Merge Healthcare* and other recent Court of Chancery opinions, it appears that the only transactions excluded from cleansing under *Corwin* are controller transactions in which the controller (a) "stands on both sides of the transaction" (such as a going-private transaction) or (b) extracts a personal benefit not shared by the other stockholders (such as receiving disparate merger consideration).

Background

The plaintiffs challenged the adequacy of the sale process, price and disclosure relating to the $1 billion acquisition of Merge Healthcare, Inc. (the "Company") by IBM. The plaintiffs alleged that the CEO-Chair-director-27% stockholder was a controller; and that the directors approving the transaction were not independent and disinterested, based on their alleged significant ties and relationships with him. The plaintiffs contended, further, that the directors had acted in their own personal interests in approving the transaction, motivated by obtaining liquidity, by obtaining post-merger employment with the surviving corporation and, in the case of the alleged controller, by collecting a $15 million consulting fee to which he would become entitled if the merger were consummated (although he waived his right to the consulting fee prior to the stockholder vote on the merger). The plaintiffs also claimed that the merger price (which represented a 32% premium above the unaffected stock price) was unfair and did not fully value the Company. Almost 80% of the shares outstanding voted in favor of the transaction—which, after excluding the 26% owned by the alleged controller, represented a majority of the disinterested shares. Vice Chancellor Glasscock rejected the plaintiffs' disclosure claims and dismissed the case at the pleading stage of litigation. The Vice Chancellor ruled that, under *Corwin*, approval by the disinterested stockholders in a fully-informed, uncoerced vote had cleansed the transaction.

Discussion

Transactions approved by a board that was allegedly not independent and disinterested will *not* be excluded from *Corwin* cleansing. In *Corwin*, the Delaware Supreme Court held that "when a transaction that *is not subject to the entire fairness standard* is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies" (*emphasis added*). Generally, a transaction may be subject to the entire fairness standard if (i) it is a controller transaction where the controller's interests are not aligned with the interests of the other stockholders or (ii) it was approved by a board that was not independent and disinterested. The *Corwin* opinion did not clarify whether *all* transactions that would otherwise be subject to entire fairness (*i.e.*, transactions described in (i) *or* (ii) above) would be excluded from "cleansing" under *Corwin*, or whether it was only transactions described in (i) above (as was the situation in *Corwin*) that would be excluded. Chancellor Bouchard suggested in the Court of Chancery's opinion in *Corwin* that *only those transactions described in (i) above would be excluded from Corwin cleansing*. Since *Corwin*, the Court of Chancery has issued two additional opinions endorsing that suggested approach.[2] *Merge Healthcare* is now the third post-*Corwin* opinion suggesting that transactions approved by a board that allegedly was not independent and disinterested will not be excluded from cleansing under *Corwin*. As noted, the Delaware Supreme Court has not addressed this issue.

Controller transactions will be excluded from *Corwin* cleansing *only if* the controller's interests are not aligned with the interests of the other stockholders. *Merge Healthcare* reaffirms that *Corwin* will not apply (and the entire fairness standard of review will apply), post-closing, only when a controller "stands on both sides of the transaction" (*i.e.*, is himself the buyer, as in a going-private transaction) or extracts a personal benefit not shared by the other stockholders (such as receiving different compensation or receiving a consulting fee contingent on consummation of the transaction). In such a situation, the court explained (consistent with longstanding Delaware jurisprudence) that coercion is deemed "inherently present" and the transaction cannot be cleansed. In *Merge Healthcare*, the court found that the alleged controller's interests *were* aligned with the other stockholders' interests. Although the alleged controller had a consulting arrangement with the Company pursuant to which he was entitled to a $15 million consulting fee if the Company entered into the merger with IBM, during negotiation of the deal with IBM, he waived the fee in exchange for IBM's increasing the aggregate merger consideration by $15 million. The plaintiffs argued that the waiver "came too late and . . . the sale process [had] already [been] 'poisoned' by the existence of th[e] fee." The court disagreed, stating that the waiver fully aligned the controller's interests with those of the other stockholders. The court noted, further, that the controller, as the largest stockholder of the Company, had every incentive to negotiate for the highest possible price, and that he would receive $188 million on the sale, which "dwarf[ed] the consulting fee."

Amplification of the meaning of the "waste" standard under *Corwin*. The Delaware courts have previously clarified that, when the business judgment rule applies under *Corwin*, a post-closing challenge to the transaction will be dismissed at an early stage of the litigation unless the transaction constituted "waste." The courts have characterized "waste" as a "vestigial" and "only theoretical" standard, with "little real-world relevance"—particularly in the *Corwin* context, because, as Vice Chancellor Glasscock noted in *Merge Healthcare*, "it is difficult to envision a majority vote in favor of a transaction so unfavorable as to constitute waste." On this basis, it has been difficult to fathom what purpose the waste standard serves. In a footnote in the *Merge Healthcare* opinion, the Vice Chancellor provided the following helpful further explication: "[W]aste is best viewed [in the *Corwin* context] as a kind of 'judicial out,' a way around the strictures of the cleansing rule given a fact situation of some undefined level of egregiousness, such that equity would intervene."

Reaffirmation of the court's stringent "materiality" standard for disclosure claims. The court found that the plaintiffs had not alleged disclosure violations involving material information. Consistent with other recent Delaware decisions dismissing post-closing disclosure claims made in the context of plaintiff arguments that *Corwin* cleansing should be held inapplicable because the stockholder vote was not "fully informed," the court reiterated:

> 'Fully informed' does not mean infinitely informed. . .[and] information [need not] be disclosed simply because. . .it would be helpful, or interesting. . .. [Rather, information will be found material if,] from the perspective of a reasonable stockholder, there is a substantial likelihood that it significantly alters the total mix of information made available. Redundant facts, insignificant details, or reasonable assumptions need not be disclosed. . . [and the summary of the financial advisor's analysis does not require] a cornucopia of financial data, but rather an accurate description of the advisor's methodology and key assumptions. . . [that is] sufficient for the stockholders to usefully comprehend, not recreate, the analysis.

Practice Points

As discussed, the opinion reaffirms that, in the *Corwin* context, the court will apply a high bar to finding that an alleged non-disclosure may be "material." **The court concluded as follows with respect to the *Merge Healthcare* plaintiffs' specific disclosure claims**:

- ***Alleged controller's waiver of the consulting fee***. The plaintiffs argued that the proxy misleadingly suggested that the controller waived his consulting fee for the purpose of obtaining a price increase, when there was evidence that his purpose was avoiding formation of a special committee that would exclude him. The court stated that disclosures relating to a board's "subjective motivation or opinions" (*i.e.*, "asking why") does not state a meritorious disclosure claim.

- ***Atypical treatment of SBC***. "[Even] [a]ssuming for purposes of this argument that the accounting treatment of SBC [(stock-based compensation)] would be material to stockholders," it was not necessary to disclose that, in the financial advisor's DCF analysis, the advisor "atypically" treated SBC as a cash expense. The court reasoned that the proxy disclosed the Company's unlevered-free-cash-flow (UFCF) projections; disclosed that the advisor used the UFCF projections; and disclosed that, in creating the UFCF projections, management used GAAP earnings (which, as the defendants had pointed out, requires treatment of SBC as a cash expense).

- ***SBC projections***. Disclosure of the Company's projections for SBC for 2015-2019 were not required, as the proxy provided a "detailed summary of [the advisor]'s work, including projections for Revenue, Gross Profit, EBITDA, EBIT, Net Income, Earnings Per Share, and UFCF. Therefore,. . .it [was] not reasonably conceivable that the actual projections of SBC, while they might [have been] of interest to stockholders, [were] necessary for a fair summary of [the advisor]'s work in light of the disclosures actually made."

- ***NOLs' present value***. A separate value for the Company's net operating losses (NOLs) was not required. The court rejected the plaintiffs' contention that the NOLs had to be disclosed as a "key input" pursuant to *Netsmart* (where the court held that "the valuation used to arrive at [a banker's] opinion as well as the *key inputs* and range of ultimate values generated by those analyses must . . . be fairly disclosed"). The Vice Chancellor wrote: "I fail to see how the separate disclosure of the present value of NOLs under the facts here would alter the total mix of information available to the stockholders given the detailed fair summary of [the financial advisor]'s work already contained in the Proxy."

ENDNOTES:

[1]Jan. 30, 2017.

[2] *Solera*, Jan. 5, 2017, written by Chancellor Bouchard, and *Larkin v. Shah*, Aug. 25, 2016, written by Vice Chancellor Slights.

GERMAN COMPETITION LAW CHANGES: NEW RULES ON MERGER CONTROL, MARKET DOMINANCE, DAMAGES CLAIMS, AND CARTEL FINES

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On March 9, 2017, the German Federal Parliament passed the ninth amendment to the Act against Restraints of Competition (ARC) (*Gesetz gegen Wettbewerbsbeschränkungen*). The amendment will come into force in the second quarter of 2017 and will substantially change German competition law.

The reform is driven in part by formal requirements to implement EU legislation into national German law (in particular, provisions of Directive 2014/104/EU, the "Cartel Damages Directive"), and to eliminate some inconsistencies between EU and German law in the area of cartel enforcement. But it also aims to adjust the domestic competition law framework to some of the challenges that come with big data, two-sided markets, and with the digital economy more generally.

For companies and investors doing business in Germany, the new law brings a number of practical changes:

- It introduces a **new transaction value threshold for mergers** to require clearance by the German Federal Cartel Office (FCO) (*Bundeskartellamt*);
- It exempts certain **cooperations among newspaper and magazine publishers** from (German) antitrust scrutiny, aiming to create efficiencies in particular for small and medium size market players.
- It puts an end to certain practices of **avoiding monetary fines** from cartel investigations by restructuring the affected corporate entities;
- It harmonizes the German approach towards **parental liability for cartel fines** with EU law;
- It expands the FCO's tool box to **assess market power** when dealing with "big data" or network effects in digital markets, both in merger cases and in antitrust investigations;
- It introduces a number of changes to the framework for bringing follow-on cartel damages cases in Germany, *e.g.* with respect to the

passing-on defense, disclosure obligations, statute of limitations, plaintiffs' exposure to litigation costs, or settlements.

The reform is the first major competition law change since 2013 and the first relevant change in the area of private cartel enforcement since 2005. However, with digitalization constantly driving market changes, it seems a safe bet that subsequent changes will come within much shorter periods of time. In particular, the new law itself asks that the federal government shall monitor the application of some of the new rules, and report back to Parliament after a three-year period. And prior to the recent reform, although it did eventually not (yet) materialize, there was also a discussion about broadening the FCO's regulatory scope towards a general consumer protection agency.

Details

New Merger Control Rules

From an M&A perspective, the most relevant element of the reform is likely the introduction of an additional merger control threshold.

Traditionally, German merger control follows a pure revenue-based approach to determine whether a proposed transaction is reportable for mandatory FCO clearance. Both parties to the transaction must have combined worldwide revenues of more than €500 million; one party to the transaction (*e.g.*, the buyer) must have German revenues of more than €25 million; and another party to the transaction (*e.g.*, the target) must have German revenues of more than €5 million.

Under the new law, these revenue thresholds will remain in place, and if a transaction meets all three of them, it will continue to be reportable already on these grounds. In addition, the new law introduces a transaction value test to still cover transactions that only meet the higher one of the two domestic thresholds, *i.e.*, where the target has less than € 5 million German revenue. These transactions shall now require FCO clearance if:

- The transaction value exceeds € 400 million (to be determined on the basis of the purchase price as agreed as a cash compensation or in another form, including assumed liabilities); and
- The target has "significant" business in Germany, as demonstrated for example by a strong customer base or substantial R&D activities in Germany.

The purpose of this adjustment is to capture transactions that may not (yet) be sizable by revenue standards, but that may nevertheless have a competitive impact, for example, because they concern some innovative start-up business. According to the new law's official reasoning, which explicitly refers to the Facebook/WhatsApp merger in that respect, it is this type of transactions that triggered the introduction of the additional threshold. However, while Facebook's acquisition of WhatsApp did not trigger the existing turnover thresholds in Germany at the time, the acquisition was notified to the European Commission for a full review under Article 4(5) of the EU Merger Regulation (case COMP/M.7217), as the relevant jurisdictional thresholds in at least three other Member States were satisfied. It was then cleared unconditionally in October 2014.

Facilitating Cooperations in the Publishing Sector

The new law introduces a sector-specific exemption for all non-editorial cooperations (for instance, sale of advertisements) among newspaper and magazine publishers from the cartel ban. Unless they are structured as a formal joint venture (and on that basis, trigger a merger control review), such cooperations shall not be subject to further antitrust scrutiny. According to the official reasoning of the new law, in particular small and medium press companies shall benefit from this relaxation by enhancing their potential for synergies and rationalization.

The publishing industry had successfully lobbied for this relief against the background of shrinking advertising and sales revenues in the changing market environment where they are facing increasing competitive pressure from digital media. The new law now therefore potentially allows even hardcore-restrictions (such as price agreements) among publishing houses where they are deemed to be required to preserve the diversity of the press and its ability to compete internationally. During the legislative process, similar exemptions had also been requested in favor of cooperations between public broadcasters and mutual savings banks, but those did not eventually make it into the new law.

With all these sector-specific provisions, however, it must be noted that they can legally only effect the non-application of the cartel ban as provided for in German law, but not a non-application of EU Community-level antitrust law. So wherever a certain sector co-operation has a cross-border dimension to it, it will thus remain subject to full scrutiny under Article 101 of the Treaty on the Functioning of the European Union (TFEU).

Liability and Succession: Closing the "Sausage Gap"

In response to an urgent demand from the FCO, the new law expands the liability for monetary fines in cartel cases. In part, this goes back to a specific case in the German meat industry where the FCO had issued a €130 million fine against a certain corporate entity. As a result of an internal restructuring, the addressee of the fine had then ceased to exist and thereby managed to avoid its liability.

This loophole, commonly referred to as the "sausage gap," will no longer be available. Under the new law, not only the addressee of the fine, but also its legal successor shall be liable for FCO fines and, more generally, the new law establishes a principle of parental liability as it already exists under EU competition law. Accordingly, a parent company can now be held liable for fines that were only imposed on its subsidiary, even where the parent was itself not involved in the competition law infringement or where it did not violate any supervision duties in relation to the subsidiary.

In an M&A context, this will become relevant when it gets to assessing potential liabilities of a target company during due diligence. Specific care should thus be taken where the target in a transaction is (or was) part of a group of companies which had been involved in antitrust infringements. This target might end up being held liable for FCO fines even if it was not itself involved in the infringement or an addressee of the fine. A potential acquirer may want to mitigate such risk by asking the seller for respective indemnities or other safeguards when negotiating the transaction.

Enhanced FCO Tool Box for Assessing Market Power

With a particular focus on dealing with digital businesses, the new law expands the FCO's tool box when it comes to defining markets and assessing market power. These new rules will apply:

- in a *merger control* context when the FCO needs to assess whether a transaction results in a significant impediment to effective competition under the SIEC test; and
- in *investigations of specific business practices* that the FCO might deem to be an abuse of market dominance.

In particular, the new law introduces the following provisions, which to a large extent come as legislative clarifications of practices that the FCO has already developed in more or less established case law over the last few years:

Clarification that it does not require any cash flow between supply and demand side for a "market" to exist. In traditional German case law, a "market" in competition law terms only existed where goods or services were offered for (cash) remuneration. As a consequence, legislative tools for regulating market structures or behaviors did not apply to "free" services. But regulators had already reconsidered this view in recent years, and this is now explicitly reflected in statutory law.

Criteria to determine market power on multi-sided markets. The new law picks up a number of criteria that the FCO's own task force for the digital economy identified as relevant factors to assess an undertaking's role in a given market, namely:

- Direct and indirect network effects;
- Multi-homing (parallel use of services) and users' switching costs;
- Economies of scale in conjunction with network effects;
- Access to competitive data; and
- Innovation-driven competitive pressure.

Again, these concepts are not entirely new, and have at least in part already been applied in recent FCO and court cases.

Overall, these changes will likely not shift the focus of the FCO's merger control and antitrust enforcement, but they may well lower the FCO's threshold for exerting its discretion when launching an investigation into "new" markets or business practices, and help the FCO argue a theory of harm in big data and other "digital" cases. At least indirectly, this may then also have an impact on evaluating the chances to achieve FCO merger control approval for a proposed transaction in these markets.

Implementation of the Cartel Damages Directive (2014/104/EU)

In Europe, participants in anti-competitive conduct increasingly see themselves confronted with so-called follow-on litigation, where customers claim compensation for the overcharge that they paid for cartelized products or services. Where a cartel has been sanctioned by the EU Commission or a Member State competition authority, such claims benefit from the binding effect of the infringement decision. In court, the plaintiff then only has to establish the amount of damages occurred, but not the existence of the cartel as such.

Until now, the legal framework to bring such cartel damages claims varies among EU Member States, with Germany, the Netherlands, and the UK being the preferred venues for plaintiffs. To harmonize these standards, and to encourage damages claims as "private enforcement" of antitrust laws, the EU Commission therefore adopted the Cartel Damages Directive in late 2014. Germany is already late in implementing the Directive into national law (the two-year implementation period lapsed on December 27, 2016), which will now happen as a key element of the new German competition law.

Key changes to the legal framework for bringing cartel damages claims under German law include:

- ***Rebuttable presumption of harm***: It shall be legally assumed that cartel infringements generally lead to damages but the infringer shall have the right to rebut this assumption. The assumption shall apply to the existence of the harm as such and to the causality link with the infringement, but not to the actual amount of damages caused.
- ***Passing-on defense***: The new law specifies the principle of the passing-on defense, and also facilitates it compared to the existing standards as developed in German case law. Accordingly, the defendant in an action for damages can invoke that the claimant passed on the whole or parts of the overcharge to its own customers, but the defendant shall bear the burden of proof to establish the underlying facts for this defense.
- ***Claims from indirect purchasers***: By specify-

ing the passing-on rules, the new law also facilitates claims from indirect purchasers. It introduces a statutory presumption for the benefit of the indirect purchaser that the direct purchaser passed on the overcharge.

- ***Disclosure requirements***: The new law introduces certain tools for both the claimant and the defendant in a cartel damages case to require the respective other party to disclose some of its internal documents and calculations. This disclosure claim can be enforced together with, or separately from, the damages claim, including by way of preliminary injunction.

- ***Statute of limitations***: Under legacy German law, cartel damages claims became time-barred within three years from the end of the calendar year in which the damages claim arose and if the claimant knew (of should have known) about the relevant underlying facts. The new law extends this limitation period from three to five years.

- ***Joint and several liability***: The new law introduces some exemptions from the general principle that the participants in a cartel shall be jointly and severally liable for the full amount of damages caused by the cartel. Going forward, the joint and several liability of small and medium enterprises, as well as recipients of full immunity during the infringement proceedings, shall generally be limited to their own direct or indirect sales.

- ***Settlement effects***: Under existing German law, there is a risk for each cartelist that a settlement with one claimant will still not prevent the other cartelists from bringing contribution claims against the settling defendant. The new law makes settlements binding upon the other cartelists to the extent that the share of damages settled is concerned. This will make individual settlements for cartelists more attractive.

- ***Plaintiffs' exposure to litigation costs***: The "loser pays" principle applies in German civil proceedings, *i.e.*, the plaintiff faces the risk of having to cover the statutory attorneys' fees for all defendants. In cartels with many members, the plaintiff therefore faced a considerable cost risk, which is now being reduced by the new law. The losing plaintiff will only have to pay the statutory attorneys' fees of the actual defendant(s) and one intervenor.

These changes will obviously not have a primary impact on M&A activity. But again, like with the enhanced rules on cartel fines, liability risks from private antitrust enforcement may still become a diligence issue when assessing a proposed transaction.

Outlook

After almost two years of intense discussions in the antitrust community, and at least in part guided by a dedicated EU law framework, the new German competition law generally comes with few surprises; but it still contains a number of paradigm shifts that will have material practical implications going forward.

With regard to merger control, the supplemental transaction value test is less clear than the existing revenue-based filing thresholds. Even where the lower domestic revenue threshold is not met, the parties to a transaction will still have to apply further efforts to determine whether a filing would be required. At least until some further FCO guidance is available on the new criteria, we will likely see more German filings even in smaller cases, just because the merging parties want to mitigate any potential risk of violating filing (and gun-jumping) requirements. Also, it remains to be noted that German merger control does not only apply to transactions that result in a change of control over the target company. As long as the revenue thresholds (or, going forward, the transaction value test) are met, even the acquisition of a minority shareholding in the target company would be reportable to the FCO, provided that the buyer acquires at least 25% of the capital or voting rights or otherwise gains "relevant competitive influence" over the target business.

Beyond merger control, where the new law adopts a number of principles from recent case law with respect to market definitions and assessing dominance, these additions will not have an immediate impact on the business community. Nevertheless, the changes may still pave the way for the FCO to continue, and maybe even intensify, its sometimes-tough approach toward the digital economy. Here, the new framework may help the FCO to come up with a more robust theory of harm and to ultimately defend it in court.

DONE DEAL! NOT SO FAST: STRATEGIES FOR MINIMIZING POST-CLOSING DISPUTES

By Joseph B. Crace, Jr. and Elaina S. Al-Nimri

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The topic of post-closing liability continues to be of interest to businesses active in the ever-changing arena of mergers and acquisitions. Post-closing disputes seem to be increasing and often relate to indemnification for alleged breaches of representations or warranties in a transaction agreement, or for claims or lawsuits brought by third parties after closing and arising out of facts occurring pre-closing. Sometimes these disputes are the result of unforeseeable circumstances that are impossible to avoid. Often, however, these disputes implicate contractual provisions that many businesses and their attorneys regard as "boilerplate," and, therefore, might get little attention during the negotiation of a transaction. Careful consideration of these provisions on the front-end can facilitate resolution of these disputes down the road.

Merger and Anti-Reliance Provisions

Most, if not all, merger and acquisition agreements include contractual language similar to the following:

> This Agreement constitutes the entire understanding and agreement between the parties, and there are no terms, conditions, restrictions, representations, or understandings between the parties not included herein.

Provisions such as these are intended to prevent parties from later bringing claims based on promises or statements outside the four corners of the agreement. Parties and their counsel should be aware, however, that certain courts have found this language, standing alone, insufficient to preclude one party from later bringing claims for breach of contract or fraud based on extra-contractual promises or representations. Courts in both Delaware and New York now expect parties to go beyond this boilerplate language if they want to fully protect themselves from claims relating to representations outside the agreement.

In early 2016, the Delaware Chancery Court held that despite a merger agreement's inclusion of a basic merger clause such as the one discussed above, a buyer could bring a fraud claim based on statements made by the seller before the signing of the agreement.[1] In so holding, the court noted that the agreement lacked an affirmative expression by the buyer as to the specific information it was relying on when it entered into the agreement or a disclaimer that the buyer was not relying on any representations made outside of the merger agreement. The agreement's disclaimer *by the seller* about what it was neither representing nor warranting was not enough to preclude *the buyer*'s reliance on extra-contractual statements. New York courts have similarly held that absent specific anti-reliance language, a merger clause alone will not preclude a fraud claim.[2]

Going forward, parties should keep this distinction in mind when drafting merger or purchase agreements. To avoid a later dispute and potential liability over what was or wasn't said prior to closing a deal, in addition to standard merger clause language, parties—especially sellers—should make every effort to include the following: (1) an affirmative acknowledgment by both parties that no extra-contractual representations were made; and (2) an affirmative disclaimer by both parties—and especially the buyer—of reliance on extra-contractual statements and omissions. An example of such a clause is:

> Buyer agrees and acknowledges that Seller has not made, and Buyer is not relying upon and hereby disclaims, any representations and warranties other than the representations and warranties of Seller that are expressly set forth in this Agreement, and Seller shall not have any liability to Buyer resulting from Buyer's reliance on any such representations or warranties.

While no contractual language can completely foreclose the possibility of a post-closing dispute, these steps should help deter parties from bringing claims for breach of contract or fraudulent inducement based on representations not contained in the parties' written agreement.

Sandbagging Provisions

Another potential issue that periodically arises in post-closing disputes is the issue of "sandbagging," which refers to the practice of one party—typically the buyer—entering into a transaction despite knowing of the potential inaccuracy or breach of a representation or warranty by the other side—typically the seller—and later making a claim for breach of contract, or even fraud based on the purported "misrepresentation."

The easiest way to render sandbagging a non-issue is to negotiate an "anti-sandbagging" clause in the agreement, the purpose of which would be to preclude a buyer from bringing an indemnification claim against the seller based on facts or circumstances of which the buyer had knowledge when it entered into the transaction:

> Buyer has no knowledge of any facts or circumstances that would serve as the basis for a claim by Buyer against Seller based upon a breach of any of the representations and warranties of Seller contained in this Agreement. Buyer shall be deemed to have waived in full any breach of any of Seller's representations and warranties of which Buyer has knowledge at the Closing.

Anti-sandbagging provisions, however, typically meet heavy resistance from buyers at the negotiation stage. More often, buyers will negotiate to include a "pro-sandbagging" provision to preserve their right to bring an indemnification claim in the contract for defects the buyer knew existed before completion of the transaction. An example of such a clause would be:

> The right to indemnification, payment, reimbursement, or other remedy based upon any such representation, warranty, covenant, or obligation will not be affected by any investigation (including any environmental investigation or assessment) conducted or any knowledge acquired at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, such representation, warranty, covenant, or obligation.

But what happens when an agreement is silent on the issue of sandbagging? Both Delaware and New York courts tend to take a buyer-friendly approach. The Delaware Chancery Court has held that a buyer was entitled to indemnification for breaches of the seller's representations and warranties even if the buyer knew of the seller's breach prior to closing.[3] In fact, the court held that the buyer could bring an indemnification claim even if the buyer did not rely on the seller's breach of warranty or misrepresentation.

New York similarly allows sandbagging and will also allow an indemnification claim even where the buyer cannot establish reliance on the alleged misrepresentation. Unlike Delaware, however, New York will take into consideration whether the source of the buyer's knowledge was the seller or another party.[4] If the buyer learned of the breach from the seller (*i.e.*, during discussions leading up to the merger), the buyer will be less likely to be able to sue for indemnification later. However, if the buyer learned about the breach from a third party, its claim for indemnification is more likely to go forward.

We underscore the importance of ensuring that any representations and warranties made in a merger or purchase agreement are accurate to the best of a party's knowledge, regardless of whether or not the other side "is aware" or "should know" of any possible issues. However, because many courts tend to allow sandbagging when the contract is silent about it, sellers in particular should attempt to contractually limit the buyer's right to assert claims in cases where it knew or was on notice of a seller's breach prior to closing. Likewise, if buyers know of a breach prior to signing, they may well be better served by raising the issue and getting a purchase price adjustment versus relying on a cumbersome and often limited recourse indemnification process after closing. Leaving these issues unaddressed or up to the interpretation of a court may not always be in either parties' best interest.

Best Practices

With analysts forecasting a big year for M&A, parties can minimize the possibility for liability in connection with post-closing disputes by following certain best practices:

Be Specific. While conscious ambiguity may have its place on occasion, most often the more specific the terms of an agreement, the less chance of an eventual dispute about what the agreement requires. Sellers should seek to include an appropriate merger clause and anti-reliance language to limit the terms of the agreement to the written contractual language. Buyers may likewise at least try to preserve fraud claims.

Be Transparent and Consistent. Err on the side of full disclosure and if you have disclosed an issue in discussions with the other party, make sure the representations and warranties and disclosure schedules reflect the parties' mutual understanding.

Plan Ahead. Consider whether alternative dispute resolution would be appropriate for any post-closing disputes that do eventually arise, especially if parties do not want sensitive business issues discussed in a public forum.

ENDNOTES:

[1] *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*,131 A.3d 842 (Del. Ch. 2016).

[2] *See e.g., Plaza PH2001 LLC v. Plaza Residential Owners LP*, 79 A.D.3d 587 (N.Y. App. Div. 2010*); Danann Realty Corp. v. Harris*,157 N.E.2d 597 (N.Y. 1959).

[3] *Universal Enter. Grp., L.P. v. Duncan Petroleum Corp.*, 2013 WL 3353743 (Del. Ch. July 1, 2013).

[4] *Galli v. Metz*, 973 F.2d 145 (2d Cir. 1992); *Kriegel v. Donelli*, No. 11 CIV. 9160 ER, 2014 WL 2936000, at *7 (S.D.N.Y. June 30, 2014).

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

By Stephen D. Bohrer and Akio Hoshi

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How times have changed since "Doing Deals in Japan" was first published in 2010![1] Japan still remains in the M&A spotlight, but from a new perspective. In 2010, Japanese companies had an insatiable appetite for purchasing American companies. The premise of the first edition of "Doing Deals in Japan," therefore, was to provide U.S. dealmakers with a basic understanding of Japanese M&A techniques in order to better advise Japanese clients through comparative analysis and to anticipate (and manage) deal "blind spots." While Japanese companies still have a healthy appetite for American companies, there has been a resurgence of the Japanese economy and inbound investment activity. Coupled with this pivot, recent changes to Japanese law have materially impacted Japanese M&A practices making descriptions in the first edition of "Doing Deals in Japan" either incomplete or no longer applicable. "Doing Deals in Japan Revisited" fills this void by providing a comprehensive one-stop update.

The Japanese economy is roaring back. Based on Japanese government reports, between fiscal years 2012 and 2015 real GDP grew from 520 to 529 trillion yen (ranking Japan as the third-largest economy in the world), annual corporate ordinary profits increased by 20 trillion yen, and unemployment declined from 4.3% to 3.4%. Inbound investment activity also experienced a similar strong growth trend. The net amount of inward forward direct investment in 2015 reached a record annual high of 24.5 trillion yen and Prime Minister Abe announced that he would use all his political power to increase foreign direct investment even further to 35 trillion yen by 2020. Needless to say, international investors are taking notice. Since January 2011 the Nikkei 225 has approximately doubled in value, and a 2015 UNCTAD report on world investment ranked Japan as the 13th most attractive destination for multinational companies over the 2015-2017 period. The United States continues to remain the single largest net investor into Japan, and there are no signs that this trend will end. With the wind blowing toward inbound investment (especially from the United States), a U.S. practitioner's basic understanding of Japanese M&A techniques is now more useful than ever.

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.

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, 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.

There are fundamental differences between the

U.S. and Japanese corporate governance models. 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] The Companies Act of Japan ("Japan Companies Act"), however, does not necessarily require a board of directors-centered supervisory structure. The Japan Companies Act allocates a portion of the supervisory function to the company's shareholders and statutory auditor (*kansa-yaku*).[3] Consequently, 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 typically absent in Japan. This difference in supervisory approach has influenced how the rights and responsibilities of directors and shareholders are apportioned under the Japan 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 Japan 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, select the company's accounting firm, petition a court to dissolve the company, and establish the upper limit of the aggregate amount of compensation to be awarded to all directors.[4] 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).[5] Shareholders of Japanese companies, therefore, typically have vaster and deeper voting rights than shareholders in Delaware corporations.

Board of Directors

Weak director independence, limitations on who is capable of lawfully binding a company, and the absence of functioning board committees are the principal corporate governance differences when comparing U.S. and Japanese boards of directors.

Weak director independence. 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, most board members of Japanese public and private companies concurrently serve as senior executives of the company. To address the lack of director independence at the public company board level, over the past few years the Japanese government has overhauled the director independence requirements under the Japan Companies Act and the Tokyo Stock Exchange has amended its listing maintenance rules as part of efforts to strengthen Japan's corporate governance under economic reforms sponsored by the Abe administration. As a result, Japan now has complicated and multi-layered requirements for director independence that apply (and sometimes overlap) depending on such factors as the size of the company, whether the company is a reporting company, and whether the company's shares trade on a major stock exchange. While detailing the complexities of these various independence requirements is beyond the scope of this article, the introduction of the new director independence requirements has made little difference on board composition—while relatively more "independent directors" now serve on Japanese boards than in 2010, Japanese boards still remain dominated by company management.[6]

A continued lack of board independence is not limited to outlier Japanese companies. A report published by the Tokyo Stock Exchange on July 27, 2016, revealed that of the companies listed on the Tokyo Stock Exchange Section 1 (the premier stock exchange in Japan, reserved for the largest and most profitable companies), 97.1% had at least one independent director (up from 31.5% in 2010) and 79.7% had at least two independent directors (up from 12.9% in 2010). However, in 2016 (i) the average size of the boards of directors for companies listed on the Tokyo Stock Exchange Section 1 was 9.29 persons, and (ii) only 4.6% of all Tokyo Stock Exchange Section 1 listed companies had a board comprised of 50% or more independent directors. With independent directors having unmistakable minority representation on the boards of practically all of Japan's most prestigious and noteworthy companies, a conducive environment does not exist for Japanese boards to impartially check and monitor the activities of senior management.

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. 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 would 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*), and unless a special delegation has been made to such persons, then they ordinarily will not have the authority to enter into contracts on behalf of the company.[7] 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).

Absence of functioning board committees. Unlike Delaware corporate law, the Japan 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. The establishment of a special committee to negotiate with a purchaser in the M&A context is also currently uncommon in Japan. However, Japanese companies since the mid-2000s have with greater frequency established special committees to review the terms and conditions of a management buyout or to decide whether to implement anti-takeover defensive measures (primarily due to the recommendations made in reports published by study groups established by Japan's Ministry of Economy, Trade and Industry). Since these special committees do not have binding authority and typically cannot engage their own advisors, they are frequently viewed as simply an advisory committee to the board of directors.

M&A Acquisition Methods

While Japanese acquisition techniques vary depending on whether the target is publicly-traded 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. 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.[8] The concept of shares with a par value no longer exists under the Japan Companies Act.

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, the choice of either a stock acquisition or a merger is the common acquisition method 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.

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 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.

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. 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.[9]

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 requirements below are satisfied:[10]

Requirements	**Qualified Merger, Corporate Split, Share Exchange, Share Transfer or Contribution-in-Kind**		
	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		
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)*	
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 shareholders who are expected after the transaction to hold shares of purchaser (or the shares of its parent if used as the consideration) must, before the transaction, hold at least 80% of target's shares unless target has 50 or more shareholders ● 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.

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 company 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 acquiror'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.

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.

Tender offer regulations. U.S. and Japanese tender offer regulations are closely aligned.[11] Nonetheless, principal differences exist. For example, generally speaking, Japanese tender offer rules are automatically triggered when a purchaser increases its beneficial ownership[12] 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.[13]

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.[14]

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.[15] 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 to be purchased, shorten the tender offer period, decrease the minimum number of shares to be purchased, 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 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.

Defensive measures. While unsolicited transactions are becoming more prevalent in Japan, the number of hostile acquisitions of Japanese companies pales in comparison to the United States.[16] Nonetheless, the May 2016 issue of *MARR* reports that as of March 31, 2016, 475 publicly-traded Japanese companies have adopted anti-takeover mechanisms (approximately 75 fewer companies than as of May 31, 2010), principally in the form of publishing notices that detail (1) the procedures that a purchaser should follow in order for the board (or shareholders) to consider an acquisition proposal, and (2) the potential defensive measures the company may take. This practice is called "advance warning" (*jizen keikoku*).[17] The use of U.S.-style "poison pills" in Japan remains rare.[18]

A series of cases decided in 2005 promoted the use of "advance warning" by Japanese publicly-traded 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 acquiror is an "abusive acquiror," then the court should award injunctive relief to stop the target from effecting anti-takeover mechanisms.[19] 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 sufficient time to decide whether the hostile purchaser or the current directors should manage the target.[20] 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.

Staggered boards 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 Japan 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).

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:[21]

- 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 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 a common source of information and a focal point of the due diligence exercise.

- 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 realistic 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 infrequent. The use of representation and warranty insurance is virtually non-existent, but this hedge could gain traction as Japanese deal-makers become familiar with this policy in cross-border M&A transactions. 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) carve-outs from the baskets and caps for certain representations and warranties and breaches of covenants, (2) double materiality scraps, (3) pro-"sandbagging" clauses, (4) a tax gross-up for indemnification payments (or claim off-sets for tax benefits resulting from the indemnification claim or insurance proceeds received), or (5) 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 company 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.

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.[22] 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 (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 shall 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

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. As discussed above, however, a cash-out merger would cause the target to incur a capital gains tax on its assets and goodwill. In order to avoid unnecessary tax leakage at the target level, the current common method for an acquiror to squeeze out minority shareholders is to use procedures that are afforded to a super-majority controlling shareholder.[23]

Super-majority shareholder squeeze-out. A cash squeeze out of the minority shareholders by a super-majority controlling shareholder has been available to acquirors only since 2015, and can be effected according to the following scheme:

- Once an acquiror 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 company not owned by the Special Controlling Shareholder, other than any treasury shares held by the target company. The basic features of the conditional call option include: (i) it is created immediately upon an acquiror 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 company (and is not with respect to only 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 company's articles of incorporation) of the total voting rights in the target company, either alone or together with its wholly-owned subsidiary.

- To exercise the conditional call option, the Special Controlling Shareholder must (i) notify the target company's board of directors in writing of its intention to exercise the conditional call option and provide the relevant details concerning the conditional call option 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 company 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 company'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 company'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.

It is a frequent Japanese practice in friendly transactions for an acquiror to enter into a take-private acquisition agreement with the target company 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 super-majority shareholder squeeze-out could ever be fixed at an amount less than the first-step tender offer price as 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 a recent Japan Supreme Court holding discussed below, transaction parties also can minimize the risk that an acquiror would need to pay the minority shareholders a price greater than the first-step tender offer price.

Remedies. Prior to amendments to the Japan Companies Act in 2014, exercising appraisal rights was essentially the sole remedy available to dissenting minority shareholders. However, in a super-majority shareholder squeeze-out process, minority shareholders who object to a decision by the target company'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 company's directors arising from its improper approval of the exercise of the call option.[24]

Since the *Rex Holdings'* case, the judiciary's determination of "fair value" in appraisal proceedings has been one of the most widely debated topics in the Japan M&A scene given its vagaries and potential incentives to encourage appraisal proceedings by wily dissenting shareholders.[25] In the recent *Jupiter Telecommunications* appraisal proceeding, Japan's Supreme Court issued an opinion that will likely discourage appraisal arbitrage in Japan. In this case, Japan's 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 judiciary, in principle, should approve that same price as the fair value for the cashed-out minority shares.[26] The Supreme Court's holding marked a dramatic change in court precedents (including its own verdict in the *Rex Holdings'* case and its progeny), 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 most likely will dissuade 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).[27]

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 (1) the employee committed a severe breach of the company's work rules or other rules relating to employment, (2) the employee lacks competence or the necessary business skills, or (3) the survival of the subject company's business requires that headcount be reduced.[28] 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."[29] 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 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.[30]

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.[31] 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 minimis*), 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:

- 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 245 Americans there is one lawyer, while in Japan there is one lawyer for every 3,257 Japanese.[32] 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.

- Commercial parties may view Japanese judges with skepticism (jury trials do not exist in civil trials in Japan) because (1) most judges turn to this profession 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, 2016, the Japan Commercial Arbitration Association (the Japanese counterpart of the American Arbitration Association) handled only 47 arbitration cases (21 new cases and 26 cases carried forward), and no mediation cases.

Conclusion

Many Japanese companies have a reputation of priding themselves on their native business practices and scorning 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. The convergence of increased local competition arising from greater foreign direct investment and the world spotlight turning to Japan in light of the 2020 Summer Olympics in Tokyo could provide the requisite spark for Japanese businesses to discard outdated practices and implement deep changes. Should this occur and 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]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.

[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 approximately 40 permissible corporate governance structures available under the Japan Companies Act. In practice, however, an overwhelming majority of Japanese companies have adopted a single corporate governance form of a *kabushiki kaisha* (the practical equivalent of a corporation in the United States) that has a board of direc-

tors and statutory auditors. 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. For ease of comprehension, in this article we focus on the predominant Japanese corporate governance structure of a *kabushiki kaisha* with a board of directors and statutory auditors.

[4]Unlike the "Say-on-Pay" votes in the United States, shareholder resolutions on executive compensation in Japan are legally binding. Normally, the board of directors decides how to allocate compensation among directors within the aggregate amount approved by shareholders. It is well known that executives at Japanese companies are paid much less than their U.S. counterparts, and performance-based compensation normally constitutes only a small portion of their compensation packages. A scholarly work suggests a link between governance structure and the levels and forms of executive compensation. *See* Robert J. Jackson & Curtis J. Milhaupt, *Corporate Governance and Executive Compensation: Evidence from Japan*, 2014 Colum. Bus. L. Rev. 111.

[5]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 Japan Companies Act.

[6]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 (with conflict of interest not precisely defined, but left to be determined subjectively on a case-by-case basis). 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 ten 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.

[7]In the case of a *kabushiki kaisha* that has a board of directors and three statutory committees (*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). As of August 1, 2016, only approximately sixty listed companies had adopted this corporate governance structure in Japan.

[8]Under the Japan 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.

[9]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). 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.

[10]A corporate split (*kaisha bunkatsu*), share ex-

change (*kabushiki kōkan*), and share transfer (*kabushiki-iten*) are forms of business combinations prescribed under the Japan 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.

[11]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.

[12]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).

[13]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.

[14]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 ten-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.

[15]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 company pays dividends after the commencement of the tender offer, (b) the target company's disclosure documents include false statements or material omissions, or (c) a material contract of the target company 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.

[16]According to the Thomson One database, during the period from January 1, 2005 through February 28, 2017, there were only 15 hostile offers in Japan, none of which resulted in the hostile offeror succeeding in gaining a majority ownership in the voting rights of the target.

[17]According to the data provided in the May 2016 issue of *MARR*, 472 Japanese companies have adopted "advance warning" procedures as of March 31, 2016.

[18]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 widely known in Japan as the only case where a poison pill, which was adopted by the target after the purchaser had commenced its hostile takeover bid, was intentionally triggered. One may think that, in light of the *Bull-dog Sauce* case, Japanese corporate law would allow the target to adopt a poison pill after the emergence of a hostile purchaser. 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."

[19]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).

[20]*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).

[21]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.

[22]We note that in the cross-border context, Japanese courts may respect an integration clause if the parties knew or should reasonably have 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, and therefore, 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).

[23]Prior to the introduction of super-majority shareholder squeeze-out, virtually all recent cash-out transactions were made using the "shares subject to call" (*zenbu-shutoku-jōkōtsuki-syurui-kabushiki*) squeeze out method. However, the use of the super-majority shareholder squeeze-out is becoming the preferred choice of squeeze-out technique by acquirors, with acquirors utilizing this technique over target companies listed on the Tokyo Stock Exchange in approximately 30 transactions since July 2015. For details of the shares subject to call squeeze out method, *see* Bohrer & Hoshi, *supra* note 1, at 20-21.

[24]Japan's business community has widely shared the view that directors owe fiduciary duties towards the company's stakeholders as a whole, including the company's employees, and not solely to the company's shareholders (a fiduciary duty approach similar to a "benefit corporation" in the United States, though not directly formalized under the Japan Companies Act). However, the Tokyo High Court recently held, in dictum, that the fiduciary duties of directors include ensuring that the company's public shareholders receive fair consideration in connection with a management buyout transaction. *See* Tōkyō Chihō Saibansho [Tokyo High Ct.] April 17, 2013, Hei 23 (ne) no. 2230, 2190 Hanrei Jihō [Hanji] 96 (Japan). Many commentators in Japan cite this pivotal case as a new

view that directors owe fiduciary duties directly to the company's shareholders. Japanese fiduciary duty analysis is currently in a state of flux pending guidance from Japan's Supreme Court.

[25]*See* SAIKŌ SAIBANSHO [Sup. Ct.] May 29, 2009, Hei 20 (ku) no. 1037 & Hei 20 (kyo) no. 48, 1326 KIN'YŪ SHOJI HANREI [KINHAN] 35 (Japan). In the *Rex Holdings'* case, the Supreme Court dismissed the target company's appeal from the Tokyo High Court's decision, which awarded dissenting shareholders in a management buyout transaction an amount approximately 1.5 times higher than the first-step tender offer price. Justice Tahara stated in his concurring opinion that the "fair value" owed to the dissenting shareholders should be equal to the target's share price but for the transaction (the "objective share value" for the subject securities), plus a "premium" (which is offered as compensation to the departing shareholders for the value that is expected to be created by the management buyout transaction). Justice Tahara's concept of "fair value" has been utilized by numerous Japanese lower courts in appraisal cases, but vastly different economic inputs have been considered by these courts to reach "fair value," leading to great outcome uncertainty and legal debate. For example, (i) to establish "objective share value," lower courts have examined the average market price of the target company's securities anywhere from one month to one year preceding the announcement of the takeover transaction and some courts have even made an upward adjustment to the average market price of the target company's securities in order to reflect the rapid increase of share prices in Japan between the announcement of the transaction and the effective date of the squeeze-out transaction, which took place after the introduction of *Abenomics,* by way of a regression analysis between the prices of the target company's securities and those of a share index, and (ii) to fix the "premium" amount, lower courts have applied a percentage ranging from 20% to 43% or a half of the difference between the DCF valuation made by a third party appraiser and the "objective share value." Furthermore, some courts, in order to reach a conclusion that the tender offer price was equal to the "fair value," held that the premium was equal to the difference between the tender offer price and the "objective share value."

[26] *See* SAIKŌ SAIBANSHO [Sup. Ct.] July 1, 2016, Hei 28 (kyo) no. 4 to 20, 1497 KIN'YŪ SHŌJI HANREI [KINHAN] 8 (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.

[27]The Japan Companies Act was amended in 2014 to permit a target company to make a tentative payment to dissenting shareholders for an amount the target company considers to be fair. By paying this amount (which often will equal the price paid in the first step tender offer), Japan's statutory 6% 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.

[28]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.

[29]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).

[30]In 2012, Japan's Labor Contracts Act was amended to provide a new Article 18 that also requires employers to provide a fixed-term contract employee with employment for an indefinite term not subject to automatic termination at the end of the contract term upon the request of the employee if 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.

[31]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 Kōtō Saibansho [Tokyo High Ct.] August 28, 2007, Hei 19 (yo) no. 20047, 1272 Hanrei Taimuzu [Hanta] 282 (Japan).

[32]As of December 31, 2015, the United States had 322,060,152 inhabitants (according to the survey of the U.S. Census Bureau) and 1,315,561 lawyers as of December 31, 2015 (based on data published by the American Bar Association). As of January 1, 2017, Japan had 126,860,000 inhabitants (according to the survey of the Statistics Bureau of Japan's Ministry of Internal Affairs and Communications) and 38,954 lawyers as of January 1, 2017 (based on data published by the Japan Federation of Bar Associations and excluding judges and public prosecutors).

FROM THE EDITOR

International Shakeups, Domestic Ambitions

So far in 2017, hopes among dealmakers of a burst in M&A deal activity show signs of coming true, at least in the short term. According to Thomson Reuters, roughly $771.3 billion in new deals, representing 10,229 transactions, was announced in the first quarter. That's an 11% increase from the year-over-year quarter, in terms of dollar volume.

At a mergers conference held at Tulane University in late March, there were heady predictions of huge-ticket deals. Most notably Kurt Simon, global chairman for mergers and acquisitions at JPMorgan, predicted we could see a record all-cash takeover bid of $100 billion. The rationale is that the U.S. economy and stock market is in good shape, interest rates are still at historical lows, and the Trump Administration won't present many antitrust obstacles.

That said, there are plenty of counter-currents, particularly from overseas. Rising protectionism could spoil many potential cross-border deals, particularly from China. And as our lead article shows, complications arising from the UK's upcoming departure from the European Union are just starting.

As Norton Rose Fulbright's Jay Modrall writes, "Brexit is likely to have significant consequences for businesses engaged in acquisitions or joint ventures triggering antitrust review in Europe." For one thing, Brexit means that many deals may have to be registered both in the UK and the EU. "Thus, Brexit will likely lead immediately to more UK merger notifications, a significant increase in the UK Competition and Markets Authority's workload, and increased burdens for companies," he writes. If there are duplicate filings needed in Brussels and London, "both authorities will often need to examine the same European markets in parallel, both authorities employ front-loaded, information-heavy regimes and any required remedies may overlap or even conflict," as Modrall notes.

This issue also includes a major revision to "Doing Deals in Japan," a popular feature that first ran in our October 2010 issue—a guide to the complex Japanese M&A market by Stephen Bohrer and Akio Hoshi. Where in 2010, Japanese companies had a healthy appetite for American targets, now "there has been a resurgence of the Japanese economy and inbound investment activity. Coupled with this pivot, recent changes to Japanese law have materially impacted Japanese M&A practices, making descriptions in the first edition of "Doing Deals in Japan" either incomplete or no longer applicable," the authors write. No fear: the guide is now up-to-date, greatly in-depth and well worth a read.

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